MITIGATING THE HARMFUL EFFECTS OF PROXY ACCESS (SEC RULE 14a-11)

(DRAFT 06.06.11)

By Bernard S. Sharfman*

ABSTRACT

Traditionally, the nomination of directors has been under the control of the board of directors and its nominating committee. However, Section 971 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 14(a) of the Securities Exchange Act of 1934 to permit the Securities and Exchange Commission (SEC) to adopt rules that will allow shareholders access to a public company's proxy solicitation materials for purposes of nominating their own directors. In response, the SEC promptly issued Rule 14a-11 which provides the current rules for giving certain shareholders proxy access.

A key aspect of the current proxy access rules is that they are mandatory. There is no opportunity to opt-in or at least opt-out. This one-size-fits-all approach to corporate governance is wealth reducing because it does not allow for private-ordering. In addition, federally mandated proxy access eliminates the benefits of our federalist system from this area of corporate governance. Why proxy access will be less without state experimentation is because there is no basis to believe that the SEC has discovered the optimal default rule for proxy access. Supporting this assertion, it is argued here that Rule 14a-11 will lead to increased error in the nomination of directors and a shifting of opportunistic behavior from corporate management to certain shareholders who, unlike directors, are not subject to fiduciary duties.

If the SEC insists in pursuing mandatory proxy access, no matter what the outcome of the pending litigation, then a way must be found to mitigate its harmful effects on corporate governance. To mitigate these effects it is recommended that only those shareholders who are information traders should have access to company proxy materials for purposes of nominating their own candidates for board membership.

*Mr. Sharfman is an adjunct professor of business law at the George Washington University School of Business. This article is dedicated to Mr. Sharfman's wife, Susan Thea David, and his daughter, Amy David Sharfman, for without their love and encouragement this article would never have been completed.

TABLE OF CONTENTS

I. INTRODUCTION

Traditionally, the nomination of directors has been under the control of the board of directors and its nominating committee.[1] In this role, the board is to evaluate the characteristics of the existing management team and incumbent board members and the challenges and opportunities facing the corporation and then take these factors into consideration when nominating director candidates.[2] However, this traditional function of the board is now under attack from new federal legislation and recently promulgated Securities and Exchange Commission (SEC) rules allowing certain shareholders to participate in the nominating process.

Section 971 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act)[3] amended Section 14(a) of the Securities Exchange Act of 1934

---

[1] See NYSE, Inc., Listed Company Manual, § 303A.04303A.04(a) (Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.) and NASDAQ, Inc., Listing Rules RR. 5605-6(e) ((1) Director nominees must either be selected, or recommended for the Board's selection, either by: (A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate, or (B) a nominations committee comprised solely of Independent Directors.).

[2] Elaine Buckberg and Jonathan Macey, *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation*, NERA Economic Consulting (April 17, 2009) at 10, available at http://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf.

[3] Section 971 provides the SEC with undisputed authority to use its authority to promulgate proxy access rules as long as it can be justified on the grounds that it is "in the interests of shareholders and for the protection of investors":

(a) PROXY ACCESS.—Section 14(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(a)) is amended— (1) by inserting ''(1)'' after ''(a)''; and (2) by adding at the end the following:

''(2) The rules and regulations prescribed by the Commission under paragraph (1) may include— ''(A) a requirement that a solicitation of proxy, consent, or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer; and ''(B) a requirement that an issuer follow a certain procedure in relation to a solicitation described in subparagraph (A).''.

(b) REGULATIONS.—The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, (the Securities Act) to permit the SEC to adopt rules that will allow shareholders access to a public company's[4] proxy solicitation materials for purposes of nominating their own directors. In response, the SEC promptly issued Rule 14a-11[5] which provides the current rules for giving certain shareholders proxy access.

A key aspect of the current proxy access rules is that they are mandatory. Public companies are not allowed to opt-out of the proxy access rules unless their governing documents or the state corporate law under which they operate prohibits the nomination of directors by shareholders.[6] This one-size-fits-all approach to corporate governance is much reviled among corporate law scholars and practitioners who believe that a very important reason why corporate law is wealth enhancing is because it allows for private-ordering.[7] That is, company officials and investors are in a much better position to determine the optimal corporate governance arrangements of their company then public officials.[8] In addition, federally mandated proxy access eliminates the benefits of our

---

under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors.

Pub. L. No. 111-203, §971, 124 Stat. 1376 (2010).

[4]A public company or publicly held firm is an economic organization in which (i) management and shareholding are separable and separated functions; (ii) the shares are held by a number of persons; and (iii) the shares are freely transferable. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 n.9 (1992).

[5] SEC, *Final Rule: Facilitating Shareholder Director Nominations*, Release No. 33-9136; 34-62764 (August 25, 2010).

[6] SEC Release No. 33-9136 at 38.

[7] As will be subsequently described, the value of private-ordering must be understood in the context of maintaining a strong centralized authority for purposes of decision-making. *See supra* text accompanying notes __ to __. This limits the amount of private-ordering that can actually take place. As noted by Professor Brett McDonnell, the law makes it very "hard to opt out of the presumption of board authority." Brett McDonnell, *Professor Bainbridge and the Arrowian Moment*, 34 DEL. J. CORP. L. 139, 149 (2009). However, this is not the case for a close corporation which can elect to be governed by its shareholders and therefore can act very much like a partnership if its certificate of incorporation so provides. *See* DEL. CODE ANN. tit. 8, § 351.

[8] Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 1, 24 (2010).

federalist system from this area of corporate governance.[9] As so eloquently stated by Justice Brandeis many years ago, "a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[10] Why the proxy process will be less without state experimentation is because there is no basis to believe that the SEC has discovered the optimal default rule for proxy access.[11] Supporting this assertion, it is argued here that Rule 14a-11 will lead to increased error in the nomination of directors and a shifting of opportunistic behavior from corporate management (board of directors and executive management) to certain shareholders who, unlike directors, are not subject to fiduciary duties.

The imposition of a mandatory regime of inefficient proxy access rules, no matter what the will of the majority of shareholders or the individual needs of a particular firm, must be considered wealth reducing.[12] This suggests that a better approach to proxy access would be to provide public companies the option to opt-in[13] or at least opt-out of the SEC's proxy access rules.

Why the SEC would so quickly embrace rules that have a wealth reducing effect is a reflection of the strong political forces that support mandatory proxy access,[14] as

---

[9] Unfortunately, in the seventy year struggle between state and federal authority over the nomination of a public company's directors, those who favor federal regulation have won a significant victory. For a history of proxy access over the last seventy years, *see* Jill E. Fisch, *The Destructive Ambiguity of Federal Access*, Research Paper No. 11-05, Institute for Law and Economics, the University of Pennsylvania Law School (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1769061.

[10] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, L., dissenting).

[11] Grundfest, *supra* note 8, at 6 ("[B]ecause the Commission has no particular insight as to the preferences of the shareholder majority that might be viewed as value-maximizing at each company subject to the proxy access rules, the Commission would have to guess at the appropriate default rule.").

[12] *Id.*

[13] According to Professor Grundfest, the best option would be to "structure its proxy rules to allow shareholders, acting on their own initiative, to propose, and by majority vote to adopt, proxy access standards that are suited to the individual circumstances of each corporation." *Id.* at 2.

[14] Somewhat surprisingly, the Democratic Party, supported in large part by labor unions and public pension funds (*Id.* at 19), does not have complete ownership of mandatory proxy access. While it is true that mandatory proxy access became a reality under President Obama, allowing for the SEC Commission to be made up of three

evidenced by the inclusion of Section 971 in the Dodd-Frank Act, even though there are no facts to support the argument that proxy access will enhance financial stability,[15] and the shareholder democracy movement in general,[16] fueled by the growing power of institutional investors,[17] the growing importance of shareholder advisory services such as Institutional Shareholder Services,[18] the ability of hedge funds to raise large pools of funds so as to seek significant positions in public companies,[19] and the strong advocacy of public and labor union pension funds for corporate governance reforms.[20]

Rule 14a-11 was to become effective on November 15, 2010. Fortunately, a lawsuit filed by the Business Roundtable and the U.S. Chamber of Commerce in the D.C. Circuit Court of Appeals seeking to have the rules vacated[21] and an accompanying

---

Democrats and two Republicans (The three Democrats voted for proxy access while the two Republicans voted against. *See* Marcy Gordon, *Proxy Access: SEC Gives Shareholders Greater Say On Corporate Board Seats*, Huffington Post (08.25.10).), it should be remembered that William H. Donaldson, a Republican Chairman of the SEC, had proposed a limited form of mandatory proxy access back in 2003. *See* Stephen Labaton, *S.E.C. to Propose Change in Election of Boards*, N.Y. TIMES, May 19, 2009.

[15] According to the preamble to the Dodd-Frank Act, the purpose of the Act is: "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." *See* Pub. L. No. 111-203 Preamble.

[16] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. R. 1255, 1255 (2008) ("The most important trend in corporate governance today, however, is the move toward "shareholder democracy."')

[17] *Id.* at 1275.

[18] *Id.* at 1274.

[19] *Id.* at 1278.

[20] Grundfest, *supra* note 8, at 6.

[21] Business Roundtable, et al. v. SEC, No. 10-1305 (D.C. Cir., filed Sept. 29, 2010). The suit does not deny the authority of the SEC to promulgate proxy access rules only that Rule 14a-11 as currently written was in violation of federal law in numerous respects. *Id.* For example, the suit claimed that Rule 14a-11 was "arbitrary and capricious" and therefore in violation of the Administrative Procedure Act in estimating how often proxy access would be used, how it would be used by certain activist shareholders, and its treatment of state law. *Id.*

motion for a stay of the proxy rules[22] has resulted in the SEC granting the stay[23] until the Court of Appeals can complete its review. At this point, it does not appear that the SEC's proxy access rules will be implemented any sooner than the 2012 proxy season.[24] The delay in implementation has given those who are interested the opportunity to review Rule 14a-11 and make recommendations on how it can be revised so that its inefficiencies can be mitigated.

If the SEC insists in pursuing mandatory proxy access, no matter what the outcome of the pending litigation, then a way must be found to mitigate its harmful effects on corporate governance. One approach is to develop creative defensive corporate governance strategies that would effectively create a partial if not complete opt-out but would also need to be structured to survive a legal challenge based on federal pre-emption or state corporate law.[25] For example, Professor J.W. Verret has recommended that public companies revise their bylaws regarding director qualifications such that it would be difficult for a shareholder to nominate a director that does not have the skills and experience that the board would find satisfactory.[26] Moreover, these bylaws could require that a director hold an MBA degree, have obtained the title of Certified Financial Analyst and have at least 20 years of experience as an executive officer at a comparable institution.[27]

However, there is an alternative approach to the mitigation of the harm caused by mandatory proxy access that should face significantly less in the way of legal challenges. This alternative approach, the focus of this article, is to significantly revise Rule 14a-11 by allowing only those shareholders who are information traders to have access to

---

[22] Business Roundtable, et al. v. SEC, Motion for Stay of Proxy Access Rules, No. 10-1305 (D.C. Cir., filed Sept. 29, 2010).

[23] SEC, Order Granting Stay, In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America For Stay of Effect of Commission's Facilitating Shareholder Director Nominations Rules (Oct. 4, 2010).

[24] Steven Davidoff, *The Heated Debate Over Proxy Access*, Dealbook, The New York Times (Nov. 2, 2010) ("The hope is that the court will rule in time to allow implementation of the proxy access rules by 2012, if they are upheld."), available at http://dealbook.nytimes.com/2010/11/02/the-heated-debate-over-proxy-access/.

[25] 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, 392 (2011).

[26] *Id.* at 404.

[27] *Id.* This is the defensive strategy that Professor Verret believes is least vulnerable to challenge. *Id.*

company proxy materials for purposes of nominating their own candidates for board membership.

The analytical approach taken in this article is meant for general application in all jurisdictions that have their own corporations law. Nevertheless, the discussion that follows has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest U.S. companies are incorporated,[28] and its corporate law often serves as the authority that other U.S. states look to when developing their own statutory and case law.[29] Therefore, the primary examples are from Delaware, but the thinking is meant to be global in nature.

Part II provides an overview of the SEC's proxy access rules. Part III explains how proxy access can be understood as a tool of accountability. Part IV argues that only information traders should be able to take advantage of proxy access. Part V suggests modifications to the SEC's proxy access rules so that they favor information traders. Part Part VI provides a brief conclusion.

II. The Currently Proposed Proxy Access Rules

As already noted, the SEC's proxy access rules do not allow a public company to opt-out of proxy access unless the company's governing documents or the state corporate law under which it operates prohibits the nomination of directors by shareholders.[30] Regarding the process itself, the rules of most interest provide that shareholders will be able to have their nominee included in the proxy materials if:

- They own at least three percent of the total voting power of the company's securities that are entitled to be voted on the election of directors at the annual meeting.[31]

---

[28] *See* Lewis S. Black, Jr., Why Corporations Choose Delaware 1 (2007), *available at* http://corp.delaware.gov/whydelaware/whycorporations_web.pdf. According to the State of Delaware web site, Delaware is the legal home to more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500. *See* Delaware Division of Corporations, http://corp. delaware.gov (last visited May 2, 2011).

[29] Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 Fordham J. Corp. & Fin. L. 393, 397 (2007).

[30] SEC Release No. 33-9136 at 38.

[31] *Id.* at 24.

- Shareholders will be able to aggregate holdings to meet the three percent threshold.[32]

- Shareholders will be required to have held their shares for at least three years.[33]

- A shareholder will be able to include no more than one nominee, or a number of nominees that represents up to 25 percent of the company's board of directors, whichever is greater.[34]

- When a company has a classified (staggered) board, the 25% calculation would still be based on the total number of board seats.[35]

- Where there are multiple eligible nominating shareholders, the nominating shareholder or group with the highest percentage of the company's voting power would have its nominees included in the company's proxy materials.[36]

- Rule 14a-11 is not available to shareholders seeking control of the company. For example, each nominating shareholder must certify on Schedule 14N that it is not seeking corporate control or that it is attempting to nominate more than the maximum number of nominees that is allowed under Rule 14a-11.[37]

- The nominating shareholder or group must provide notice to the company of its intent to use Rule 14a-11 no earlier than 150 days prior to the anniversary of the mailing of the prior year's proxy statement and no later than 120 days prior to this date.[38]

- Moreover, the nominating shareholder or group will be required to file on EDGAR and transmit to the company its notice on Schedule 14N on the same date.[39]

---

[32] *Id.* at 24.

[33] *Id.* at 25.

[34] *Id.* at 26.

[35] *Id.* at 27.

[36] *Id.* at 26-27.

[37] *Id.* at 174.

[38] *Id.* at 26.

[39] *Id.* at 26.

As will be subsequently discussed, the efficiency of these rules would be greatly enhanced if they were written for the benefit of information traders.

III. WHY MANDATORY PROXY ACCESS IS HARMFUL TO CORPORATE GOVERNANCE

For-profit corporations can become very large in size in terms of both employment and investment in plant and equipment. For example, think of General Motors with over 200 thousand employees and its massive investment in automobile factories in the U.S. and around the world. Why a corporation would decide to produce what it needs internally under a command and control structure, and thereby potentially grow to great size in terms of employment and investment in plant and equipment, and not simply purchase from external sources, is a function of transaction costs and the marginal analysis that goes into determining which is the better alternative.[40] In such a Coasean world, firm "managers continuously compare the incremental costs and payoffs of internal production (expansion or vertical integration) against external procurement, choosing whichever alternative provides the best payoff until the two are equalized at the margin."[41] Therefore, it may be simply less costly for the firm to produce what it needs internally under a hierarchical structure of authority versus going out into the marketplace and "making and enforcing all the contractual agreements that would be required."[42]

The point of optimal firm size and shape then becomes a function of this marginal analysis:

> In The Nature of the Firm the comparative costs of the price mechanism, as Coase put it, explained its size and shape. Does it produce its own raw materials or buy them on the open market? Does it provide its own energy by building and operating an electrical or hydraulic plant, or does it purchase electricity on the market? Does it do its own legal work or procure legal services from an outside law firm? The aggregation of many thousands of decisions such as these, ranging from the large to the trivial, gives us a picture of both the size of the firm and the extent of its vertical integration into upstream or downstream areas. The firm's "boundaries"

---

[40] Ronald H. Coase, *The Nature of the Firm*, 4(16) ECONOMICA 386, 393-97 (November 1937).

[41] Herbert Hovenkamp, Coasean Markets 1, 5 (August 2010) (in the words of Professor Hovenkamp), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1580059.

[42] John R. Boatright, *What's Wrong-and What's Right with Stakeholder Management*, 21 J. PRIVATE ENTERPRISE 106, 110-111 (2006).

> are located at the precise point where the marginal cost of inside production and outside procurement are in equipoise.[43]

The genius of state corporate law, especially Delaware General Corporation Law (Del. Gen. Corp. L.), the corporate law that governs the majority of publicly-traded U.S. corporations,[44] is that it recognized, long before Professor Ronald Coase wrote "The Nature of the Firm," the need for the law to facilitate the ability of a corporation to ultimately become a very large organization in terms of both employment and investment and for such a corporation to be efficiently managed. It achieved its goal, according to Professor Adolph Berle and Dr. Gardiner Means, writing just after the 1927 and 1929 amendments to the Del. Gen. Corp. L., by granting "management a staggering degree of power."[45] As described below, a centralized, hierarchical authority is necessary for the successful management of a large corporation.

To facilitate growth, the Del. Gen. Corp. L. provides that the board of directors does not have to seek approval from its shareholders if the board decides to acquire another company as long as the existing shareholders are not diluted by more than 20 percent or if the acquisition is paid for in cash.[46] To facilitate a centralized, hierarchical management structure, a public company's board is provided the exclusive authority to manage and execute the various forms of explicit and implicit contracts that encompass a firm's contractual make-up.[47] However, board involvement in day-to-day operations is not necessary as statutory law allows the board to delegate its authority to executive

[43] Hovenkamp, *supra* note 39, at 9.

[44] *See text* associated with note 28.

[45] A.A. Berle, Jr. and Gardiner C. Means, *Corporations and the Public Investor*, 20 AMER. ECON. REV. 54, 60 (1930). From the perspective of Berle and Means, the success of corporate law in helping to create large for-profit organizations was a cause for alarm as it concentrated economic power in the hands of a limited number of institutions and created the potential for opportunistic behavior by corporate management that was harmful to the interests of shareholders. *Id.* at 55-61. Interestingly, they note that the 1927 and 1929 amendments to the Delaware General Corporation Law were essentially written by New York law firms whose clients included large banking houses and large corporate clients. *Id.* at 59.

[46] DEL. CODE ANN. tit. 8, § 251(f).

[47] Del. Gen. Corp. L. § 141(a) provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (2001).

management.[48] This decentralization frees up many board members from having to participate in the management of the firm, but at the same time consolidates power at the top of a corporation's hierarchy (the board and executive management) without providing shareholders a role in the decision-making mix.[49] As a result, there is a significant imbalance between the authority of the board and executive management versus the accountability that can be provided by shareholders.

Examples of this imbalance are easily observed. For example, corporate assets are controlled by the corporation's board of directors, not its shareholders;[50] it is the board that decides if a dividend will be paid;[51] the board is not required to follow the commands of its shareholders, even if shareholders pass a unanimous resolution requesting the board to act in a specific manner;[52] shareholders may ratify a board's action, but the board must first approve the action; the business judgment rule protects from liability the decisions of independent and disinterested boards' even when their decisions have disastrous outcomes;[53] requiring shareholders to make demand before filing a derivative suit or demonstrating demand futility;[54] and the exclusive right of the board or its nominating committee to select the slate of director nominees that will appear in a company's proxy materials.

---

[48] Del. Gen. Corp. L. § 142(a) provides that "[e]very corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws." DEL. CODE ANN. tit. 8, § 142(a) (2001).

[49] Demonstrating the insignificant role played by shareholders in corporate management, Professor Christopher Bruner has pointed out that "enacting, amending, and repealing bylaws are essentially the only corporate governance actions that shareholders can undertake unilaterally." Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 3 (2011).

[50] Bernard S. Sharfman & Steven J. Toll, *A Team Production Approach to Corporate Law and Board Composition*, 103 NW. U. L. REV. COLLOQUY 380, 383-84 (2009), http://www.law.northwestern.edu/lawreview/colloquy/2009/11/LRColl2009n11Sharfman&Toll.pdf.

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *Id.*

To explain the minimal involvement of shareholders in the decision-making process, Professors Michael P. Dooley and Stephen M. Bainbridge argue that corporate law must protect board authority to maximize economic efficiency.[55] They base their argument on Kenneth Arrow's theory that centralized authority in a large organization is the most efficient for the management and analysis of information.[56]

> Arrow's [theory] starts out with the basic proposition that "authority is needed to achieve a coordination of the activities of the members of the organization." But, more importantly, centralized authority enhances organizational efficiency. According to Arrow, *efficiency is created in a large organization because "the centralization of decision-making serves to economize on the transmission and handling of information*." Arrow's theory on how centralized authority creates value is based on four propositions:
>
> 1. Since the activities of individuals interact with each other, being sometimes substitutes, sometimes complements, and frequently compete for limited resources, joint decision on the choice of individuals' activities will be superior to separate decisions.
>
> 2. The optimum joint decision depends on information which is dispersed among the individuals in the society.
>
> 3. Since transmission of information is costly, in the sense of using resources, especially the time of the individuals, it is cheaper and more efficient to transmit all the pieces of information once to a central place than to disseminate each of them to everyone.
>
> 4. For the same reasons of efficiency, it may be cheaper for a central individual or office to make the collective decision and transmit it

[55] *See* Dooley, *supra* note 4; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547 (2003), *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002) and *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

[56] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68 (1974). Professor Michael Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. *See* Dooley, *supra* note 4, at 467. Professor Bainbridge has adopted Professor Dooley's application of Arrow's theory and readily acknowledges the contribution Professor Dooley has made in the development of his director primacy model. *See* Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 55, at 85 n.11 (2004). For a good discussion of Professor Bainbridge's application of Arrow's work, *see* McDonnell, *supra* note 7.

rather than retransmit all the information on which the decision is based.

For an organization to be successful in its decision making, its decisions must be based on adequate information and made in a timely manner. This requires the organization "to facilitate the flow of information to the greatest extent possible." Such facilitation requires "the reduction of the volume of information while preserving as much of its value as possible." Centralized authority allows for "superior efficiency" by minimizing the number of communication channels required in a large organization.[57]

Furthermore, the value of centralized authority provides extra benefits to widely-held public companies. According to Professor Dooley, the value of centralized authority in an organization is magnified as the knowledge and interests of its members diverge. In a public company, information and interests differ between management and shareholders.[58] Especially where there are a large number of shareholders, it is much more efficient for the board of directors and executive management, the corporate actors that possess an overwhelming information advantage, to make corporate decisions rather than shareholders.[59]

In sum, the value of authority, as represented by the board and executive management, arguably creates a default position under corporate law that the "preservation of managerial discretion should always be the null hypothesis."[60] As such,

---

[57] Bernard S. Sharfman, *The Enduring Legacy of Smith v. Van Gorkom*, 33 DEL. J. CORP. L. 287, 294-95 (2008). (quoting ARROW, *supra* note 54, at 68-70) (footnotes omitted).

[58] Dooley, *supra* note 4, at 466–67. The value of centralized authority is not as great in general partnerships and closely-held corporations because the same persons perform both the managerial and risk-taking (investment) functions. Management and partners or shareholders are essentially one and the same. *Id.*

[59] *Id*. The value of such specialization of function is quite clear. The best managers can be selected without regard to their ability to finance the company. On the other end of the spectrum, the shareholder pool is greatly increased as shareholders are not required to bring decision making expertise along with their equity capital. *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 301 (1986).

[60] Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 55, at 109.

it has been used to defend board use of poison pills,[61] even though it reduces the disciplinary effect on corporate management by protecting them from hostile takeovers.[62]

However, this does not mean that the corporate board and its executives should be allowed to wield its authority without any accountability to shareholders[63] or other stakeholders who make significant firm-specific investments.[64] Management needs to be held accountable for its decisions or else it may act irresponsibly with the "likelihood of unnecessary error."[65] Moreover, "unaccountable authority may be exercised opportunistically."[66] Therefore, it is legitimate to criticize such authority and put into place some sort of "corrective mechanism."[67]

Examples of tools of accountability at public companies include fiduciary duties, the enforcement of fiduciary duties through shareholder class action and derivative lawsuits, required shareholder approval of major corporate actions, the power of shareholders to unilaterally propose and adopt bylaws, proxy contests, director independence requirements for companies listed companies on U.S. stock exchanges, and now proxy access under SEC Rule 14a-11.

From the shareholders' perspective, tools of accountability are meant to keep the board and executive management focused on the corporate objective, maximizing

---

[61] Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 1, 3 (2006)

[62] *Id.* at 52-58. For a beautifully written argument explaining why hostile takeovers are necessary for corporate governance, *see* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965) ("Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders. Compared to this mechanism, the efforts of the SEC and the courts to protect shareholders through the development of a fiduciary duty concept and the shareholder's derivative suit seem small indeed.").

[63] Bainbridge, *The Board of Directors as Nexus of Contracts*, *supra* note 55, at 7.

[64] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[65] ARROW, *supra* note 56, at 73–74.

[66] Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 55, at 107.

[67] ARROW, *supra* note 56, at 75.

shareholder wealth. As understood in the context of the firm as a nexus of contracts,[68] shareholder wealth maximization is the corporate objective when it is ***assumed*** that all of the corporation's contracts are ***complete*** except for the firm's contract with shareholders.[69] Complete contracts "specify all the future payoff-relevant contingencies."[70] Therefore, those who enter into complete contracts would be "contractually protected against any negative consequence."[71] However, the contract with shareholders is anything but complete. Shareholders part with their money in exchange for the expectation of future returns, but without any guaranteed returns.

In a world where all parties are protected by contract except for shareholders, shareholders are truly the sole residual claimants to the net cash flows of the firm. As residual claimants, shareholders take on the residual risk, i.e., "the risk of the difference between stochastic inflows of resources and promised payments to agents," and in

---

[68] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, at 12 (1991); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN at 7 (2008); Michael C. Jensen and William H. Mecking, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976) as reprinted in MICHAEL C. JENSEN, A THEORY OF THE FIRM at 88 (2000).

[69] MARGARET M. BLAIR, OWNERSHIP AND CONTROL at 230 (1995). There is a broad but not universal consensus that shareholder wealth maximization should be the corporate objective. For example, Professors Margaret Blair and Lynn Stout have argued that shareholder wealth maximization does not apply when stakeholders make firm-specific investments in the firm. Firm-specific investments are "irrevocable commitment(s) of resources to the joint enterprise," and can be made by various stakeholders including executives, employees, researchers, creditors, the local community and marketers, among others. Stakeholders are willing to make firm specific investments because they give rise to implicit contracts that provide them with residual claims on the net cash flows of the corporation, just like the residual claims held by shareholders. The board must honor these implicit contracts or else face a reduced investment or disinvestment in the corporation by those stakeholders who allow the company to prosper. When this occurs, shareholder wealth is no longer the corporate objective. *See* Bernard S. Sharfman, *How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms*, 5 VA. L. & BUS. REV. 349, 356 (2011) *citing* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (This article is the seminal work on team production and corporate law.).

[70] Eugene F. Fama and Michael C. Jensen, *Separation of Ownership and Control*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94034 at 3.

[71] Luigi Zingales, *In Search of New Foundations*, 55 J. OF FIN. 1623, 1632 (2000).

exchange receive the right to receive the net cash flows of the corporation.[72] Since shareholders bear risks from discretionary decisions made by the corporation, shareholders would require shareholder wealth maximization as part of the hypothetical bargain with the firm's other parties.[73] This would mean that all major decisions such as compensation policy, new investments, dividend policy, strategic direction and corporate strategy should be implemented based on the best interests of shareholders.[74]

However, contracts are never really complete with non-shareholder parties. It is just too costly when writing up a contract to specify all the future payoff-relevant contingencies.[75] But even if these contracts cannot be made complete, most corporate law contractarians would still argue that shareholder wealth maximization must be the default rule because the gaps in the shareholder contract are significantly greater than found in the contracts of other parties contracting with the firm.[76]

An increase in the application of tools of accountability does not necessarily result in increased shareholder wealth. The fear is that in the process of trying to correct errors resulting from irresponsible decisions, "the genuine values of authority" will be destroyed.[77] Such "a sufficiently strict and *continuous* organ of responsibility can easily amount to a denial of authority."[78] Arrow suggests, "[I]f every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."[79]

The fear that a tool of accountability may be inefficiently applied is the problem with proxy access as currently structured. The responsibility for director nominations is

---

[72] Fama and Jensen, *supra* note 70, at 3.

[73] EASTERBROOK & FISCHEL, *supra* note 68, at 67-68.

[74] MACEY, *supra* note 68, at 7.

[75] Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 232 (1999).

[76] *Id*.

[77] ARROW, *supra* note 56, at 78.

[78] *Id.* (emphasis added).

[79] Bainbridge, *The Board of Directors as Nexus of Contracts*, *supra* note 55, at 7. According to Professor Bainbridge, "Preservation of managerial discretion should always be the null hypothesis." Bainbridge, *The Business Judgment Rule as Abstention Doctrine, supra* note 55, at 109.

being shifted from the corporate apparatus that has the greatest informational advantage in understanding the needs of the corporation, the board of directors, to certain shareholders who do not possess such an advantage and indeed may have little information in that regard. The result will be an increased likelihood of error in the director nomination process.

Moreover, proxy access shifts the potential of opportunistic behavior in the director nominee selection process from the board to those shareholders who are able to get their nominees in the company's proxy solicitation materials. That is, shareholders who take advantage of proxy access may "use their position to self-deal—i.e., to take a non-pro rata share of the firm's assets and earnings—or to otherwise reap private benefits not shared with other investors."[80] For example, Professor Joseph Grundfest points out that proxy access may generate at certain firms significant "megaphone externalities" in the form of the ability of shareholders to draw attention to their own special causes, such as union and pension fund issues, even if their nominees have no chance of winning election.[81] These megaphone externalities may promote objectives that the majority of shareholders do not consider to be in the best interests of the corporation.[82] As a result, certain shareholders are provided "electoral leverage" that can be used in negotiating with the board to extract concessions for whatever they are trying to accomplish, harmful or not to the corporation.[83]

---

[80] Stephen M. Bainbridge, *Shareholder Activism in the Obama Era* (2010) 1, 16, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1437791 (in describing the interests of unions and public pensions in shareholder activism).

[81] Joseph A. Grundfest, *supra* note 8, at 19. The following excerpt from Roberto Romano's article on shareholder activism would appear to describe the benefits that union and pension fund shareholders can reap from proxy access:

> Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment, the "revolving door" issue for government employees, whose salaries are considerably lower than the private sector.

Roberta Romano, *Less Is More: Making Shareholder Activism A Valued Mechanism Of Corporate Governance*, 18 YALE J. REG. 174, 231 (2001).

[82] Grundfest, *supra* note 8, at 19.

[83] *Id.*

As currently written, Rule 14a-11 allows shareholders to take advantage of proxy access without any accountability. Unlike directors, shareholders do not have to take into consideration any type of fiduciary duties when availing themselves of proxy access, and thus encouraging opportunistic behavior. If so, then perhaps fiduciary duties should apply to shareholders who take advantage of proxy access. Professors Anabtawi and Stout argue that, in this era of shareholder democracy where more and more corporate decision-making is being move from the board to activist shareholders, fiduciary duties should apply to activist minority shareholders, similar to controlling shareholders, when they pressure the board and corporate officers to take actions that are in their own self-interest, either in the context of a business decision or a corporate transaction.[84] However, this idea does not appear workable in the context of proxy access. For example, the duty of loyalty would be difficult to enforce as there is no particular business decision or transaction involved that would directly implicate a shareholder's economic self-interest, even though it may be clear that the shareholder who is utilizing proxy access is not acting in the best interests of the corporation or other shareholders. More specifically,

---

[84] Anabtawi & Stout, *supra* note 16, at 1295. According to Professors Anabtawi and Stout:

> [W]e propose that all shareholders, like all directors and officers, be viewed as owing latent duties to the firm and their fellow shareholders. These latent duties would be triggered whenever a particular shareholder—whether or not it is technically a shareholder capable of controlling the boards' decisions as to all matters—in fact manages to successfully influence the company's actions *with regard to a particular issue in which that shareholder has a material, personal economic interest*.

Moreover,

> [S]hareholder fiduciary duties would not, as it is now, be triggered by a particular shareholder's ability to direct corporate decision-making in the abstract, but rather by that shareholder's ability to influence the outcome of a particular corporate decision in which it has a personal conflict of interest. This change in level of analysis—from the general corporate level to the level of a discrete issue—defines the idea of "control" more expansively to account for the reality that modern shareholders can influence corporate policy through a variety of strategies that do not require them to control a numerical majority of the firm's voting shares. Thus, we would say that a shareholder "controls" corporate conduct whenever its action is a determinative, or "but for," cause of the particular corporate decision in issue.

Id. (citations omitted).

how would fiduciary duties be applied when the head of a public pension fund with political ambitions utilizes proxy access to enhance his corporate governance credentials or when a union pension fund utilizes proxy access in order to gain a negotiating advantage with the company for its union members?[85]

Still, there may not be cause for alarm. According to Professors Kahn and Rock, proxy access will not have a significant effect on corporate governance.[86] They claim that institutional investors will not make significant use of proxy access and those investors with the greatest interest in taking advantage of proxy access, hedge funds and union pension funds, will have significant difficulty in satisfying the three percent rule and the three year holding requirement.[87]

Perhaps Professors Kahn and Rock are correct in arguing that proxy access will not have a significant effect on corporate governance. However, if they are wrong, by not taking action now to mitigate the potential value reducing effects of mandatory proxy access, a great opportunity will have been lost to provide the SEC with guidance on how the final rules should be written so as to minimize their potential damage to corporate governance. In addition, mandatory proxy access should be understood as part of a very disconcerting trend, the federally mandated implementation of shareholder democracy, especially as it has imposed over the last ten years through the Sarbanes-Oxley Act,[88] the Dodd-Frank Act[89] and SEC approved stock exchange rules.[90] The cumulative effect may

[85] *See also*, Verret, *supra* note 25, at 398-99 (citing the un-workability of fiduciary duties in the context of proxy access).

[86] Marcel Kahan and Edward B. Rock, *The Insignificance of Proxy Access*, New York University Law and Economics Working Papers (11-1-2010), available at http://lsr.nellco.org/cgi/viewcontent.cgi?article=1244&context=nyu_lewp&sei-redir=1#search=%22%22insignificance+of+proxy+access%22%22.

[87] *Id.*

[88] Pub. Law No. 107-204, 15 U.S.C. §§ 7201 et seq. (2003). The Sarbanes-Oxley Act includes a number of provisions that affect a public company's corporate governance. For example, it requires independent audit committees, restricts a company's purchases of non-auditing services from their auditors, prohibits corporate loans to officers, requires executive certification of financial statements and the clawback of CEO and CFO non-salary compensation in the event of a material restatement of the company's financials. For an excellent critique of the Sarbanes-Oxley Act, *see* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005).

[89] The Dodd-Frank Act has several other significant corporate governance provisions besides proxy access. For example, Section 951 requires periodic shareholder advisory votes on executive compensation (say-on-pay), Section 952 requires that the compensation committees of a reporting company, Section 953 directs the SEC to require

be extremely harmful and threaten the attribute of corporate law that makes it so beneficial to large organizations: the providing of the board and executive management with an extreme amount of authority to manage the corporation.

IV. UTILIZING INFORMATION TRADERS TO MITIGATE THE INEFFICIENCIES OF MANDATORY PROXY ACCESS

Rule 14a-11 shifts responsibility for director nominations from the corporate apparatus that has the greatest informational advantage in understanding the needs of the corporation, the board of directors, to certain shareholders who do not possess such an advantage and indeed may have little information in that regard. The result should be an increased likelihood of error in the director nomination process.

Assuming an opt-out provision will not be available, the goal is to revise Rule 14a-11 so that the increase in error and opportunistic behavior is mitigated to the greatest extent possible.[91] This requires an approach to proxy access that limits its use to only those shareholders that have an adequate level of information to make an informed decision in the best interests of the corporation, something akin to what we expect of

---

public companies to provide additional disclosures with respect to executive compensation, Section 954 expands the ability of the SEC to clawback executive compensation, and Section 972 requires that companies disclose whether the same person holds both the CEO and Chairman of the Board positions and why they either do or do not do so. Dodd-Frank §§ 951-954 and § 972.

[90] Under Section 19(b)(1) of the Securities Exchange Act of 1934, stock exchanges, such as the NASDAQ and the NYSE, must gain SEC approval for rule changes prior to implementation. 15 U.S.C. 78s(b)(1). A key focus of the major U.S. stock exchanges is to make sure that the board of a listed company is composed of a majority of independent directors. In general, independent directors can be defined as directors whose ties to the corporation are not so significant as to influence their judgment in corporate matters. The stock exchanges set out both subjective and objective tests for establishing director independence. *See e.g.*, NYSE, Inc., Listed Company Manual, §§ 303A.02 (2006). Moreover, the stock exchanges require a listed company to have a majority of independent directors and that the major corporate board committees—audit, compensation, and nominating—be composed entirely of independent members. *See e.g.*, NYSE, Inc., Listed Company Manual §§ 303A.04–303A.06 (2006).

[91] One can think of this goal as trying to seek a “pareto improvement” in the current mandatory rules. That is, the goal is to change the rules such that all affected parties are better off and no party is worse off.

directors. As argued here, these investors are what Goshen and Parchomovsky refer to as "information traders."

A. *Differentiating Between Shareholder Types*

The discussion of information traders begins by diverging from the standard model of corporate governance where shareholders are believed to be diversified, passive and suffer from a collective action problem.[92] Even though this may be true to a significant degree, it is more robust to describe a public company's stockholders as either being insiders, liquidity traders, noise traders, market makers or, most importantly, information traders.[93]

Insiders are stockholders, such as board of directors and executive management, who have access to nonpublic information about the firm, but have significant restrictions in the trading of that information for profit.[94]

Liquidity traders do not collect and evaluate information; rather they participate in the market depending on their funding needs.[95] These are your passive, index fund investors.[96]

Noise traders are irrational investors and utilize diverse investment strategies.[97] A major problem with noise traders is that it is hard to differentiate them from information traders.[98] Some noise traders may invest based on fads and rumors while others simulate information traders but in a less efficient manner as they rely on old information or are simply slower in analyzing information that is publicly available.[99]

---

[92] Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 55, at 106 and 112. Smith, *supra* note 75, at 227 ("The rational investor is diversified across all classes of capital assets and consequently is, in spite of much academic cheerleading to the contrary, largely passive.")

[93] Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L. J. 711, 722 (2006)

[94] *Id.*

[95] *Id.* at 724.

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] *Id.* at 724-25.

Market makers are professionals who facilitate trading and maintain a market for securities by offering to buy or sell securities on a regular basis.[100] Market makers are well informed about the demand and supply of a security but they are not as well informed as information traders regarding firm-specific information.[101]

Information traders are those market participants who trade in the financial markets based on recommendations and advice and those who provide such recommendations and advice.[102] These traders "are willing and able to devote resources to gathering and analyzing information as a basis for their investment decisions."[103] Information traders include sophisticated professional investors such as institutional investors, money managers and other market professionals.[104] Analysts who do not trade for their own account are still considered information traders (indirect traders) because they provide valuations and recommendations to their clients who will then utilize this information for their own trading purposes.[105] Information traders look for differences between value and price based on the information they possess and "then trade to capture the value of their informational advantage."[106] Information traders move security prices toward their fundamental values and are in essence "the agents who render markets efficient."[107]

B. *The Importance of Information Traders*

Unfortunately, the role played by information traders in the financial markets has been minimized because the "efficient markets hypothesis" has been misunderstood to mean that information traders add little value to the pricing of publicly traded securities. The efficient market hypothesis "states that in free and actively traded markets, stock

---

[100] *Id.* at 725.

[101] *Id.*

[102] *Id.* at 723.

[103] *Id*. at 723.

[104] *Id*.

[105] *Id*.

[106] *Id*. at 726.

[107] *Id*. at 719.

prices will fully reflect all available information about the corporation."[108] Such a misunderstanding can be summarized as follows:

> Adherents of the efficient market thesis contend that the principal tool of securities analysts in predicting future stock prices--the use of fundamental or intrinsic value analysis to find undervalued or overvalued stocks-is useless, at least for the average analyst and average investor. This is so because the market has already taken into account expected events in currently pricing the stock. Accordingly, the current stock price is the best estimate of the stock's intrinsic value, and future price movements will be random.[109]

This statement essentially says that an efficient securities market does not need the help of information traders to implement a price setting process as it is always in equilibrium. But how can the securities markets even come close to equilibrium without the involvement of information traders?[110]

Information traders must be motivated to gather and analyze information in order for securities prices to move as close as possible to their fundamental values at any particular point in time.[111] For example, think of a financial market where there are no information traders, only liquidity traders.[112] Such a market would be characterized by general price shifts affecting all indexed stocks as the liquidity needs of these investors shift over time.[113] However, such a market would not be able to price securities close to

---

[108] Barbara A. Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N. C. L. REV. 435, 437-38 (1984).

[109] *Id.* at n.8 *citing* Fama, *Random Walk in Stock Market Prices*, FIN. ANALYSTS J., Sept.-Oct. 1965, at 55, *excerpted in* ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 156, 157-62 (R. Posner & K. Scott eds. 1980).

[110] Bernard S. Sharfman, *Taking a More Sophisticated Approach to Market Efficiency: How Securities Analyst Reports can be used to Establish Loss Causation in a Federal Securities Fraud Action*, 38 SEC. REG. L. J. 57, 58 (2010).

[111] *Id.*

[112] Jill E. Fisch, *Confronting the Circularity Problem In Private Securities Litigation*, WISC. L. REV. 333, 346 (2009). According to Professor Jill Fisch, "Passive diversified investing may be a rational strategy for a particular investor, but this strategy is devastating for the market as a whole." *Id.*

[113] Gosen and Parchomovsky, *supra* note 93, at 726.

their fundamental values as liquidity traders buy and sell securities regardless of new information, making their trades random relative to new information entering the market.[114] Thus, without market participants such as information traders, there would be no mechanism in place to allow a market to efficiently price securities.

The error in ignoring the contributions of information traders in the pricing of securities was first pointed out by Professors Sanford J. Grossman and Joseph E. Stiglitz.[115] They noted that it is not possible for securities markets to operate without market participants investing in information and earning positive returns for their efforts:

> If competitive equilibrium is defined as a situation in which prices are such that all arbitrage profits are eliminated, is it possible that a competitive economy always be in equilibrium? Clearly not, for then those who arbitrage make no (private) return from their (privately) costly activity. Hence the assumptions that all markets, including that for information, are always in equilibrium and always perfectly arbitraged are inconsistent when arbitrage is costly.
>
> We propose here a model in which there is an equilibrium degree of disequilibrium: prices reflect the information of informed individuals (arbitrageurs) but only partially, so that those who expend resources to obtain information do receive compensation.[116]

Trading on information is what moves securities prices toward equilibrium, even if equilibrium is unobtainable.[117] According to Professors Ronald J. Gilson and Reinier H. Kraakman, such information about a company comes in two forms, hard or soft.[118]

---

[114] *Id.* at 729.

[115] Sanford J. Grossman and Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AMER. ECON. REV. 393 (1980).

[116] *Id.*

[117] Goshen and Parchomovsky, *supra* note 93, at 730. According to Professors Goshen and Parchomovsky:

> A perfectly efficient equilibrium, however, is unattainable. Because prices always deviate from value and information traders engage in a continuous alignment of prices and value, the fluctuations of price around value represent some level of inefficiency. Yet, it is precisely this inefficiency that creates an incentive to invest in information and constantly pushes the market to become more efficient. (footnotes omitted)

[118] Ronald J. Gilson and Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 561 (1984).

Hard information is what has been referred to as hard facts. Soft information, on the other hand, would be the forecasts and predictions about a company's value and prospects such as developed by securities analysts.[119] The two types of information are linked through the process by which an analyst will study the newly disclosed hard facts and incorporate them into her security valuation.[120] Such study and the resulting modifications in security valuation create new (soft) information for investors to trade on, helping the market properly price the security.[121] Moreover, *the process of study takes time* and therefore, the information it generates, the resulting changes in valuations, is not immediately available to the market.[122]

C. *Informational Traders and Proxy Access*

As already stated several times, but bears repeating, mandatory proxy access shifts the responsibility for director nominations from the corporate apparatus that has the greatest informational advantage in understanding the needs of the corporation, the board of directors, to certain shareholders who do not possess such an advantage and indeed may have little information in that regard. The result will be an increased likelihood of error in the director nomination process. To mitigate that error, proxy access needs to target those company shareholders who possess the most information to make an informed decision on selecting director nominees.

Noise traders who trade based on fads or past price movements, liquidity traders who invest in indexed funds or investment portfolios that primarily utilize passive investment strategies and market makers in company stock do not devote resources to the gathering of company information in their investment decisions. They clearly do not possess the information to make an informed judgment on which candidates to nominate for seats on the board. If so, then purely on efficiency grounds, these are not the type of shareholders you want to participate in proxy access.

On the other hand, those institutional investors, money managers and other market professionals who gather and analyze information on the company when making their investment decisions have the most information on the company. Information traders have a clear information advantage over the other types of investors. Therefore, a good starting point for mandatory proxy access reform is to limit it to information traders.

---

[119] *Id.*

[120] *Id.*

[121] *Id.*

[122] Sharfman, *supra* note 110, at 59.

In addition, given that the focus of information traders is to look for differences between value and price based on the information they possess and "then trade to capture the value of their informational advantage,"[123] this should also help reduce the potential for opportunistic behavior. However, limiting proxy access to information traders does not provide complete protection against opportunistic behavior. For example, a large institutional investor, such as a public or union pension fund, even though it has invested in company stock based primarily on gathering and analyzing information may trump, ignore or not even seek the advice of its portfolio managers and analysts and pursue proxy access for purely opportunistic reasons.

V. ENHANCING THE SEC'S PROXY ACCESS RULES TO FAVOR INFORMATION TRADERS

To try and restrict proxy access to those investors who can be considered information traders, criteria must be developed that can identify them. At the very least, these criteria should create a *rebuttable presumption* that the investor is indeed an information trader. As a rebuttable presumption, the company should have the opportunity to challenge the claim that the shareholder is actually an information trader between the time the nominating shareholder or group first provides notice to the company of its intent to use Rule 14a-11[124] and the time when the shareholder nominations are entered into the company's proxy materials. Presumably these challenges would be handled by the SEC in an expedited manner so a ruling could be made prior to the printing and distribution of the company's proxy materials.

A. *Passive v. Active Investment Strategies*

The key criteria proposed to identity whether or not an investor is an information trader is to distinguish between investors who utilize passive versus active investment strategies. Investors utilizing passive investment strategies, such as investing in standard indexed funds that track the S&P 500 or the Russell 2000, do not need to gather and analyze information relevant to stock valuation. Therefore, they cannot be considered information traders. Investors utilizing active investment strategies, such as actively managing a stock portfolio based on fundamental analysis, would be considered information traders.

For institutional investors who maintain only investment portfolios that utilize passive strategies, the company stock held in those portfolios would not count for proxy

[123] Goshen and Parchomovsky, *supra* note 93, at 726.

[124] The nominating shareholder or group must provide notice to the company of its intent to use Rule 14a-11 no earlier than 150 days prior to the anniversary of the mailing of the prior year's proxy statement and no later than 120 days prior to this date. SEC Release No. 33-9136 at 26.

access. These investments are ruled out of proxy access because the decision to invest in them was made not made based on the gathering and analyzing of information.

For those institutional investors who maintain numerous portfolios, some actively managed and some not, the decision to invest in company stock may or may not have been based on the gathering and analyzing of information. To deal with this situation, the company stock held in actively managed portfolios would count for proxy access while those held in portfolios utilizing passive strategies would not. For example, for the fiscal year ending in March 31, 2010, the New York State and Local Retirement System (the System) reported that of its $51.5 billion in domestic equity investments,[125] 80 percent were managed in portfolios utilizing passive investment strategies, 13 percent managed in portfolios with active investment strategies and 7 percent managed in portfolios with enhanced index strategies.[126] For purposes of proxy access, only the company stock held in the 20 percent of portfolios that utilized active investment strategies would count for purposes of proxy access. The company stock held in the 80 percent of portfolios that utilized passive investment strategies would not.

There is no doubt that distinguishing between investment portfolios based on passive versus active investment strategies will have the effect of reducing the ability of large public pension funds, such as the New York State and Local Retirement System or the California Public Employees' Retirement System (CalPERS), or large mutual funds, such as the Vanguard 500 Index Fund with $112.6 billion in assets as of April 20, 2011,[127] to take advantage of proxy access. However, this is the only way to advance the goal of limiting proxy access to information traders.

1. Attest in Writing

Unfortunately, even if an investor were to claim that company stock was being held in an investment portfolio that utilizes active investment strategies, it can only be presumed that this is the case. An actively managed portfolio may turn out to be one that trades with no rhyme or reason or a portfolio with an enhanced index strategy may have little in the way of active management. Therefore, investors trying to take advantage of proxy access must also attest in writing that they do indeed gather and analyze information in the process of making their investment decisions for the portfolio being used in proxy access.

---

[125] New York State and Local Retirement System, *2010 Comprehensive Annual Financial Report, For Fiscal Year Ended March 31, 2010*, at 71, available at http://www.osc.state.ny.us/retire/about_us/annual_report_2010/index.php.

[126] *Id.* at 61.

[127] Vanguard 500 Index Fund Investor Shares (VFINX), information available at https://personal.vanguard.com/us/funds/snapshot?FundId=0040&FundIntExt=INT.

B. *The Three Percent Rule*

It is believed by several commentators that the Rule 14a-11 provision requiring a shareholder or a shareholder group to own at least three percent of the total voting power of the company's securities in order to have the opportunity of getting their nominees into the company's proxy materials will greatly reduce the ability of shareholders to utilize proxy access.[128] According to Professor Jill Fisch, "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 the institution's portfolio."[129]

Most likely, the hurdle for investors to jump over will become even higher if they will not be able to count as part of their holdings company stock that has been purchased utilizing passive strategies. However, the point of proxy access is not that it generates a lot of activity, but that it is efficiently used as a tool of accountability. As already discussed, corporate law is geared toward giving the board and executive management decision-making authority because it is the best way for large organizations to be governed. Just because proxy access is a federal tool of corporate governance accountability, that doesn't make it any less of a tool. As a tool of accountability proxy access must be applied very gently or else real damage could be done to the efficiency of corporate governance. Moreover, a 3% threshold will most likely minimize the issue of trying to distinguish noise traders from information traders.[130] Therefore, the three percent hurdle or one that is even higher can be justified.

C. *The Three Year Holding Rule*

Contrary to the SEC's assertion that the three-year holding period will limit proxy access to shareholders with a long-term perspective,[131] there is no empirical evidence to support this claim.[132] But more importantly, it is hard to understand the logic in having a three-year holding period. For example, what makes investors who have held large amounts of company stock for 10, 20 or 30 years in portfolios using passive strategies more qualified to utilize proxy access than investors who have held company stock for six months but made their decision to invest based on fundamental analysis? Moreover, this will have a detrimental effect on information traders, such as hedge funds, who have

---

[128] See Kahan and Rock, *supra* note 86 and Fisch, *supra* note 9.

[129] Fisch, *supra* note 9, at 27.

[130] Goshen and Parchomovsky, *supra* note 93, at 724.

[131] Release No. 33-9136, *supra* note 5, at 107.

[132] Fisch, *supra* note 9, at 27.

the ability and desire to buy 3% or more of company stock, but cannot meet the three-year holding requirement.[133]

VI. CONCLUSION

In a Coasean world, the purpose of corporate law can be understood as facilitating the efficient management of large companies in terms of employment and investment. Any new tool of corporate accountability, whether it was created by the marketplace or by operation of law, must be justified on efficiency grounds. Given that centralized authority is so highly valued in a large organization, this means that any new tool of accountability must provide enough value to overcome the default position that the "preservation of managerial discretion should always be the null hypothesis."[134] If the tool of accountability cannot be justified on efficiency grounds, then its justification must be based on public policy.[135] Unfortunately, federally mandated proxy access cannot be justified on either basis, even though it is the path that public corporations are being forced to take.

Mandatory proxy access shifts the responsibility for director nominations from the corporate apparatus that has the greatest informational advantage in understanding the needs of the corporation, the board of directors, to certain shareholders who do not possess such an advantage and indeed may have little information in that regard. The result should be an increased likelihood of error in the director nomination process. Moreover, proxy access shifts the potential of opportunistic behavior in the director nominee selection process from the board of directors and its nominating committee to certain shareholders who, unlike directors, are not subject to fiduciary duties.

Given the critical role information traders play in the workings of an efficient securities market and the informational advantages they hold over other shareholders, the best way to mitigate this increased likelihood of error and opportunistic behavior is to restrict proxy access to information traders. As a means to identify information traders, it is proposed that investors are distinguished between those who use active investment strategies versus passive strategies in the management of their investment portfolios. If

[133] *Id*. *See also* Kahan and Rock, *supra* note 84, at 28 ("The three year holding period is a particular problem for hedge funds, given their intense focus on internal rates of return.").

[134] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 53, at 109 (2004).

[135] *See, e.g.*, Compaq Computer Corp. v. Horton, 631 A.2d 1 (Del. 1993) (The court discussed the statutory right of stockholders under Del. Gen. Corp. L. § 220(b) to inspect the company books if they have a proper purpose and how public policy may allow inspection even if it is adverse to the corporation's interests.).

company stock is held in a portfolio that is being managed utilizing an active investment strategy, then it would be eligible for proxy access.