THE GOOD, THE BAD AND THE REALITY: WHY THE NEW PROXY ACCESS RULES BENEFIT LAWMAKERS, HARM SMALL BUSINESSES, BUT END UP A WASH

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I. INTRODUCTION

The internal affairs of a corporation are regulated at both the state and federal levels.[1] Traditionally, state law has taken an enabling approach, allowing for individuality and choice as to how the internal affairs of a corporation will be run.[2] In contrast, mandatory corporate law at the federal level compels a more universal approach to regulation thereby reducing private shareholder choice in a corporation's internal affairs.[3] On August 25, 2010, the U.S. Securities and Exchange Commission ("SEC") adopted two rule changes affecting proxy access.[4] As a result, shareholders in publicly traded companies will gain the right to nominate candidates for corporate boards and have their candidates included in proxy materials mailed out by the company, at the company's expense.[5] The SEC majority sees the measures as adding enhanced board accountability and responsiveness.[6]

The SEC's approval follows the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*,[7] which provided the SEC with the authority to make rules addressing shareholder access to proxy

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[1] *See generally* Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations (Aug. 25, 2010).

[2] *Id.*

[3] *Id.*

[4] Press Release, U.S. Sec. & Exch. Comm'n, 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.

[5] *See generally* Facilitating Shareholder Director Nominations Rule, Securities Act Release No. 33-9136; Exchange Act Release No. 34-62764 (August 25, 2010) (to be codified at 17 CFR pts. 200, 232, 240 & 249, currently on hold).

[6] David Page, *Distilling the Debate on Proxy Access*, 1 HARV. BUS. L. REV. ONLINE 15 (2010), http://www.hblr.org/2010/11/distilling-the-debate-on-proxy-access/.

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376 (2010).

materials.[8] Proxy access is viewed as an avenue for dramatically lowering costs of an election, and both proponents and opponents predict a significant impact.[9] Under the new rules, applicable shareholders may have their nominees included in the company proxy materials sent to all shareholders.[10] Furthermore, shareholders may establish procedures for including shareholder director nominations in the proxy materials.[11]

There is significant disagreement as to the effect of this proxy access and whether it is desirable or not. Supporters contend that proxy access will make board elections more competitive and less of a rubber stamp for the board's nominees.[12] In turn, boards should be more responsive to shareholders and increasingly vigilant in performing their oversight duties to avoid potential election defeats.[13] Supporters also argue that since board oversight lapses played a significant role in the recent financial crisis, the time is ripe for governance reforms that increase board accountability.[14] While grateful the SEC passed rules making it easier for shareholders to submit 14a-8 proposals, these supporters further believe the benefits of the new rules should apply to small-cap companies as well.[15]

Proxy access opponents have a number of compelling arguments against the new rules. These dissenters feel the SEC has gone too far in potentially burdening smaller issuers, and should consider amending Rule 14a-11 while the smaller issuers are currently exempt.[16] Experts and commentators in line with this rational also see several legitimate reasons shareholders may not prefer a regime of ready access to nominate directors.[17] They see the new rules as dissuading companies from going public and listing on U.S. exchanges.[18] Even if the nominees do not win their election, opponents argue their presence on the ballot will force companies to become overly focused on politically charged issues to the

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[8] U.S. Sec. & Exch. Comm'n, *supra* note 4.
[9] Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access* 2 (U. Pa., Inst. for Law & Econ., Research Paper No. 10-26; N.Y.U. Law and Econ., Research Paper No. 10-51) (2010), *available at* http://ssrn.com/ abstract=1695682.
[10] Facilitating Shareholder Director Nominations Rule, *supra* note 5.
[11] *Id.*
[12] *Proxy Access,* THE COUNCIL OF INST. INVESTORS, http://www.cii.org/resourcesKeyGovernanceIssuesProxyAccess (last visited Mar. 27, 2011).
[13] Page, *supra* note 6.
[14] *Id.*
[15] *See* Andrew Shapiro, *SEC Passes Minimalist Proxy Access Rule: Small Company Governance Left* Behind, SEEKING ALPHA BLOG (Aug. 26, 2010), http://seekingalpha.com/article/222380-sec-passes-minimalist-proxy-access-rule-small-company-governance-left-behind.
[16] *See* Paredes, *supra* note 1.
[17] *Id.*
[18] *Id.*

detriment of creating shareholder value and competiveness in the long run.[19]

The most captivating argument may be that the rule changes will impact shareholder nominations on a much lesser scale than predicted by conventional wisdom. Marcel Kahan, from New York University Law School and Edward Rock of the University of Pennsylvania Law School, have closely followed the goverence questions surrounding the new proxy access rules. Kahan and Rock believe proxy access will lead to few shareholder nominations, most will inevitably be defeated, and the infrequent nominees who are elected will have a marginal impact.[20] Further, the effects will result in an increase in company expenses without a comparative increase in shareholder leverage.[21] These arguments are persuasive, particularly for large, widely held firms. Shareholders who engage in activism already have a number of devices at their disposal such as sponsoring shareholder resolutions, campaigning for withhold votes, running a traditional proxy contest, or asking a company to place certain person on the board.[22] Kahan and Rock believe that one additional option for activism may make little difference.[23]

It is also possible that while promising some advantages, proxy access involves significant disadvantages when compared to traditional proxy contests. Considering that cost savings may be overstated, the limitations are significant: the company retains control over the proxy card and preliminary voting information; shareholders can propose fewer nominees; and the dissident shareholders and their nominees are vulnerable to attacks by the company.[24] Many entities with an interest in shareholder activism, hedge funds and union-affiliated funds, will usually not even satisfy the ownership and holding period requirements to participate.[25] While certain public funds will use the new access to include nominees to unruly boards, the limitations involved are substantial considering the overstated costs savings. Overall, and in particular because small reporting entities are currently exempt,[26] proxy access may be little more than a talking point for lawmakers.

The SEC has placed a stay on the new rules because it did not want to force companies into potential costly compliance measures while the rules

[19] Page, *supra* note 6.
[20] Kahan & Rock, *supra* note 9, at 2.
[21] *Id.*
[22] Page, *supra* note 6.
[23] Kahan & Rock, *supra* note 9, at 6, 28.
[24] *Id.* at 2.
[25] *Id.*
[26] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 24.

face litigation.[27] However, the SEC has not wavered from its decision. The agency has promised the rules will take effect eventually, projecting the litigation will be resolved in the spring.[28] These rules, and the SEC's decision to delay implementation pending the challenge, have fueled vigorous debate on the merits of proxy access and the details of its implementation.[29] Businesses that will have to deal with proxy access must prepare for changes that seem inevitable.

II. THE HISTORY OF PROXY VOTING

Regulation of the proxy process was one of the original responsibilities that Congress assigned to the Commission as part of its core functions in 1934.[30] The earliest attempt to give shareholders use of company proxy materials to solicit shareholder votes for a nominee was in 1942.[31] Then in 1977, the SEC again sought comments on whether it was appropriate for shareholders to have this right. But again, the proposals were not adopted.[32] The proxy access conversation began with new intrigue in 2003, when the SEC again solicited comments for a proposal for proxy access.[33]

Under the proposal, shareholder access would be for two years following a triggering event—either a thirty-five percent or more "withhold" vote in a director election, or a majority vote by shareholders electing to make the company subject to proxy access.[34] Only shareholders who held at least five percent of the company stock for at least two years could make a nomination.[35] Moreover, these nominations could only relate to a minority of the board seats.[36] Republican Chairman Donaldson sided with two Democratic commissioners at the time in support of the rules.[37]

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[27] *See* Order Granting Stay, Securities Act of 1933 Release No. 9149, Security Exch. Act Release No. 63031, Investment Company Act Release No. 29456, File No. S7-10-09, at 1 (Oct. 4, 2010).
[28] *Id.* The SEC has sought expedited review of the challenge.
[29] *See generally* Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 24.
[30] *Id.* at 9.
[31] *Id.* at 21.
[32] Kahan & Rock, *supra* note 9, at 7; *see also* Sec. & Exch. Comm'n, Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors 3 (July 15, 2003), *available at* http://www.sec.gov/ news/studies/proxyrpt.htm.
[33] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 47.
[34] *Id.* at 46–47.
[35] Kahan & Rock, *supra* note 9, at 7.
[36] *Id.*
[37] *See* Jonathan Peterson, *SEC Offers Conflicting Shareholder Proposals*, L.A. TIMES, July 26, 2007, http://articles.latimes.com/2007/jul/26/business/fi-boards26 ("Chairman Donaldson and the SEC's Democratic commissioners supported the SEC's 2003 proposal.").

After strong opposition from the Business Roundtable and the Chamber of Commerce,[38] Donaldson ended a push for adoption of the rules when he resigned in 2005.[39]

Following this defeat, proponents of proxy access went to the courts. In 2005, the American Federation of State, County and Municipal Employees ("AFSCME") sued AIG for omitting its proposal to implement a proxy access regime.[40] Following the SEC's position that it could, AIG omitted the proposal under Rule 14a-8(i)(8),[41] and AFSCME sued. The Court of Appeals for the Second Circuit ruled the proposal could not be excluded. In its opinion, the court criticized the SEC for changing its rules without providing a rationale.[42] The ruling by the Court of Appeals suggested the SEC had to do something to clarify the law and remedy the criticisms noted of the court.

In July 2007, the SEC released comment for two proposals.[43] The first resembled the 2003 proposal. The second would remedy the shortcomings criticized by the court, and provide a basis for a shareholder proposal to implement proxy access for a single company to be excluded under Rule 14a-8.[44] Each proposal was supported by three of the five commissioners, albeit with party line splits—the first by the two Democratic commissioners and Chairman Cox, the second by Cox and the two Republican commissioners.[45] The second proposal was adopted by a party line vote of 3 to 1 in November 2007.[46]

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[38] *See* Bill Baue, *Opening Up Pandora's Box: SEC Proxy Roundtable Questions Role of Non-binding Resolutions*, SOCIAL FUNDS (May 15, 2007), http://www.socialfunds.com/news/article.cgi/2293.html ("The SEC allowed the rule it proposed in October 2003, allowing shareowners proxy access to nominate directors in certain circumstance, to die on the vine due to opposition by the Business Roundtable and the US Chamber of Commerce, which threatened a lawsuit.").

[39] Stephen Labaton, *Donaldson Announces Resignation as S.E.C. Chairman*, N.Y. TIMES, June 1, 2005, http://www.nytimes.com/2005/06/01/business/01wiresec.html?ex=1275278400&en=d89d9d8be5440394&ei=5090&partner=rssuserland&emc=rs.

[40] Am. Fed. of State, Cnty, Mun. Emp. v. Am. Ins. Grp., Inc., 462 F.3d 121, 123–24 (2d Cir. 2006).

[41] *Id.* at 124.

[42] *Id.* at 129.

[43] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 9.

[44] Kahan & Rock, *supra* note 9, at 9.

[45] *See* Nicholas Rummell, *SEC Splits Proxy Access Votes as Cox Says 'Yea' to Two Proposals*, FIN. WK., July 25, 2007, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070725/REG/70725013/1036.

[46] Kahan & Rock, *supra* note 9, at 7.

Following the election of Barack Obama, Mary Schapiro, a Democrat, replaced Chairman Cox. Democrats now held three of the five seats on the Commission.[47] At its open meeting on May 20, 2009, the SEC, by a three to two vote, proposed rules intended to provide stockholders with greater access to corporate proxies and exercise their state law rights to nominate and elect directors.[48] Since then, the SEC has received and reviewed more than six hundred public comments about its proposal.[49] The SEC delayed action until Congress, as part of the financial reform bill, granted the disputed authority to the SEC.[50] Congress' reform laws explicitly granted the SEC with authority to adopt rules that require companies to include shareholder board nominees in company proxy materials.

III. NEW PROXY ACCESS RULE: 14A-11

New Rule 14a-11 will, under certain circumstances, allow stockholders to include director nominees in the company's proxy materials.[51] This is the "stockholder proxy access" rule. Rule 14a-11 will apply to all reporting companies subject to the Securities Exchange Act of 1934 proxy rules, subject to a few exceptions.[52] Rule 14a-11 will apply only when applicable state or foreign law or a company's governing documents do not prohibit shareholders from nominating a specific candidate for election as a director.[53] Rule 14a-11 will not apply to companies subject to the proxy rules solely because they have a class of debt securities registered under Section 12 of the Exchange Act.[54] Moreover, companies are not able to

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[47] *Current SEC Commissioners*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/commissioner.shtml (last visited Mar. 27, 2011).

[48] U.S. Sec. & Exch. Comm'n, *supra* note 4. Statement of Chairman Mary L. Schapiro:

> As a matter of fairness and accountability, long-term significant shareholders should have a means of nominating candidates to the boards of the companies that they own ... Nominating a director candidate is not the same as electing a candidate to the board. I have great faith in the collective wisdom of shareholders to determine which competing candidates will best fulfill the responsibilities of serving as a director. The critical point is that shareholders have the ability to make this choice.

Id.

[49] *Id.*

[50] Jeff Morgan, *SEC Proxy Access Vote Delayed Until Early 2010*, NAT'L INVESTOR REL. INST. (Oct. 6, 2009), http://www.niri.org/Main-Menu-Category/advocate/Presidents-Note/SEC-Proxy-Access-Vote-Delayed-Until-Early-2010.aspx.

[51] Facilitating Shareholder Director Nominations Rule, *supra* note 5.

[52] *Id.* at 264.

[53] U.S. Sec. & Exch. Comm'n, *supra* note 4.

[54] *Id.*

"opt out" of the rule in favor of a different framework for including shareholder director nominees in company proxy materials.[55] Therefore, the rule will apply regardless of whether any specified event has occurred to trigger it and regardless of whether the company is subject to a concurrent proxy contest.[56]

The SEC's new Rule 14a-11 allows a stockholder or group of stockholders to include their proposed nominees for up to twenty-five percent of the board in the company's proxy statement and on the company's proxy card.[57] Any previously elected dissident nominee who remains on the board counts towards this maximum.[58] State law or a company's governing documents may adopt provisions providing for even greater proxy access, but proposed Rule 14a-11 will, in the SEC's view, preempt any state law or company governing document that establishes more restrictive proxy access provisions.[59] Under the rules, shareholders will be eligible to have their nominees included in the proxy materials if they own at least three percent of the company's shares continuously for at least the prior three years.[60] Shareholders can pool shares together to form a group satisfying the threshold, but the three percent requirement must be satisfied by the date the nomination is made.[61] Shareholders must submit nominees no later than 120 days before the anniversary date of the mailing of the company's proxy statement in the prior year.[62] Rule 14a-11 will also apply to smaller reporting companies, but on a delayed basis.[63]

A. *Nominee Requirements*

The nominee's candidacy or, if elected, board membership must not violate applicable laws and regulations. The nominee must satisfy objective independence standards of the applicable national securities exchange or national securities association.[64] Neither the nominating shareholder nor the nominee may have a direct or indirect agreement with the company

[55] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 41.
[56] *Id.* at 265.
[57] 17 C.F.R. § 240.14a-11(d) (2010).
[58] 17 C.F.R. § 240.14a-11(d)(2).
[59] Facilitating Shareholder Director Nominations Rule, 17 C.F.R. pts. 200, 232, 240 & 149 (2010).
[60] 17 C.F.R. § 240.14a-11(b)(2).
[61] *Id.*
[62] 17 C.F.R. § 240.14a-11(b)(10).
[63] *Id.* The delayed basis will be three years. *Id.*
[64] U.S. Sec. & Exch. Comm'n, *supra* note 4.

regarding the nomination of the nominee.[65] There will be no restrictions on the relationship between the nominating shareholder and the nominee.[66]

The nominating shareholder will be required to file with the SEC and submit to the company a new Schedule 14N, which would be publicly available on EDGAR, the SEC's electronic filing system.[67] The Schedule 14N will require, among other things: disclosure of the amount and percentage of the voting power of the securities owned by the nominating shareholder, the length of ownership and a statement that the nominating shareholder intends to continue to hold the securities through the date of the meeting.[68]

The disclosure provided in the Schedule 14N will identify the nominee or nominees, include biographical information about the nominee(s), and include a description of the nature and extent of the relationships between the nominating shareholder and nominee(s) and the company.[69] In addition, the Schedule 14N will require several certifications relating to eligibility and the accuracy of the information provided.[70] A nominating shareholder can also include a statement of support for its nominee in the Schedule 14N.[71] The company will include in its proxy materials disclosure concerning the nominating shareholder, as well as the shareholder nominee or nominees, that is similar to the disclosure currently required in a contested election.[72]

B. *Companies Subject to the Rule*

1. *Generally*

New Rule 14a-11 will apply to companies that are subject to the Exchange Act proxy rules,[73] including investment companies registered under § 8 of the Investment Company Act of 1940.[74] The rule also will apply to controlled companies and those companies that choose to voluntarily register a class of securities under § 12(g).[75] Smaller reporting

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[65] *Id.*
[66] Facilitating Shareholder Director Nominations Rule, *supra* note 5.
[67] *Id.*
[68] U.S. Sec. & Exch. Comm'n, *supra* note 4.
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 24.
[74] 15 U.S.C. § 80a-3 (2006). Registered investment companies currently must comply with the proxy rules under the Exchange Act when soliciting proxies. *See* Investment Company Act Rule 20a-1, 17 C.F.R. § 270.20a-1 (2008) (requiring compliance through Section 14(a) of the Exchange Act).
[75] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 54.

companies will be subject to the rule, but on the delayed basis described below.[76] Companies that are subject to the proxy rules solely because they have a class of debt registered under Section 12 of the Exchange Act are exempt from the rule.[77] In addition, foreign private issuers are exempt from the SEC's proxy rules with respect to solicitations of their shareholders, so the rule will not apply to these issuers either.[78]

2. *Investment Companies and Shareholder Liabilities*

Under the Proposal, Rule 14a-11 would apply to registered investment companies,[79] and the SEC sought comment as to whether 14a-11 should in fact apply to them. Several commentators supported including registered investment companies in the rule because, like other boards, investment companies must be responsive and accountable to shareholders.[80] A number of other commentators, largely from the investment company industry, were not so sure.[81] Those who opposed the inclusion of registered investment companies asserted that the SEC had not presented sufficient empirical evidence of problems in the industry to warrant extending the rule to them, and that investment company boards tended to have the strongest governance practices.[82] The SEC found costs imposed on investment companies to be less than costs imposed on other companies.[83] In the end, after considering both sides of the argument, the Commission crafted Rule 14a-11 to apply to registered investment companies.[84]

As is the case when directors nominate candidates, the nominating shareholder or group will be liable for any false or misleading statements it makes about the nomination under Rule 14a-9, regardless of whether the statements are included in the company's proxy materials.[85] A company will not be responsible for information provided by the shareholder and then reproduced in the company's proxy materials.

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[76] *Id.*
[77] *Id.*
[78] Exchange Act Rule 3a12-3, 17 C.F.R. § 240.3a12-3 (2011) (exempting securities of certain foreign issuers from Section 14(a) of the Exchange Act).
[79] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 55.
[80] *Id.*
[81] *Id. See, e.g.*, Letter from the Inv. Co. Inst. to The Hon. Mary L. Schapiro et al., U.S. Sec. & Exch. Comm'n (Apr. 7. 2010), *available at* http://www.ici.org/pdf/24235_letter_to_sec.pdf.
[82] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 56. The Commission noted that ninety percent of funds have boards that are seventy-five percent or more comprised of independent directors. *Id.*
[83] *Id.* at 61.
[84] *Id.* at 58.
[85] *Id.* at 116.

C. *The Process for Shareholder Proposals*

A total of around 6000 firms are listed on the NYSE, the AMEX and NASDAQ, including foreign issuers.[86] Before examining the effect of proxy access, it is important to examine the current system.

1. *Uncontested Solicitations*

Most publicly traded companies hold shareholder meetings once a year and solicit proxies for these meetings under federal proxy rules.[87] Further still, the majority of these meetings are all but routine.[88] Counsel for the company must produce a proxy statement that complies with the requirements of Regulation 14A. Along with the proxy card and a request for instructions (voting instruction form), Broadbridge distributes the proxy statement to the shareholders.[89] Proxies and instructions are collected, votes are tabulated, and the results are reported. NYSE Rule 465 sets the maximum charges for the principal elements of proxy distribution, although a number of services by Broadbridge are outside the scope of the rule.

Total costs of annual proxy solicitation typically fall within $10,000 to $100,000.[90] For example, Air Products & Chemicals, with a market cap of $15.4 billion, produced its 2010 proxy solicitation at a cost of around $80,000.[91] Broadbridge received $35,700; $14,000 went to Morrow & Co. for proxy solicitation, and $30,000 went to RR Donnelley for proxy printing and EDGAR preparation.[92] The proxy statement itself was produced in-house.[93]

2. *Contested Solicitations*

Contested elections occur quite infrequently. A proxy contest for control typically involves mailings to shareholders, telephone solicitations, advertisements and perhaps litigation. The number of contested solicitations since 1981 has ranged from a low of three in 1993 to a high of

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[86] Kahan & Rock, *supra* note 9, at 17.
[87] *Id. See also* Concept Release on the U.S. Proxy System, Release No. 34-62495, 75 Fed. Reg. 42982 (July 22, 2010).
[88] Kahan & Rock, *supra* note 9, at 17.
[89] *Id.* at 17–18. Broadridge provides outsourcing solutions to financial institutions and public companies that includes products and services for securities and proxy processing, document management and investor communication. *See About Us*, *BROADRIDGE*, http://www.broadridge.com/about.asp (last visited Mar. 27, 2011).
[90] Kahan & Rock, *supra* note 9, at 18.
[91] *Id.*
[92] *Id.*
[93] *Id.*

fifty-seven in 2009, with an upward trend beginning in the mid 1990s.[94] However, with over 6000 publicly traded companies, this equates to over ninety-nine percent of votes being uncontested.[95]

These contests solicitations tend to be more costly for larger companies (as measured by market cap) than smaller ones.[96] For smaller companies with a capitalization of less than $300 million, the average and median costs amounted to $267,000 and $200,000, respectively.[97] For companies with a larger capitalization, between $300 million and $1 billion, the average and median costs were $643,000 and $275,000.[98] Even larger still, companies with capitalization over $1 billion, had average and median costs of $2.17 million and $1.15 million.[99]

When limiting the data to after 2005, a recent study of 129 contests showed that in about half of the contests (sixty-six), the dissidents obtained some board representation, either as a result of a ballot success or pursuant to a settlement.[100] Most of the proxy contests involved small companies. Only eight companies (six percent) had a market cap of more than $10 billion (large-cap),[101] nine others had a cap of between $2 billion and $10 billion (mid-cap),[102] and forty more had a cap of between $300 million and $2 billion (small-cap).[103] Thus, micro-cap companies were the predominant users of proxy contests, with an average and median cap of $93 million and $66 million, respectively.[104] In total, micro-cap companies, those with less than $300 million, account for less than 2.5% of the market capitalization of U.S. companies despite making up a large fraction of publicly traded companies.[105]

It is apparent that small and micro-cap firms make up the large majority of proxy contests. Very few analysts closely follow the effects of firms

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[94] *Id.*
[95] *Id.* at 18–19.
[96] *Id.* at 19. 57 divided by 6000 equals .0095, less than 1%.
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.* at 19–20.
[101] *Id.* at 20.
[102] *Id. See also Definition of Mid Cap*, INVESTOPEDIA, http://www.investopedia.com/terms/m/midcapstock.asp (last visited Mar. 27, 2011).
[103] Kahan & Rock, *supra* note 9, at 20. *See also Definition of Small Cap*, INVESTOPEDIA, http://www.investopedia.com/terms/s/small-cap.asp (last visited Mar. 27, 2011).
[104] Kahan & Rock, *supra* note 9, at 20.
[105] *See id.*

with below $300 million market cap.[106] Bob Greirfeld, President and CEO of NASDAQ, observed this reality in noting that thirty-five percent of all publicly traded U.S. firms had no analyst coverage.[107] Additionally, he cited estimates by Reuters that from January 2002 to June 2005, 691 publicly traded US companies had lost all analysts' coverage.[108] Almost all of these companies had market capitalizations under $1 billion.[109] Because of fewer levels of accountability, these smaller companies might naturally be presented with governance challenges distinct from those of larger companies.

Among micro-caps, hedge funds accounted for fifty-four percent of the dissidents, former insiders eighteen percent, and other dissidents twenty-eight percent.[110] The success rate of the dissidents for micro-cap companies was fifty-one percent.[111] The highest success rates came from former insiders at a rate of sixty-nine percent, while dissidents who were neither former insiders nor hedge funds (sixty-three percent) succeeded in only twenty-eight percent of the contests.[112] Dissidents in those micro-caps represented a 9.7% ownership stake, with hedge funds tending to have higher stakes than other dissidents (11.2%).[113] Similarly, former insiders tended to have higher stakes than other non-hedge fund dissidents (9.2%).[114] In conclusion, only former insiders were very successful in waging proxy contests.[115] Other investors rarely attempted or succeeded.[116]

D. *Potential Conflicts with State Law*

Given the prohibitive expenses associated with traditional proxy contests, supporters claim that proxy access allows shareholders to effectively exercise their state law rights.[117] Supporters believe shareholders need proxy access to exercise this right to elect and remove

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[106] Justin Canivet, *Small cap analyst coverage: an "under-the-radar" dilemma*, WORLD FED'N OF EXCH., http://www.world-exchanges.org/news-views/views/small-cap-analyst-coverage-under-radar-dilemma (last visited Mar. 27, 2011).

[107] Cem Demiroglu & Michael Ryngaert, *The First Analyst Coverage of Neglected Stocks*, 39 FIN. MGMT. 555 (Summer 2010), *available at* http://onlinelibrary.wiley.com/doi/10.1111/j.1755-053X.2010.01084.x/pdf.

[108] *Id.*

[109] *Id.*

[110] Kahan & Rock, *supra* note 9, at 21–22.

[111] *Id.* at 22.

[112] *Id.*

[113] *Id.*

[114] *Id.* at 23.

[115] *See generally id.*

[116] *Id.*

[117] *See* Shapiro, *supra* note 15.

board members.[118] As stated above, Kahan and Rock's study supports this assertion: with over ninety-nine percent of elections being uncontested, the shareholders' role in board nominations is clearly rarely exercised.[119] The question is whether shareholders wish it to be any different.

Opponents of the new rules believe recent corporate governance developments and certain state law changes already provide shareholders with meaningful opportunities to participate in director elections. In *CA Inc. v. AFSCME*,[120] the Delaware Supreme Court held that shareholders may adopt provisions facilitating the nomination of director candidates without board approval.[121] The Delaware Legislature later adopted § 112 that explicitly allows proxy access to be adopted through a bylaw.[122] Under § 112, shareholder nominations may be included in proxy materials in a process of its choosing. Thus, under Delaware law, shareholders have the ability to adopt proxy access via bylaws.[123]

Those in opposition view the amendments as intruding into matters traditionally governed by state law or imposing a "one size fits all" rule for all companies.[124] Despite this concern, and after weighing the competing interests of facilitating shareholders' ability to exercise their state law rights to nominate and elect directors against potential disruption and cost to companies, the SEC was convinced that adopting the proposed amendments served the purpose of regulating proxy access in the public's interest and on behalf of investors.[125]

As previously stated, § 112 of the Delaware General Corporation Law expressly authorizes, but does not require, bylaws granting shareholder access to a corporation's proxy materials to nominate directors.[126] Section

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[118] Page, *supra* note 6.
[119] Kahan & Rock, *supra* note 9, at 18–19.
[120]CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227 (Del. 2008).
[121] *See* DEL. CODE ANN. tit. 8, § 109 (2010).
[122] DEL. CODE. ANN. tit. 8, § 112 (2010).
[123] In contrast to the SEC's proxy access rule, § 112 is consistent with an "enabling" approach to corporate governance, as it permits each company to determine for itself whether to have proxy access and to tailor the terms in which shareholders should be eligible to make nominations, rather than impose the same "one size fits all" approach.
[124] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 11–12.
[125] *Id.* at 13–14.
[126] DEL. CODE ANN. tit. 8, § 112 (2010).

> The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition

112 also authorizes an "opt in" to access and states that access rights, if afforded, may be subject to any limitations that are lawful.[127] To some, Rule 14a-11 denies shareholders the flexibility § 112 allows in fashioning proxy access rights.[128] The new rules force a company and its shareholders into Rule 14a-11, even if shareholders prefer to opt out, such as by adopting a bylaw permissible under Delaware law that imposes more restrictions before shareholders are afforded access.[129]

Further, Rule 14a-11 denies a state's ability to opt out of the federal right of access by adopting a more restrictive right than is created by the federal rule. The adopting release clearly states: "Also consistent with the Proposal, companies may not 'opt out' of the rule–either in favor of a different framework for inclusion of shareholder director nominees in company proxy materials or no framework."[130] Furthermore, "the rule will apply regardless of whether any specified event has occurred to trigger the rule and will apply regardless of whether the company is subject to a concurrent proxy contest."[131]

Assume a state legislature prefers only to confer proxy access upon shareholders with a five percent ownership stake while keeping the same holding period as Rule 14a-11 and adopts a statutory provision to this effect.[132] Notwithstanding the state legislature's considered policy judgment concerning corporate governance, shareholders could still avail themselves of Rule 14a-11's easier right of access.[133] Shareholders of a company incorporated in the state would have a federal right of access at a lower ownership threshold than the state legislature determined was appropriate. If the SEC were to facilitate shareholder's ability to exercise their state law rights, the final rule would not supersede shareholder choice by negating shareholder-approved bylaws that are lawful under state law.[134] Therefore, Rule 14a-11 would not displace state law as it does by overriding corporation codes that afford shareholders a more limited right of access.[135]

> to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder.

Id.

[127] *Id.*

[128] Paredes, *supra* note 1.

[129] *Id.*

[130] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 24.

[131] *Id.*

[132] Paredes, *supra* note 1.

[133] *Id.*

[134] *Id.*

[135] *Id.*

The proposed amendments have been criticized by Troy A. Paredes, the Commissioner of the SEC.[136] While many disagree that greater stockholder oversight could have prevented the financial crisis and recession, this rule seems to be crafted at least in part as a response to it. Paredes criticized the new rules for displacing state laws that already provide expanded proxy access.[137] Delaware has new corporate law and other states may also have laws that will be preempted, but that provide much of what the proxy access rule seeks to achieve, the key difference between the two being the mandate of proxy access.[138]

IV. SHAREHOLDER PROPOSALS INCLUDED THROUGH RULE 14A-8

A number of shareholder proposals are included in the company proxy statement pursuant to Rule 14a-8. Under Rule 14a-8, a shareholder who holds more than $2000 worth of stock for one year can make a proposal, which is a much lower threshold than the proxy access threshold.[139] Previously, companies could exclude stockholder proposals under Rule 14a-8(i)(8), the "election exclusion," that relates to a nomination or election or procedures for nominations or elections.[140] Amended Rule 14a-8(i)(8) will narrow the scope of the exclusion and provide stockholders the opportunity to require the company to include in its proxy materials proposals that would amend, or request an amendment to, the company's governing documents relating to nomination procedures or the company's disclosures related to stockholder nominations.[141] In order to utilize this rule, stockholders must have continuously held company voting securities of at least $2000 or one percent in market value, whichever is less, for a period of at least one year prior to submitting the proposal.[142]

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[136] *See id.*
[137] *Id.*
[138] *Id.* Paredes stated:

> Rule 14a-11's immutability conflicts with state law. Rule 14a-11 is not limited to facilitating the ability of shareholders to exercise their state law rights, but instead confers upon shareholders a new substantive federal right that in many respects runs counter to what state corporate law otherwise provides. Modifying the phrase "state law rights" with the word "traditional," as the adopting release does, does not change the reality that Rule 14a-11 is at odds with state law.

Id.
[139] *See* 17 C.F.R. § 240.14a-8 (2007).
[140] *Id.*
[141] U.S. Sec. & Exch. Comm'n., *supra* note 4.
[142] *Id.* The new Exchange Act Rule 14a-8(i)(8) precludes a company from relying on Rule 14a-8(i)(8) to exclude shareholder proposals from its proxy materials.

Specifically, shareholder proposals by qualifying shareholders that seek to establish a procedure in the company's governing documents for the inclusion of shareholder director nominees in company proxy materials are not excludable under amended Rule 14a-8(i)(8).[143] A company may not include in its proxy materials a shareholder proposal that seeks to limit the availability of Rule 14a-11.[144]

Under Rule 14a-11, to have a proposal included in a company's proxy materials, a shareholder must submit the proposal no later than 120 days before the anniversary date of the mailing of the company's proxy statement in the prior year.[145] Shareholders will be able to submit proposals for inclusion in the next year's proxy statement if the 120 day deadline falls on or after the effective date of the rules.[146] Effectively, Rule 14a-8(i)(8) will preclude companies from relying on the rule to exclude from their proxy materials shareholders' proposals by qualifying shareholders that seek to establish a procedure under a company's governing documents for the inclusion of one or more shareholder director nominees in the proxy materials.[147]

V. ADVANTAGES TO PROXY ACCESS VERSUS TRADITIONAL PROXY CONTESTS

In considering the effect new proxy access will have on the corporate form, it is important to highlight the benefits and problems proxy access presents. The closest alternatives to proxy access are either waging a traditional proxy contest or to withhold the vote for company nominees.

The first and most obvious benefit are the reduced costs. In most cases, the existing directors nominate candidates and the company sends information to the shareholders through proxy materials for shareholders to make their selections.[148] Shareholders with voting rights have typically had little input into nominating candidates.[149] While shareholders may nominate different candidates at the annual shareholder meeting, it is of little influence as the proxy votes have already been cast. Shareholders

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[143] U.S. Sec. & Exch. Comm'n, *supra* note 4.
[144] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 35.
[145] *Id.* at 26.
[146] *Id.* at 24–25.
[147] *Id.* at 35.
[148] *Proxy Access Legal Challenge: Issue Backgrounder*, BUS. ROUNDTABLE (Sept. 29, 2010), http://businessroundtable.org/news-center/proxy-access-legal-challenge-issue-backgrounder/.
[149] *See Sec. & Exch. Comm. Proxy Rules: Hearings on H.R. 1493, H.R. 1821 and H.R. 2019 Before the H. Comm. on Interstate and Foreign Commerce*, 78th Cong. 17–19 (1943) (testimony of Ganson Purcell, Chairman).

who wished to nominate their own candidates were forced to launch a proxy fight in which they mail out their own ballots.

Thus, it is important to compare proxy access to a traditional proxy contest. The principle benefit of the new rules on proxy access is to reduce costs of conducting contested election. Again, this is achieved by forcing the company to include shareholder nominees in the company's proxy statement.

A. *Costs of Preparing and Distributing Proxy Statements in Compliance with Regulation 14A*

Dissident shareholders in proxy access must submit to the company the Form 14N.[150] The cost savings is recognized as the shareholder is no longer forced to prepare her own proxy statement required by 14A, which is filled with duplicated and unnecessary information already present in the company's proxy statement.[151] However, the requisite substantive information is essentially the same. Therefore, the proxy access rules only reduce costs to the extent that duplicate and technical information is no longer required. This net cost savings could be even greater if the SEC removed the requirement for dissident proxy statements to include this information in a Form 14A.[152]

The actual content of a proxy statement can be generally divided into four parts: the required substantive information about the dissident and her nominees, technical information that indentifies the issues and explains the basic ground rules, disclosures related to the company that duplicates the information provided by the company in its proxy statement and additional information not required by the proxy rules.[153] Substantive information includes biographical information about the nominees, information about other participants and their interests in the solicitation and information about solicitation methods and expenses. Unlike technical and duplicative information, substantive information must be prepared from scratch by the dissident. This information can be extensive and contains the greatest regulatory compliance costs. The new proxy access rules do nothing to reduce the cost of preparing this substantive information because the

[150] 17 C.F.R. § 240.14n-1 (2010).
[151] Kahan & Rock, *supra* note 9, at 35.
[152] *Id.* at 39. Academics argue that the SEC could have, and perhaps should have, eliminated the requirement of the dissident providing the information. To the extent proxy access results in a cost reduction, this reduction is unrelated to the purpose of proxy access and could be achieved without it. *Id.*
[153] *Id.* at 35–36.

dissident is still required to provide this information to both the SEC and the company on the newly created Schedule 14N.[154]

Technical information includes: the name and address of the company, the place of the annual meeting, information about how to vote, the record date, the effect of abstentions and broker no-votes, proxy revocability, the required number of shares outstanding and some additional disclosures to shareholders who share an address. Proxy access would definitely reduce the costs in this arena, but because technical information is limited and copied from the company's proxy statement, the costs savings may be trivial.

The type of information that would be duplicative includes information about shareholders by five percent owners and by management, as well as information as to whether a change of control has occurred and by what deadline shareholder proposals must be submitted for the annual meeting. This information is already included in a company's proxy statement. It is therefore copied from the company's proxy statement, as is the case with the technical information. A dissident generally does not have superior access to this information and it may not be entirely necessary for a dissident's proxy statement to even contain this information.[155] Unless private information is available indicating the information provided by the company is false, a dissident could be relieved from including this in the proxy statement. While this is not all that costly, even the smallest additional costs that require duplicate material are wasted unnecessarily. If this reform were enacted, as the SEC has done with other informational items, the costs savings of proxy access in this regard would be even less.

Moreover, the proxy access rules eliminate the requirement for dissidents to distribute the proxy statement to all applicable shareholders and prepare return postage and processing of returned forms. This reduces printing and mailing costs. Under proxy access, there is only one form of voting instructions, which contains both the company's and dissident's nominee(s).[156] Similarly, proxy statements and voting forms can now be mailed together.[157] This distribution is no longer a cost to the dissident shareholders. But, as mentioned above, there is not any hint that these types of trivial reductions in costs will create a voice for a group of dissidents who did not already participate in shareholder activism.[158] Provisions in place already provide for these costs to be reduced if a

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[154] 17 C.F.R. § 240.14n-101 (2010).
[155] *See* Kahan & Rock, *supra* note 9, at 37–38.
[156] *Id.* at 41.
[157] *Id.*
[158] *Id.* at 28.

dissident chooses to forego sending small shareholders a proxy statement.[159]

A considerable portion of the proxy statement relates to information that is not required by the proxy access rules.[160] It tends to take the appearance of other campaign expenses as it is usually used to influence shareholder votes.[161] This includes: additional information about the dissident and her nominee(s), information about the reasons for the solicitations, business strategies the dissident would want to explore, the address of the proxy solicitor who can provide further information and boldfaced recommendations on how to vote.[162] Because these items function as campaigning, it follows that proxy access does not result in any costs savings to these items.

In conclusion, the proxy access rules seem to reduce costs only to the extent that duplicative and technical information is required. The costs savings with regard to the duplicative information could have been achieved even without the rules by eliminating the requirement of the dissident providing the information.[163] In addition, the real cost savings associated with proxy access relates to the narrow category of technical information which lasts only a few paragraphs. This information is relatively simple to prepare by copying the pertinent passages from the company's proxy statement.[164] Therefore, while the cost savings of proxy access are recognizable, they may ultimately be trivial.

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[159] Recently enacted rules on internet availability of proxy materials offer another option in which a dissident does not have to mail paper proxy statements to shareholders as long as they provide notice more than ten day before a proxy form or other solicitation is sent to shareholders. Usually,

> [L]ess than five percent of the shareholders request paper copies. Thus, notice and access reduces the costs for printing and mailing the proxy statement. Notice and access, however, requires the dissident to make one mailing of the notice without any campaign literature and imposes a ten day delay for the distribution of campaign materials. For that reason, most dissidents do not avail themselves of notice and access.

Kahan & Rock, *supra* note 9, at 40.

[160] *Id.* at 38.

[161] *Id.*

[162] *Id.* at 39. *See, e.g.*, Cyberonic, Inc., Definitive Proxy Statement (Schedule 14A) (Jan. 14, 2007).

[163] Kahan & Rock, *supra* note 9, at 39.

[164] *Id.*

B. *Costs of Campaign, Legal and Regulatory Expenses*

Campaign expenses are typically the largest campaign item in most contests.[165] They include all materials provided to shareholders that go beyond the required disclosures in the proxy statement and are typically full of fine print for the purpose of regulatory compliance.[166] In contrast, the other mailings to shareholders tend to be more focused on the issues and information likely to influence the shareholders.[167] For large holders, dissidents sometimes even make presentations detailing their future strategic plans for the company and the benefits they expect.[168] In addition, solicitors make personal phone calls to record holders and other institutions that are known, though public filings, to hold shares in the company.[169] The cost of advice, both strategic and legal, are also included in the campaign expenses. The new proxy access rules have no impact on these expenses.[170] Even under proxy access, if a dissident is to engage in these campaigns, the expenses must be borne the dissident.

A dissident's effectiveness will probably be proportionately reduced to the extent the dissident reduces campaign expenditures. The only exception is that a dissident may include a supporting statement of up to 500 words in the company's proxy statement.[171] A 500 word statement is very short to make both the negative case that the management nominee(s) should not all be reelected and the affirmative case that the dissident nominee(s) deserves election instead. While a 500 word statement in support of a shareholder proposal can be enough to identify a proposal as one of a standard type, director elections are a much more complex decision. Second, many shareholders may never read the dissident's supporting statement. Company proxy statements are significantly longer than dissident proxy statement because of additional disclosure requirements imposed only on the company.[172] The company can thus easily bury the supporting statement somewhere in the long compliance document, where it is unlikely to be noticed even by shareholders who receive a paper copy. Moreover, the company can use "notice and access" for distributing its proxy

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[165] *Id.* at 41.
[166] *Id.*
[167] *Id.* at 42.
[168] *Id.*
[169] *See id.*
[170] *Id.*
[171] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 29. This portion of the rule states: "[a] statement in support of each shareholder nominee, not to exceed 500 words per nominee (the statement would be at the option of the nominating shareholder or group)." *Id.*
[172] *See, e.g.*, 17 C.F.R. § 240.14a-101 (2010).

statement.[173] Under notice and access, the company mails a short notice to shareholders informing them how to receive a paper or electronic copy of the proxy statement.[174] Under the new proxy access rules, "the number of [eligible] nominees is more confined."[175] Only the nominating shareholder or group with the highest voting percentage will have its nominee(s) included in the company's proxy materials, up to a maximum of twenty-five percent of the board.[176] For example, in a board with nine members, the dissident may nominate two candidates. Similarly, if a board has only seven members, the dissident may nominate only one candidate. Also, "any previously elected dissident candidate will count towards the twenty-five percent maximum."[177] For a dissident who wants to nominate candidates for more than the proxy access maximum, she may very well choose to run a traditional contest instead.

Thus, a dissident itself cannot obtain a majority board representation through proxy access. The proxy access rule requires that a dissident not have the purpose of changing control or gaining more board seats than the twenty-five percent maximum available via proxy access.[178] Suppose, for example, a dissident claims not to seek control and makes nominations for less than twenty-five percent of the board. Then a year later, the dissident tries to gain control through a traditional proxy contest in the following year arguing changed circumstances because the board majority has ignored her nominee. These changed intentions would surely run the significant risk of litigation. Even if litigation is avoided or overcome, the proxy access in the following year becomes less credible.

C. *Higher Voting Threshold*

Proxy access is likely to require more votes to succeed than in traditional proxy contests, and it may take the support of a substantially greater fraction of the voting shares to get a nominee elected. "In corporate board elections, the candidates with the most votes occupy the available

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[173] 17 C.F.R. § 240.14a-16 (2010); Shareholder Choice Regarding Proxy Materials, Exch. Act Release No. 34-56135, 72 Fed. Reg. 42222 (July 26, 2007) ("Notice and Access Release"); Amendments to Rules Requiring Internet Availability of Proxy Materials, Sec. Act Release No. 33-9108, 75 Fed. Reg. 9074 (Feb. 22, 2010).

[174] *Id.*

[175] Kahan & Rock, *supra* note 9, at 44. In traditional contests, dissidents can make as many nominations as there are board seats eligible for election. A company without a staggered board can have dissidents run nominees for the entire board thereby taking over control in one contest. *Id.*

[176] Facilitating Shareholder Director Nominations, *supra* note 5, at 141–57.

[177] Kahan & Rock, *supra* note 9.

[178] 17 C.F.R. § 240.14a-11(b)(6) (2010).

seats."[179] Shareholders can usually vote for as many candidates as there are seats to be filled (without cumulative voting).[180] "In such an election, it may take the support of more than half of the shares to get elected."[181]

Kahan and Rock illustrate the above point by considering an "election with seven candidates for five seats to the board of a company with one million voting shares."[182] Even if an individual (Fred in this case) receives the vote of holders of sixty-nine percent of the voting shares, he may not be elected.[183] The table below illustrates this point and gives the votes received by each nominee.[184]

Nominee	**Votes**	**Percentage**
Alice	790,000	79%
Bill	770,000	77
Claire	750,000	75
David	730,000	73
Emily	710,000	71
Fred	690,000	69
Gillian	560,000	56
Total	5,000,000	100%

In contrast, traditional proxy contests are designed to make it likely for nominees to be elected when supported by a majority of the voting shares.[185] This is because both the company and the dissident distribute voting forms which permit shareholder's to vote for only their respective nominees.[186] While it is possible to vote for some of the dissident's nominees and some of the company's nominees not listed on the dissident form, the process to do so is very complicated.[187] Most shareholders inevitably vote for all of the company nominees or for all the dissident nominees.[188] Given this design, if holders of a majority of the voted shares,

[179] Kahan & Rock, *supra* note 9, at 47.
[180] *Id.* Cumulative voting is multiple-winner voting system intended to promote more proportional representation than winner-take-all elections.
[181] *Id.*
[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] *Id.* at 48.
[186] *Id.*
[187] *Id.* In order to do that, "the shareholder would have to show up in person at the meeting and, if the shareholder is not a record holder, would also have to get a proxy form the record holder before the meeting." *Id.*
[188] *Id.*

and sometimes fewer, support a dissident nominee, the nominee will get elected.[189]

D. *The High Financial Costs*

When faced with a challenge of a dissident nominee, a company will often campaign against the nominee.[190] As discussed above, campaigns are the largest costs associated with director elections. These campaigns, in effect, spend shareholder resources. As expected, if the dissident nominee loses, the nomination inevitably drives up expenses.

Given the low costs of making a nomination, dissidents may be inclined to make nominations even when the chances of success are very low.[191] If the chances are low, the reality is that dissidents are making the nomination with goals other than getting the nominee elected. A board will be required to expend fewer resources to assure defeat of a nominee with no chance of victory.[192] However, the increase in campaign expenses because of the increased proxy challenges is a clear downside to be weighed against any benefits of proxy access.

Commentators and academics alike have expressed serious concerns over the price of compliance.[193] When small businesses are eventually included, the effects of these costs could hinder growth of entry corporations or dissuade them from forming at all.[194] Companies accustomed to uncontested director elections may incur substantial costs of changing their practices. For companies that already have well-functioning boards, dissent can be counterproductive and could delay the board's decision-making process.[195] Companies may expend significant resources on efforts to defeat the election of stockholder nominees, resources that could surely be used in a more productive manner. To the extent disputes on whether to include particular nominees or proposals are not resolved internally, companies and/or stockholders might seek recourse in courts. All stockholders of a given company are effectively paying to subsidize the proxy contest of activist stockholders who continuously nominate directors, having a social instead of profit maximizing agendas, or who are seeking publicity.

[189] *Id.*
[190] *Id.* at 82.
[191] *Id.* at 83.
[192] *Id.*
[193] Facilitating Shareholder Director Nominations Rule, *supra* note 5, at 63.
[194] *Id.* at 73.
[195] *Id.* at 49.

D. *Concern for Dissidents' Improper Influence*

A primary contention is that proxy access will lead to the nomination of "special interest directors," such as individuals representing unions or those with social or environmental agendas.[196] Dissidents may make nominations as a shareholder group with interests very different from the interests of shareholders as a whole. This leverage might not be out in the open; but rather in backroom negotiations. Similarly, proxy access's equivalent of greenmail can leave the shareholders worse off. A recent study by Bo Becker, Daniel Bergstresser, and Guhan Subramanian suggests value in proxy access.[197] The study examines stock price effects surrounding the SEC's proxy access rule announcements and finds that firms most likely to be affected by proxy access have experienced abnormal positive gains as a result of the announcement.[198] Still, public pension funds, social issue oriented funds, and hedge funds may have divergent interests and use proxy access to advance those personal agendas.[199]

Some shareholders may be cynical as to why their fellow shareholders have taken to the director nomination. A common fear is one of private benefits to the detriment of the corporation. Therefore, shareholders may not want to have this proxy access used as a leverage tool for those benefits. Commentators argue that if a corporation wishes to do away with such access, it should be allowed to do so.

Traditional proxy contests allow dissidents to nominate as many members of the board as there are seats up for election. Therefore, a company without a staggered board runs the risk of losing control in a single proxy contest. The number of nominees under proxy access is limited to twenty-five percent of the board seats. This limitation creates a problem for dissidents who want to nominate candidates for more than twenty-five percent of the board. In such an instance, the dissident will choose to follow the route of a traditional proxy contest.

VII. STATED PURPOSE: WHO WILL USE PROXY ACCESS?

The new rules require companies to include the nominees of significant, long-term shareholders in their proxy materials, alongside the nominees of management. This "proxy access" is designed to facilitate the ability of

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[196] Page, *supra* note 6; *see also* Paul Atkins, *The SEC's Sop to Unions*, WALL ST. J., Aug. 27, 2010, at A15.

[197] Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge* (Harvard Bus. Sch. Fin., Working Paper No. 11-052), *available at* http://www.hbs.edu/research/pdf/11-052.pdf.

[198] *Id.* at 14.

[199] *See generally* Kahan & Rock, *supra* note 9.

shareholders to exercise their traditional rights under state law to nominate and elect members to company boards of directors.[200] Shareholders will not be eligible to use the rule if they are holding the securities for the purpose of changing control of the company, or to gain a number of seats on the board of directors that exceeds the number of nominees a company is required to include under new Rule 14a-11.[201]

It is fair to assume that activist shareholders who have initiated traditional proxy contests and proposals under Rule 14a-8 will use this new proxy access. First, proxy access may substitute for the other forms of activism. Second, shareholders who participate in proxy contests and 14a-8 proposals indicate a willingness to engage in activism. The two closest alternatives to proxy access are the traditional proxy contest–where a dissident submits its own proxy statement–or to withhold a vote for company nominees.[202] Traditional proxy contests differ from proxy access in that a dissident must file her own proxy statement in an election contest. Rule 14a-8 proposals do allow a shareholder to include proposals in the proxy statement, but the proposal may not concern director nominations.

Shareholders, who in the past were not active with existing remedies, may not become more active now simply because another avenue exists. However, it does follow that those active shareholders may use proxy access as a substitute for the traditional measures.

VIII. SMALL BUSINESSES: THE GREATEST POINT OF CONTENTION

As "proxy access" is currently constructed, the smallest public companies—those that are defined as "smaller reporting companies" under SEC rules—will be deferred for three years.[203] The Commission is permitted to "take into account whether such requirement for the inclusion of shareholder nominees for director in company proxy materials disproportionately burdens small issuers."[204] The three year exemption and the Commission's clear cause for further analysis has caused field experts to suggest smaller companies should be exempt outright.[205] The Commission could then conduct the necessary investigation and approach the decision in three years as to whether "smaller issuers" need to be included in the reporting requirements. Instead, small issuers must prepare for a step that may not be necessary. It may prove more difficult to pull the reigns back in after the rule has been extended, perhaps unnecessarily.

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200 U.S. Sec. & Exch. Comm'n, *supra* note 4.
201 17 C.F.R. § 240.14a-11(b)(6) (2010).
202 Kahan & Rock, *supra* note 9, at 27.
203 U.S. Sec.& Exch. Comm'n, *supra* note 4.
204 Facilitating Shareholder Director Nominations, *supra* note 5, at 67.
205 Paredes, *supra* note 1.

Small boards, which are particularly prevalent in small businesses, may be inclined to increase the size of the board in order to dilute the power of shareholder nominees. Small issuers accustomed to uncontested director elections may incur substantial costs of changing their practices. Companies may incur costs in attempting to institute policies and procedures they believe will address stockholder concerns instead of focusing on strategic or long-term issues.

A. *The SEC Deems a Temporary Exemption for Smaller Reporting Companies Appropriate*

Under the original proposal, Rule 14a-11 would apply to smaller reporting companies.[206] After the SEC solicited comment in the Proposal on what effect, if any, the application of 14a-11 would have on particular groups,[207] it delayed application to smaller reporting companies.[208] A number of commentators stated that Rule 14a-11 should not apply to small businesses.[209] One commentator argued that Rule 14a-11 should be limited to accelerated filers and that there should possibly be a transition period where the rule would apply only to large accelerated filers.[210] The fear was that smaller companies would have trouble recruiting directors since the already small pool for recruiting directors in small companies would shrink further because directors would not want to risk exposure to a proxy contest.[211]

The SEC continues to believe that Rule 14a-11 should apply regardless of company size.[212] Nonetheless, it recognized smaller companies may have less experience with existing forms of shareholder involvement in proxy access (like Rule 14a-8 proposals) and therefore have less developed infrastructures for managing these matters.[213] Thus, the Commission

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[206] Facilitating Shareholder Director Nominations Rule, Sec. Act Release No. 33-9136; 34-62764, 75 Fed. Reg. 56,668-01, at 67 (Sept. 16, 2010).
[207] *Id.* at 68–69.
[208] *Id.* at 70.
[209] *Id.* at 68.
[210] *Id.* "A large accelerated filer is an issuer that had, as of the end of its fiscal year, the following: an aggregate worldwide market value of voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter; has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for at least 12 calendar months; has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act; and is not eligible to use the requirements for smaller reporting companies for its annual and quarterly reports." *Id.; see also* 17 C.F.R. § 240.12b-2(2) (2010).
[211] *See* Facilitating Shareholder Director Nominations Rule, *supra* note 206, at 68.
[212] *Id.* at 70.
[213] *Id.*

decided on a delayed effective date for smaller reporting companies so that those companies may observe how the rule operates and better prepare for implementation of the rules.[214]

According to the SEC, the rules are expected to affect some companies deemed to be small entities.[215] The Regulatory Flexibility Act defines "small entity" to mean "small business," "small organization," or "small governmental jurisdiction."[216] The SEC's rules define "small business" and "small organization" for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Securities Act Rule 157[217] and Exchange Act Rule 0-10(a)[218] define a company, other than an investment company, to be a "small business" or "small organization" if it had total assets of $5 million or less on the last day of its most recent fiscal year. The SEC estimates 1209 issuers to be considered small entities.[219]

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[220] The SEC estimates that approximately 168 registered investment companies and thirty-three business development companies meet this definition.[221] "The new rules may affect each of the approximately 201 issuers that may be considered small entities, to the extent companies and shareholders take advantage of the rules."[222]

B. *Should Small Businesses be Exempt?*

Commentators have argued that shareholders of smaller companies should also be subject to the increased accountability that proxy access might provide.[223] Having already lost corporate protections from other small company exceptions,[224] many argue that it is small businesses that are

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[214] *Id.*
[215] *Id.* at 389.
[216] 5 U.S.C. § 601(6) (2006).
[217] 17 C.F.R. § 230.157(a) (2010).
[218] 17 C.F.R. § 240.0-10(a) (2010).
[219] Facilitating Shareholder Director Nominations, *supra* note 5, at 389.
[220] 17 C.F.R. § 270.0-10(a) (2010).
[221] Facilitating Shareholder Director Nominations, *supra* note 5, at 390.
[222] *Id.*
[223] Shapiro, *supra* note 15.
[224] Currently, companies with less than $75 million in market cap are exempt from audits required by the Sarbanes-Oxley corporate-reform law. Publicly reporting companies and their independent auditors are both required to report on the effectiveness of internal controls of financial reporting under Sarbanes Oxley § 404. On October 2, 2009, the SEC deferred compliance with Section 404(b),

most in need of proxy access to "offset the more prevalent dysfunction found in small company board's governance."[225] Thus, small businesses are just as likely to have poorly a functioning board as their larger counterparts.

Moreover, the fixed costs associated with conducting traditional proxy access are seen as a significant hurdle for smaller issuers seeking to force accountability upon a poorly governed company, regardless of size. Despite some evidence to the contrary,[226] those in favor of a small business inclusion see the costs of traditional contests as a huge barrier to shareholders and a further entrenchment protection for the poorly run boards and management of smaller companies. To be sure, "[t]he costs saved for shareholders of smaller companies via . . . proxy access serve a far greater proportional savings and reform role than . . . in larger company contests."[227] Similarly, those in favor of the inclusion argue that Rule 14a-11 would not impose a material burden on any company subject to the rules because those companies already have to distribute proxy cards and additional nominees added to those cards would be no imposition.[228]

Experts also take issue with the use of "public float" to measure an issuer's size, rather than straight market capitalization. The proposed exemptions from proxy access for smaller issuers use a measure of "public float," generally of less than $75 million. As stated above, the new rules will have a delayed effective date for smaller reporting companies as defined in Exchange Act Rule 12b-2. While the determination of whether a company is a small business is based on a company's assets, "the determination of whether a company is a smaller reporting company is generally based on a company's public float."[229] "The more shares held by those "affiliated" with the issuer, the higher the overall market cap of the issuer that would gain the exemption and the more issuers that will be exempted from proxy access."[230] Commentators argue that it is obvious

which requires independent auditors to report on the management's assessment. Fawn Johnson, *House Panel OKs Small-Business Exemption on Accounting Rules*, WALL ST. J., Nov. 4, 2009, http://online.wsj.com/article/SB125735033507128259.html.

[225] Shapiro, *supra* note 15.

[226] Some believe that much of the costs associated with traditional proxy contests are due to duplicative and unnecessary information. Kahan and Rock argue that the net costs savings would be made virtually trivial if the SEC were to remove the requirement for dissident proxy statements to include information already in the company's proxy statement. Kahan & Rock, *supra* note 9, at 35.

[227] Shapiro, *supra* note 15.

[228] Facilitating Shareholder Director Nominations Rule, *supra* note 206, at 69.

[229] The SEC expects that most small businesses that would be subject to the new rules would also qualify as smaller reporting companies. Facilitating Shareholder Director Nominations, *supra* note 5, at 385 n.1076.

[230] Shapiro, *supra* note 15.

that the more shares held by affiliated parties, the greater likelihood of a dysfunctional and unresponsive board.[231]

The following example illustrates the concern: Company A, with a $75 million market-cap or lower, no matter what the "affiliated" ownership, is exempt from proxy access; Company B, with an $80 million market cap and no "affiliated" ownership will be subject to proxy access; and Company C, with a $110 million market cap company but with thirty-five percent "affiliated" ownership means market float of only $71.5 million is also exempt.[232] Yet with thirty-five percent insider ownership, the accountability mechanism of proxy access is believed to be most necessary. "[W]ith such high insider ownership in Company C, above, passage of a shareholder 14a-8 proposal to establish an even stronger proxy access rule (where it would seem most needed) is almost impossible."[233]

IX. THE SEC PLACES A STAY ON THE NEW RULES

By late September of 2010, the U.S. Chamber of Commerce and the Business Roundtable had filed suit in the United States Court of Appeals for the District of Columbia seeking review of the recent changes to the proxy access rules.[234] Each claims that new proxy rules would give special interest groups undue power in board elections. Less than a week later the SEC put a stay on the new rules, reasoning that it did not want to force companies into costly compliance while the applicable rules faced litigation.[235] The Commission will stay the effectiveness of the amendment to Rule 14a-8 adopted contemporaneously with Rule 14a-11.[236] The Commission did not address the merits of the challenges. Rather, the Commission determined under its discretion[237] that the stay was consistent with what justice required.[238]

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[231] *Id.*
[232] *Id.* The math is as follows: 100% to 35% affiliated equals 65% public multiplied by $110 million market cap.
[233] *Id.*
[234] Petition for Review, Bus. Roundtable v. Sec. Exch. Comm'n, No. 10-1305 (D.C. Cir. Sept. 29, 2010).
[235] Order Granting Stay, *supra* note 27, at *1. The SEC found that, under all of the circumstances of this matter, a stay of Rule 14a-11 and related rule amendments were consistent with what justice required. *Id.*
[236] *Id.*
[237] 15 U.S.C. § 78y(c)(2) (2006). Section 705 of the Administrative Procedure Act also provides that an agency may stay its own action pending judicial review when it finds that "justice so requires." 5 U.S.C. § 705 (2006).
[238] Order Granting Stay, *supra* note 27.

X. FUTURE IMPLICATIONS

Boards, led by their corporate governance committees, must determine the likelihood of a shareholder director nominee. A company with very active shareholders must determine the positions of those shareholders and whether they are likely to act as a group. Group activism will make it more likely for a shareholder nominee to be elected. Similarly, these activists may be more likely to seek the election of a special interest nominee; private interests include union representation and public policy concerns. Depending on these determinations, "boards may decide to open a dialogue with shareholders who are likely to propose nominations for inclusion on the proxy so as to avoid an impairment of the board's ability to function effectively."[239]

Experts in the field are advising companies subject to the new rules to "review their shareholder list to identify which shareholders or groups of shareholders would have the requisite share ownership . . . that would enable them to present nominations for inclusion in the proxy materials."[240] In addition, a company's shareholder profile should include analysis reviewing the type of shareholder, size of holdings, turnover patterns, and length of holdings.[241] Lastly, experts have recommended that companies "revisit how the board's performance has been rated and corporate governance assessments, such as RiskMetrics' corporate governance quotient."[242]

The effect the new rules will have on established state law remains to be seen. The aforementioned enabling statutes will be minimized as the SEC has indicated that companies will no longer have the option to operate under stricter bylaws than are provided for by Rule 14a-11. Prudent boards will review all shareholder candidates in order to ensure each candidate meets the criteria for board members, if any, established in the bylaws.[243] Indeed, charters and bylaws may need to be revised to fit the suitable requirements of Rule 14a-11. This review will require documentary proof, yet another expense of time and resources.

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[239] *SEC Proposes New Rules Facilitating Shareholder Nominations of Directors*, JONES DAY (June 2009), http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=6342.

[240] *Id.*

[241] *Id.*

[242] *Id.*

[243] Under Rule 14a-11(f)(1), companies are required to determine whether any of the events permitting exclusion of a shareholder nominee have occurred.

XI. CONCLUSION

Proxy access is designed to increase fairness and accountability in the process. However, it is not entirely clear the new rules will produce real changes in corporate governance. Based on the evidence of Kahan and Rock, it seems proxy access may result in few nominations.[244] Once the nominations are made, even fewer will result in actual election of those nominees, with marginal impacts on the functions of the company. Regardless, the new rules have generated vigorous debate and may increase shareholder awareness of corporate governance issues. Only time will tell once the SEC stay is lifted, but the effects may create more of a soapbox for lawmakers than practical consequences for corporate governance.

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[244] *See* Kahan & Rock, *supra* note 9.