William & Mary Business Law Review

Volume 2 (2011)
Issue 1

Article 5

February 2011

The Securities and Exchange Commission's 2010 Proxy Access Proposals: A Poison Pill for Corporate Health

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THE SECURITIES AND EXCHANGE COMMISSION'S 2010 PROXY ACCESS PROPOSALS: A POISON PILL FOR CORPORATE HEALTH

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ABSTRACT

The SEC has proposed proxy access rules in the wake of the recent financial crisis. With the stated purpose of removing impediments to the exercise of shareholder voice and increasing director accountability, the proposed rule changes are not without problems. The proposed rules enter a mix in which the corporate governance landscape, shaped by powerful role players, already presents troubling possibilities for activist shareholder abuse. This Article argues that adoption of the proposed rules could be the final piece to a puzzle in which shareholder power is achieved at the expense of long-term corporate health and shareholder value.

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INTRODUCTION

In June of 2009, the Securities and Exchange Commission (SEC) proposed changes to the federal proxy rules.[1] Specifically, by proposing a new rule in Rule 14a-11 and an amendment to Rule 14a-8,[2] the SEC took steps towards giving shareholders a greater voice in corporate governance.[3] This contentious topic, raised in the wake of a serious economic crisis, has engendered lively debate from scholars, practitioners, and interest groups on both sides of the issue.[4]

According to the SEC, the economic crisis has raised "serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in a loss of investor confidence."[5] As a result, the SEC proposed these rule changes to remove impediments to "the ability of shareholders to hold boards accountable through the exercise of their fundamental right to nominate and elect members to company boards of directors."[6]

The means by which proxy access is presumed to enhance director accountability is by enabling shareholders to assume a greater role in director elections.[7] It does so by removing the cost that would otherwise be incurred by a shareholder preparing his or her own expensive proxy materials featuring candidates of his or her choosing.[8] Enabling shareholders to nominate directors inexpensively would thus enhance director accountability by providing a real threat that an incumbent director may be removed from the board.

Although praised by some, these changes give others unease.[9] It is appropriate, therefore, to revisit the current landscape of corporate

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[1] *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,024 (Jun. 18, 2009) (to be codified at 17 C.F.R. pt. 240).

[2] Proposed Rules 14a-11 and 14a-8 are not the only proposed rule changes in the SEC's effort to facilitate shareholder access in board elections; however, they are the two most relevant to the scope of this paper. *See id.* (describing other rules regarding shareholder access in board elections).

[3] *See id.* (proposing changes to "remove impediments to the exercise of shareholders' rights to … elect … boards of directors").

[4] This is evidenced by the fact that the SEC saw fit to re-open the comment period in early 2010. *See* Facilitating Shareholder Director Nominations, 74 Fed. Reg. 67,144, 67,144 (Dec. 18, 2009) (comments were due on January 19, 2010).

[5] *Id.* at 29,025.

[6] *Id.*

[7] *See* Lisa M. Fairfax, *Delaware's New Proxy Access: Much Ado About Nothing?*, 11 TENN. J. BUS. L. 87, 91 (2009).

[8] *Id.* at 91-92.

[9] *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Case Against*

governance in America. This Article argues that upon close examination of corporate governance provisions already in place at many public corporations, current SEC rules, the role played by proxy advisory firms, and the composition of the shareholder group and its members' behavior, it becomes clear that the proposed rules are, at worst, threatening to long-term corporate health and, at best, unwise.

Part I explains what the SEC's proposed Rules provide and why they are perceived, by some, as necessary. Part II examines the current corporate governance landscape, including the major role players and prevalent corporate governance provisions. Part III discusses why giving greater power and a louder voice to shareholders in a climate in which opportunities for abuse already exist is threatening to the long-term health of corporations.

I. PROPOSED SEC RULES FOR FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS

A. Provisions in the Proposed Rules

Proposed new Rule 14a-11 would, if adopted, "require companies to include disclosure about shareholder nominees for director in company proxy materials" under certain circumstances.[10] The certain circumstances to which the proposed Rule refers act as a limitation; Rule 14a-11 would allow a shareholder or shareholder group to avail itself of the Rule only if the shareholder beneficially owns a specified percentage of the registrant's outstanding stock and has owned the stock for at least one year.[11] In explaining the necessity for the new Rule, the SEC noted that because public corporations have dispersed ownership, "director elections are largely conducted by proxy rather than in person and, as a result, impediments that the Federal proxy rules create to shareholders nominating directors through the proxy process translate into the inability

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Shareholder Empowerment, 158 U. PA. L. REV. 653, 653 (2010) (arguing that the "financial crisis exposes major weakness in the shareholder empowerment case").

[10] Facilitating Shareholder Director Nominations, 74 Fed. Reg. at 29,032.

[11] *Id.* at 29,035. The requirement pertaining to amount of shares owned varies depending on the size of the company, measured in assets. *Id.* For example, nominating shareholders need only own 1 percent of a company with net assets of $700 million or more. *Id.* Alternatively, for companies with net assets of $75 million or more, the nominating shareholder(s) must own 3 percent of the company's stock. *Id.*

of shareholders to effectively exercise their rights to nominate and to elect those directors."[12]

In addition to new Rule 14a-11, the SEC has also proposed an amendment to Rule 14a-8(i)(8), which would

> preclude companies from relying on [provisions in current] Rule 14a-8(i)(8) to exclude from their proxy materials shareholder proposals by qualifying shareholders that would amend, or that request an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations, provided the proposal does not conflict with proposed Rule 14a-11.[13]

Under the text of the proposed amendment, proposals may only be excluded as relating to director elections if the proposal "[w]ould disqualify a nominee who is standing for election; [w]ould remove a director from office before his or her term expired; [or] [q]uestions the competence, business judgment, or character of one or more nominees or directors …."[14] Again, the justification for this amendment appears to be that the "election exclusion" relied upon in current Rule 14-8 has operated as an impediment to the exercise of shareholder voice.

B. Why These Changes? Why Now?

As mentioned above,[15] accountability is a central theme underlying the current attempts at reform. In the shareholder proponent camp, Professor Lucian Bebchuk maintains that "[s]hareholder power to remove directors is supposed to provide a mechanism for ensuring that directors are well chosen and have incentives to serve shareholder interests once chosen."[16] Arguing that impediments under the current system preclude the exercise of this important shareholder power, Bebchuk claims that adopting the proposed rules would "improve director accountability."[17] In contrast,

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[12] *Id.* at 29,031.
[13] *Id.*
[14] *Id.* at 29,058 (internal citations omitted).
[15] *See supra* notes 5-8 and accompanying text.
[16] Lucian A. Bebchuk, Essay, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 677 (2007)[hereinafter, Bebchuk, *Myth of the Shareholder Franchise*].
[17] Letter from Lucian A. Bebchuk, Professor of Law, Harvard Law School to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commision (Aug. 17, 2009) (Comment Letter of a Bi-Partisan Group of Eighty Professors of Law, Business, Economics, or Finance in Favor of Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-60089).

proponents of maintaining the status quo argue that adopting the proposed rules would create "[a] shareholder-based agency model of the corporation [that] sends ... a simple instruction: in all circumstances, manage to maximize the market price of the stock."[18]

This has proved to be a divisive issue, as the proposed rules would increase shareholder voice, at least to the extent of creating an *in terrorem* effect in the boardroom.[19] Therefore, it is imperative to re-examine the current landscape of corporate governance in order to ascertain whether these rules are beneficial, or, on the other hand, menacing for corporate health and inimical to long-term shareholder value.

II. CORPORATE GOVERNANCE TODAY

A. Prevalent Provisions at Public Companies

1. Majority Voting

Under Delaware law,[20] elections to the board of directors are decided by a plurality of the vote, that is, the director(s) receiving the most votes are elected.[21] However, this provision may be altered by way of a bylaw amendment adopted by the shareholders, which may "specif[y] the votes that shall be necessary for the election of directors."[22] When such an amendment is passed, the standard is typically set at a majority threshold, meaning that a director must receive a majority of the votes cast in order to be elected.[23] As Claudia Allen notes, majority voting "has become the

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[18] Bratton & Wachter, *supra* note 9, at 658-59.

[19] *See* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 878 (2005) ("Introducing *the power to intervene* would induce management to act differently in order to avoid shareholder intervention.") (emphasis added) [hereinafter, Bebchuk, *Case for Increasing Shareholder Power*].

[20] Although provisions may vary by state, for simplicity's sake, the widespread incorporation of companies in Delaware encourages analysis of Delaware law. *See* Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 59 (2009) (stating that "the consensus among scholars, commentators, and practicing lawyers" is that "Delaware has won" as the most important state for corporate law issues).

[21] *See* DEL. CODE ANN. tit. viii, § 216(3) (2010) ("Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors.").

[22] *Id.*

[23] *See* Claudia H. Allen, *Study of Majority Voting in Director Elections*, Nov. 12, 2007, at 1, *available at* http://www.ngelaw.com/files/upload/majoritystudy111207.pdf (last visited Feb. 2, 2010).

prevailing election standard among large public companies."[24] Indeed, the Allen study indicates that "66% of the companies in the S&P 500 and over 57% of the companies in the Fortune 500 have adopted a form of majority voting."[25] Allen also states that this practice is not limited to large companies, but that "majority voting has been adopted by mid-cap, small-cap and some micro-cap companies."[26]

This shift in the conduct of director elections begs the question whether majority voting is beneficial or harmful to shareholder interests and value. David Porter, a former partner of a prominent law firm, regards majority voting "as a concept of good governance and shareholder democracy."[27] Nonetheless, Porter fears an *in terrorem* effect in which directors must concern themselves with placating shareholders in order to be re-elected each year.[28] Porter states that such fears could well lead to directors focusing on short-term strategies.[29] Calling upon his "experiences in practice," Porter instructs that "an undue focus on short-term strategies will usually result in poor strategies and outcome for the long-term."[30]

Is the adoption of majority voting, by itself, reason for incumbent boards to be concerned? Probably not. A director failing to receive a majority vote in an uncontested election would be a rare occurrence.[31] However, when considered in conjunction with other corporate governance provisions, a threatening mix is brewed. Porter, who believes that majority voting is a matter of good corporate governance, nevertheless predicted that majority voting could become much more threatening to incumbent directors if broker discretionary voting rules were to change.[32] The broker discretionary voting rules have since been amended. To explain the resulting situation, a discussion of this factor, and its relation to majority voting, follows.

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[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] David P. Porter, *Institutional Investors and Their Role in Corporate Governance: Reflections by a "Recovering" Corporate Governance Lawyer*, 59 CASE W. RES. L. REV. 627, 627, 666 (2009) (Porter was a partner at Jones Day in Cleveland, Ohio).
[28] *Id.* at 666.
[29] *Id.*
[30] *Id.*
[31] *Id.* at 663 ("[E]very director in the history of virtually every corporation in America has always received enough votes to be elected under the majority voting standard.").
[32] *Id.* at 663-64.

2. Amendment to Broker Discretionary Voting Rules

In July of 2009, the SEC approved a rule change proposed by the New York Stock Exchange (NYSE) that "eliminate[d] broker discretionary voting for the election of directors" because elections of directors would no longer be considered a "routine" matter for which instructions from the beneficial owners of stock are not required.[33] Prior to the rule change, brokers were permitted to vote without receiving "voting instructions from the beneficial owner on uncontested elections of directors."[34] Under the new regime, brokers may not vote without receiving instructions from the beneficial owner for any director election, whether uncontested or contested.[35]

The result is clear: if one accepts the premise that many retail investors—individuals and not institutional investors—will not give voting instructions to their brokers, fewer votes will be cast for incumbent directors.[36] This may present problems in both contested and uncontested director elections.

It may appear surprising that a director could lose an election when running unopposed. However, a 2004 director election for the Walt Disney Company is illustrative. In that election, had broker votes "not been counted, then CEO and board chair Michael Eisner would have received only 45 percent of the votes in favor of his reelection ...."[37] When coupled with the majority voting provision in place at many corporations, this example makes clear that these two factors, working in tandem, could result in a director losing in an uncontested election.

With respect to contested elections, the possibilities are more troubling for incumbent directors. When a shareholder, or a group thereof, nominates a dissident slate of directors to be elected, their chances of success are greatly increased because, as mentioned above, retail investor

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[33] Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change, as Modified by Amendment No. 4, To Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 To Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered Under the Investment Company Act of 1940, and To Codify Two Previously Published Interpretations That Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts With an Investment Company, 74 Fed. Reg. 33,293, 33,293-94 (July 10, 2009).

[34] *Id.* at 33,293.

[35] *Id.*

[36] Fairfax, *supra* note 7, at 99 ("Brokers' voting overwhelmingly follows the recommendation of incumbent boards.").

[37] *Id.*

votes—which hitherto would have often been voted by brokers in favor of incumbents—may not be available for incumbent directors. This problem would only be exacerbated by facilitating shareholder director nominations under SEC proposed Rule 14a-11. As corporate lawyer Laura Richman points out, "[i]f the SEC adopts [Rule 14a-11] … the impact of lowered retail vote returns may be coupled with a large shareholder or shareholder group supporting its own nominee."[38] The result is clear: incumbent directors may lose, and retail investors will witness a change in the composition of those managing their investment, all without having voiced their approval or opposition.

B. The Role Players

1. Activist Institutional Investors

Institutional investors now comprise a majority of all shareholders in publicly-traded companies.[39] However, activism among institutional shareholders is typically identified with hedge funds. This is so because hedge funds have more of an incentive to participate actively than do mutual funds.[40] Hedge fund managers are paid a fee based on fund performance,[41] whereas managers of other institutional investors, such as mutual funds, are prohibited by statute from receiving incentive-based pay.[42] Thus, hedge funds engage "in active corporate monitoring because the structure of their compensation provides their managers with a direct financial incentive to do so."[43]

Scholars and practitioners alike debate with great force whether hedge funds' active monitoring is beneficial or detrimental to shareholders generally. Those with a hostile view of hedge funds describe them as follows:

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[38] Laura D. Richman, *Amendment of NYSE Rule 452: Elimination of Broker Discretionary Voting in Director Elections* (July 1, 2009), http://www.mayerbrown.com/publications/article.asp?id=7172.

[39] John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better Than "Voice"*, 30 CARDOZO L. REV. 407, 416-17 (2008).

[40] Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 225, 231 (2007).

[41] *Id.* at 231.

[42] *Id.* at 318 (explaining that "§205(a)(1) of the Investment Advisors Act prohibits" mutual fund "managers from receiving compensation" based on "capital gains … of the funds").

[43] *Id.* at 231.

> These are impatient shareholders, who look for value and want it realized in the near or immediate term. Their strategy is to tell managers how to realize that value and to challenge publicly those who resist their advice, using the proxy contest as a threat …. [They] act out a game of threat and resistance in which victory lies in either the insurgent's entry into the boardroom on a minority basis or the target's diffusion of the threat with a governance concession.[44]

Commentators with the opposing view champion hedge funds for "actively direct[ing] corporate policy" and "resolv[ing] corporate law's fundamental agency problem by reuniting ownership and control."[45]

While the utility of hedge fund activism may be debated, its power may not. An illuminating example may be found with regard to hedge fund activity in the boardroom at Deutsche Borse. The Deutsche Borse board, persuaded by the company's CEO, had determined to acquire the London Stock Exchange; however, a hedge fund holding a 5 percent interest in Deutsche Borse, The Children's Investment Fund Management (TCI), opposed the move.[46] TCI opposed the move because it felt that the funds necessary to acquire the London Stock Exchange would be better spent in a stock repurchase.[47] After TCI put a plan in motion to have Deutsche Borse's chairman replaced, the company abandoned its bid for the London Stock Exchange and committed itself to distributing cash to the shareholders.[48] This example makes plain the undeniable power hedge funds wield.

The Deutsche Borse example also sheds light on the concern raised most often by those who view hedge funds in a negative light, namely that hedge funds have a short-term outlook, and thus their interests are misaligned with those of shareholders generally. Hedge funds are considered, by some, to have a short-term focus because they look for an increase in value in the short-term, and they tend to hold stock for less time than do retail investors.[49] This asymmetry between hedge fund interests and the interests of those with a longer-term outlook may lead to

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[44] William W. Bratton, *Private Equity's Three Lessons for Agency Theory*, 3 BROOK. J. CORP. FIN. & COM. L. 1, 11 (2008).

[45] Illig, *supra* note 40, at 228-29.

[46] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1035 (2007).

[47] *Id.*

[48] *Id.* at 1035-36.

[49] *See supra* note 44 and accompanying text; *see also* Kahan & Rock, *supra* note 46, at 1083 ("For some funds, holding shares for a full day represents a 'long-term' investment.").

situations in which short-term capital gains for hedge funds are large, but shareholder value generally will be decreased.

TCI's intervention at Deutsche Borse illustrates how the misalignment of interests could harm long-term value. Without considering the actual merits of Deutsche Borse's proposed bid for the London Stock Exchange, assume that the acquisition would have proved to be a wise investment and provided shareholders with valuable returns in the long-term. Kahan and Rock noted that TCI's intervention would "have had the effect of pushing the company toward the lower value outcome: an outcome worse for long-term shareholders than acquiring the LSE."[50]

Illuminating as the Deutsche Borse example is, it merely reaffirms the original proposition that hedge funds actively monitor board and management decisions. From this point some may argue that hedge fund activism creates value by preventing unwise board decisions, while others may point to examples in which valuable long-term investments were foregone. Whichever side of the story one believes, the ability of hedge funds to intervene in the boardroom is an undeniable fact.

2. Proxy Advisory Firms

Proxy advisory services such as RiskMetrics Group, Inc., Glass Lewis & Co., and Proxy Governance Inc.[51] use "ratings to formulate voting recommendations and other governance-rating providers … to advise on investment decisions."[52] These firms create a rating index based on what they consider to be best practices for corporate governance.[53] The firms then rate a corporation based on how the company's corporate governance provisions compare to the firm's ratings index.[54] Their power is great, and as a result, they have brought change to corporate governance—change that is harmful to long-term shareholder value.

One example of this power can be found with regard to staggered boards. Marc Goldstein, the head of research engagements for RiskMetrics's Governance Services unit and a member of the firm's policy board, wrote an article in which he proclaimed that RiskMetrics

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[50] Kahan & Rock, *supra* note 46, at 1084.

[51] As RiskMetrics is the industry leader, repeated reference to that firm will be made when referring to proxy advisory services generally. *See* Porter, *supra* note 27, at 667 (RiskMetrics is "the most prominent of the proxy advisory services firms.").

[52] Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1807 (2008).

[53] *Id.*

[54] *Id.*

advises shareholders to "make certain that the board they empanel will not be excessively deferential [to management] by … [i]mproving board accountability through the elimination of staggered board elections …."[55] However, the wisdom of this approach for long-term corporate health is questionable. A seasoned corporate attorney declares that "the long-term view is more obviously protected by classified boards ... which emphasizes a longer time horizon …."[56] Nevertheless, a survey of companies to whom proposals to eliminate staggered boards were presented in 2006 revealed that forty-five of forty-six supported the change.[57] While it may be difficult to ascertain how many of those companies' boards were acceding to pressure from a RiskMetrics's advisory opinion, it is fair to presume that RiskMetrics played a role in many of the votes.[58]

The influence of RiskMetrics is unmistakable.[59] However, its influence may be most startling with respect to director elections. Institutional investors, who rely heavily on RiskMetrics's recommendations, virtually always give directions on how to vote in director elections.[60] When considered in light of the "lost votes" resulting from changes to NYSE Rule 452 in broker discretionary voting, it is clear that RiskMetrics, by advising institutional investors, may determine the outcome of many director elections.

In drafting the text of new Rule 14a-11, the SEC made clear that it fails to appreciate the influence of RiskMetrics. Subparagraph (a)(1) states that the rule's provisions enabling shareholder nominations are available only if "the registrant's governing documents do not prohibit the registrant's shareholders from nominating a candidate or candidates for election as a director."[61] This "power" given to the board to amend the charter to prevent the application of 14a-11 is worthless. Given that

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[55] Marc Goldstein, *Mitigating Dysfunctional Deference Through Improvements in Board Composition and Board Effectiveness*, 103 NW. U. L. REV. COLLOQUY 490, 491 (2009), www.law.northwestern.edu/journals/lawreview/Colloquy/2009/21.

[56] Porter, *supra* note 27, at 666.

[57] Illig, *supra* note 40, at 261.

[58] *See* Porter, *supra* note 27, at 667 ("[F]or many corporations, it is common wisdom that a majority of their institutional shareholders will follow the advisor's recommendations slavishly, and so the outcome of the shareholder proposal may well be determined by what position RiskMetrics has taken on the matter.").

[59] *See id.* ("[RiskMetrics'] real role in many cases is absolute and determinative, rather than merely advisory.").

[60] *Id.* at 669.

[61] Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,082 (Jun. 18, 2009) (to be codified at 17 C.F.R. pt. 240).

RiskMetrics advocates holding boards accountable through the elimination of staggered boards, one can confidently assume that RiskMetrics would take a similar stance with regard to a charter amendment that displaces the provisions of 14a-11.[62] Because institutional investors follow advice received from RiskMetrics,[63] institutional investors are likely to be able to rip such a limiting provision from a corporate charter as fast as the directors can place it there.[64] The SEC has thus proven itself incapable of understanding the powerful influence of proxy advisory services.

The prospect of RiskMetrics determining the outcome of director elections is troubling for long-term shareholder value when one realizes that much of what RiskMetrics advises may not be in the best interests of the long-term health of a company.[65] However, a final adoption of the SEC's proposed rule changes will only enhance the influence of RiskMetrics and other proxy advisory firms as institutional investors will have greater access to the company's proxy materials.

3. The Phenomenon of "Borrowed Shares"

Henry T. C. Hu and Bernard Black published an article describing the practice of, and problems arising from, borrowing shares in a corporation.[66] An individual "borrows" shares by finding a shareholder willing to "lend" the shares.[67] The transaction results in the "borrower" acquiring the voting rights connected to the shares, while the lender retains the economic interest in the corporation whose stock has been borrowed.[68] Perhaps unsurprisingly, share borrowing is practiced to a large degree by hedge funds.[69] This "decoupling" of voting rights from economic interests presents problems for the outcome of director elections. A hedge fund nominating a slate of directors for election may borrow shares on or shortly before the record date, "reverse the transaction" afterwards, and

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[62] *See* RiskMetrics Group U.S. Policy, http://www.riskmetrics.com/policy_exchange/policy_detail?param1=rmgus&param2=board&param3=annual (last visited Nov. 16, 2010) (RiskMetrics promotes voting for proposals to repeal staggered or classified boards).

[63] Porter, *supra* note 27, at 667.

[64] *See* Bratton, *supra* note 44, at 11 (noting that hedge funds exercise their power to exact governance concessions).

[65] *See supra* note 56 and accompanying text.

[66] *See* Bernard Black & Henry T. C. Hu, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 811-12 (2006) (abstract).

[67] *Id.* at 816.

[68] *Id.* at 818.

[69] *Id.* at 819.

wield greater voting power in the election.[70] Aside from the outward unfairness of the arrangement, this practice undermines the traditional fabric of corporate law wherein voting power is "proportional to economic ownership."[71]

It is worth noting that proposed Rule 14a-11 does include a provision that could prevent some abuses by hedge funds that borrow shares. In order for a shareholder to avail itself of 14a-11, the shareholder must have beneficially owned a percentage of outstanding shares for at least one year.[72] Although this one-year provision would reduce the utility of borrowing shares by disallowing a nomination by an opportunistic shareholder that increases its holdings to the specified amount on or shortly before the record date, it would not extinguish the utility entirely. Because the one-year requirement applies only to the nominating shareholder,[73] nothing prevents like-minded institutional investors from borrowing shares to vote in favor of the dissident slate. Similarly, a hedge fund that already satisfies the threshold ownership percentage required to nominate a director could conceivably still borrow shares to wield greater voting power.

Moreover, hedge funds need not actually engage in share borrowing to effect change, as the mere threat of doing so would produce an *in terrorem* effect on incumbent boards to accede to hedge fund demands.[74] When one considers that the aim of hedge funds can conflict with sound long-term corporate decision-making,[75] the risks posed by share borrowing are brought to light.

III. A PERFECT STORM FOR SHAREHOLDER POWER

Having laid the foundation for analyzing the current landscape of corporate governance and share ownership, it is now possible to understand why the final adoption of proposed SEC Rules 14a-11 and 14a-8 is unwise. To revisit the issue, director accountability in the wake of the recent financial crisis has been given as the justification for proxy reform.[76] As one member of the pro-shareholder camp puts it,

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[70] *Id.* at 816-17.
[71] *Id.* at 811.
[72] *See supra* notes 10-11 and accompanying text.
[73] *See supra* note 11 and accompanying text.
[74] *See supra* note 28 and accompanying text.
[75] *See supra* note 56 and accompanying text.
[76] *See supra* notes 5-6 and accompanying text.

> the most effective way to ensure that directors remain focused on shareholder value—and do not become overly deferential to management—is to establish a credible means for voting them out of office. For this reason, majority voting for directors, declassification of boards, and "proxy access" … are shaping up as key issues for investors and regulators alike as they seek ways to enhance accountability and to prevent a reoccurrence of the financial market meltdown.[77]

This statement, notably made by Marc Goldstein, an officer of RiskMetrics,[78] touches upon many of the aforementioned topics. It does so by claiming that the listed provisions are necessary to enhance accountability and shareholder value.[79] This claim is mistaken. What Goldstein and others point to as the solution to a problem is better understood as the inner-workings of a corporate governance machination that threatens long-term corporate health, and by extension, shareholder value.

The topics discussed in Part II are surprisingly intertwined and combine like pieces of a puzzle to create a picture in which shareholder power is rising. The adoption of proposed SEC Rules 14a-8 and 14a-11 could be the final piece to the puzzle[80] in which shareholders achieve power at the expense of long-term corporate health and shareholder value.

The interconnection of the factors discussed can be explained as follows: hedge funds, with the guidance of proxy advisory firms,[81] can shape corporate decision making from their activist stance,[82] and affect director elections by borrowing shares.[83] Their power to affect director elections is increased by the widespread adoption of majority voting[84] and the amendment to NYSE Rule 452.[85] This power will increase with the final adoption of SEC proposed Rules 14a-11 and 14a-8.[86] It is thus inescapable that when the SEC states its desire to empower shareholders

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[77] *See* Goldstein, *supra* note 55, at 499.

[78] Marc Goldstein is an employee of RiskMetrics Group in Rockville, Maryland. *See* RiskMetrics Group, http://www.riskmetrics.com (search "Marc Goldstein").

[79] *See* Goldstein, *supra* note 55*,* at 499.

[80] *See* Fairfax, *supra* note 7, at 91 ("Shareholder advocates have long viewed access to the corporation's proxy statement as the 'holy grail' of shareholder rights ….").

[81] *See supra* Part II.B.2.

[82] *See supra* Part II.B.1.

[83] *See supra* Part II.B.3.

[84] *See supra* Part II.A.1.

[85] *See supra* Part II.A.2; *see also* Richman, *supra* note 38 ("As a result of the amendment to Rule 452, companies may need to increase their solicitation efforts ….").

[86] *See supra* notes 6-8 and accompanying text.

by way of the proposed rules, it is in reality empowering institutional shareholders, particularly hedge funds. The result is a situation in which real pressure is placed on incumbent directors who wish to be re-elected.

When the discussed factors are considered together, two conclusions are reached: (1) shareholders currently enjoy sufficient power, such that proxy reform is unnecessary; and (2) the increased pressure to be felt by directors will lead them, and the management they oversee, to "manage to the market" at the expense of long-term corporate health and shareholder value.[87]

A. Further Reform in the Interests of Shareholders is Unnecessary

With the adoption of amended NYSE Rule 452, incumbent directors are sure to lose a number of votes in future elections.[88] Meanwhile, institutional investors will continue to vote.[89] When considered alongside the adoption of majority voting, institutional investors already have a real opportunity to affect the outcome of director elections.[90] This is so because hedge funds have the ability to defeat an incumbent director by way of a "withhold-the-vote" campaign.[91] By embarking upon a "withhold-the-vote" campaign at a company that has adopted majority voting,[92] and at the present time when brokers can no longer vote without instructions from the beneficial owners,[93] the ability for an institutional investor or other shareholder to ensure that an incumbent director does not receive a majority of votes is very real. Thus, the present mix of factors impacting director elections is sufficient for shareholders to hold directors accountable, such that adoption of the proposed SEC rules is unnecessary. Indeed, even the starry-eyed shareholder proponent Professor Bebchuk acknowledges that actual proxy contests, which would be enabled by the proposed SEC rules, are unnecessary for shareholders to hold directors accountable.[94] Instead, *the power for shareholders to intervene*, he argues, ensures that directors consider shareholder interests.[95] Because shareholders already wield the power to intervene, as described above,

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[87] *See infra* Part III.A-B.

[88] *See* Fairfax, *supra* note 7, at 99 ("[B]rokers' voting overwhelmingly follows the recommendation of incumbent boards ….").

[89] *See supra* note 60 and accompanying text.

[90] *See supra* note 37-38 and accompanying text.

[91] Fairfax, *supra* note 7, at 99.

[92] *See supra* Part II.A.1.

[93] *See supra* note 35 and accompanying text.

[94] Bebchuk, *Myth of Shareholder Franchise*, *supra* note 19, at 878.

[95] *Id.*

proxy access is unnecessary to produce the wishes of even its loudest proponents.

B. Harm Caused by Managing to the Market

As noted above, a debate rages concerning whether pressure on directors is beneficial from an accountability standpoint or detrimental from a shortsightedness standpoint.[96] However, a close examination of the threat that increased shareholder power poses to long-term corporate health and shareholder value makes clear that the pendulum has swung too far, and proxy reform in the form of the current proposed SEC rules will exacerbate the problem.

When pondering the current corporate governance landscape and the proposed SEC rules, one is confronted with the question of whether increased shareholder power is beneficial. However, it is important to first ask who it is that will be empowered. The answer is hedge funds. Hedge funds are the party to benefit most directly because it is they who engage in active corporate monitoring.[97] As a result, it is imperative to examine whether empowering hedge funds is beneficial to shareholders generally.

Empowering hedge funds will not benefit shareholders generally because their interests are misaligned. As Kahan and Rock note, "hedge funds are set up to make money for their investors without regard to whether the strategies they follow benefit shareholders generally."[98] To note the misalignment of interests between hedge funds and shareholders generally, consider that "institutional investors flip shares with more frequency than retail investors."[99] The divergence of interests is aptly pointed out by Lisa Fairfax, who notes, "granting all shareholders access to the proxy statement could increase the influence of shareholders with narrow or special interests in a manner that could have negative repercussions for … shareholders as a whole."[100]

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[96] *Compare* Bebchuk, *Case for Increasing Shareholder Power*, *supra* note 16, at 677 (arguing that the power to remove directors ensures director accountability), *with* John F. Olson, *Is the Sky Really Falling? Shareholder-Centric Versus Director-Centric Corporate Governance*, 9 TENN. J. BUS. L. 295, 300 (2008) (arguing that empowering shareholders will harm "effective long-range planning").

[97] *See supra* notes 40-43 and accompanying text.

[98] Kahan & Rock, *supra* note 46, at 1071.

[99] Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 739 (2005); *see also* Jennifer O'Hare, *Retail Investor Remedies Under Rule 10b-5*, 76 U. CIN. L. REV. 521, 539 (2008) ("[T]he overwhelming majority of retail investors follow a buy-and-hold strategy.").

[100] Fairfax, *supra* note 7, at 92-93.

Therefore, situations may exist in which long-term retail investors are harmed because hedge funds "seek to push the corporation into steps designed to create a short-term pop in the company's share price so that they can turn a quick profit."[101] Such a situation would be detrimental to shareholders generally if the move advocated by the hedge fund created an initial surge in share price, but turned out to be a poor investment for the company, lowering share price in the long term.

Having thus explored what effect empowering hedge funds will have on other shareholders, it is also important to examine what effect increased shareholder access will have on corporations. The principal objection to shareholder access is that its adoption will increase pressure on boards of directors in a manner that is harmful to long-term corporate health.[102] The reason for this concern is that the louder the voice of hedge funds, the more sensitive boards are to their demands.[103] As previously discussed, hedge funds may seek near-term increases in share price.[104] Thus when boards are compelled, as a result of shareholder access, to listen to the funds, they become short-termist themselves. A former practitioner voiced this concern by pointing out that putting "an undue focus on short-term strategies will usually result in poor strategies and outcome [sic] for the long-term."[105] He likewise recognizes that this very well could result from increased pressure on directors, stating that "if the directors perceive there to be a significant risk that the director can't count on re-election, the director's current long-term outlook may well switch to 'how do I get re-elected next year?'"[106] With adoption of the proposed SEC rules, this result is all the more likely, as "the risk that the director can't count on re-election" will surely be magnified in a given year.

The result is that boards of directors and the management they oversee may "manage to the market."[107] Professor Wachter explains why this is a problem; "[s]hareholder empowerment will make it much more difficult for a good board of directors to resist pressures to manage to the market. This can lead to bad business decisions, either due to information

[101] Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003).

[102] Fairfax, *supra* note 7, at 58 (stating that although increasing shareholder access enhances accountability, doing so has negative long term effects on the corporation).

[103] Kahan & Rock, *supra* note 46, at 1029 (discussing the various levels of hedge fund activism from merely suggesting a new business strategy up to instigating litigation).

[104] *See supra* note 44 and accompanying text.

[105] Porter, *supra* note 27, at 666.

[106] *Id.*

[107] Bratton & Wachter, *supra* note 9, at 690.

asymmetry or a run of speculative mispricing."[108] Further, complications for corporate investment policy "arise when managers manage to the market, factoring expected stock price[s] … into their decisions …. [T]he risk of underpricing [sic] may lead management to pass up [a good] opportunity."[109]

To illustrate the problem, Wachter offers the recent financial crisis as an example. Countrywide Financial, who wrote risky mortgages in the subprime sector during the mid 2000s saw its share price soar, while JPMorgan, who never entered the industry to any great extent, witnessed a lagging stock price.[110] It is not difficult to imagine a hedge fund holding a significant stake in a bank pressuring the bank's board of directors to enter the subprime-lending sector in order to enjoy share price gains comparable to those seen at competing banks. The message is clear: if increased shareholder access equates to corporations managing to the market, extremely unwise business decisions may follow. This suggests that the "solution" may be a different way of arriving at the same problem. It is ironic indeed that the recent financial crisis is offered as an impetus for shareholder access when proxy reform presents the danger of leading to the very same result.

The foregoing illustrates that increasing shareholder power, which is to say hedge fund power, may lead to directors managing to the market.[111] Reuniting control with ownership may thus lead directors to ignore the informational advantages they enjoy over shareholders because they can be forced, whether by proxy contest or "the power to intervene,"[112] to acquiesce to hedge fund demands. In other words, the message may be that "the directors should ignore their own business judgment."[113] Given

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[108] *Id.*

[109] *Id.* at 700-01.

[110] *Id.* at 720 (Fig. 3).

[111] Although beyond the scope of this Article, it is worth noting that directors, or at least management directors, may currently have incentives aligned with hedge funds as a result of equity compensation. *See, e.g.*, Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 986, 994-1000 (2004) (arguing that "the internal design of equity-based compensation, generally, and fixed-price stock options, specifically, promotes corporate 'short-termism' and not long-term productivity"). While this fact may lead one to argue that management already has the perverse incentive to manage to the market—an argument to be taken seriously—it can properly be dealt with by placing greater regulation on a manager's ability to sell his or her shares. *Id.* at 994-97 (noting short-termism caused by lack of holding requirements).

[112] *See supra* notes 94-95 and accompanying text.

[113] Bratton & Wachter, *supra* note 9, at 712.

these considerations, the SEC should be hesitant to alter the current balance of power, as "[t]he prevailing legal model works differently because it instructs the directors to maximize the value of the 'corporation' and not the stock price."[114] This danger, presented by maximizing the share price in place of the value of the corporation, should not be taken lightly.

CONCLUSION

The SEC has responded to the recent financial crisis by proposing rule changes designed to hold directors accountable and increase shareholder value. In proposing these changes, the SEC has proven itself ignorant of the current mix of factors affecting director elections and corporate performance. Because the current landscape provides sufficient opportunities for shareholders to hold boards accountable, proxy reform is an unnecessary evil that threatens long-term shareholder value.

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[114] *Id.*; *see also* Olson, *supra* note 96, at 303-04 ("[The current SEC proposals] create a substantial risk that boards of directors and CEOs will no longer see themselves as primarily responsible for the direction and success of the enterprise, but rather as mere agents implementing shareholder decisions.").