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It's Not the Principle, It's the Money: The SEC and Proxy Access

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The Securities and Exchange Commission (SEC) has now ventured into the troubled waters of the proxy access controversy, but its proposal has created more problems than it has solved. There are only two real issues in proxy access: what will produce the best disclosure for shareholders and who will pay for it. The agency seems to have lost sight of its traditional role. The rule it proposed will ultimately reduce the quality of disclosure to shareholders and impose substantial unnecessary burdens on public companies. The SEC's long-standing policy, which requires two separate proxy statements for an election contest, makes the most sense from the standpoint of the agency's authority and its customary role as an advocate for the best possible disclosure, but if the SEC wants companies to pay the costs of an election contest, there is a better way to accomplish this than the rule the SEC has proposed.

Boards of directors of public companies are generally elected at annual meetings at which shareholders vote by proxy. In the usual case, the company nominates a slate of directors and solicits the votes of shareholders through a proxy statement filed with the SEC. For several years, corporate governance specialists have sought ways to give shareholders a greater voice in the nomination process. One obstacle to this objective has been the cost of preparing and circulating a separate proxy statement, which is a requirement of the SEC's proxy rules. For this reason, a popular idea—known as proxy access—has been to permit shareholders to nominate directors in opposition to the company's slate and include their nominees in the company's own proxy statement. The issue in the proxy access controversy is thus not *whether* the shareholders will have the right to nominate their own directors—they do, and they always have—but whether including their nominees in the company's own proxy statement is the *best* way to achieve this result. The SEC's policy in the past—apparently to promote better disclosure—has been to require contests for director positions to be carried on by the contending parties through separate proxy statements. The SEC now seems to be abandoning this policy.

On July 25, 2007, the SEC proposed two inconsistent rules to address the proxy access issue. One would continue the SEC's policy of requiring separate proxy statements, and will be referred to in this *Outlook* as the Current Policy Proposal. The other, clearly favored by a majority on the SEC in the public meeting that preceded the release of the two proposals, would allow amendments to company bylaws that permit opposition nominees proposed by shareholders to be included in a company's own proxy statement. This proposal will be referred to as the Proxy Access Proposal.

Two inconsistent proposals were issued because SEC chairman Christopher Cox voted in favor of both. The comments of the SEC members at the open meeting indicated that two commissioners favored the Current Policy Proposal and two the Proxy Access Proposal. Chairman Cox, who made his preference for the Proxy Access Proposal clear in his prepared statement, voted to release both as

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a way to obtain "the benefit of the full breadth of commentary about different ways of attacking this issue."[1] Unless a compromise proposal appears, this is likely to be a rare case during the Cox chairmanship in which there is a public difference of opinion among SEC members.

It is not clear why the SEC entered this thicket now. In his prepared remarks at the open meeting at which both proposals were discussed, Chairman Cox cited a decision of the Second Circuit Court of Appeals (discussed below) as the reason that some action was necessary, but the court did not actually require the SEC to do anything more than restate the reasons for its policy. Moreover, the history of the proxy access controversy would certainly have counseled reticence. In 2003, then-chairman William H. Donaldson championed a far-reaching proposal that would have allowed shareholders meeting certain criteria to place their nominees on a company's proxy statement. A strong reaction from the business community stopped this proposal, which had also been opposed by the two Republican members of the SEC, and until the Second Circuit decision it seemed as though Chairman Cox would let this sleeping dog lie. The agency's plate was already full, and Cox himself had shown a marked distaste for splitting the commission with controversial proposals.

Regulatory agencies such as the SEC are given deference in their interpretations of their authorizing statutes—and certainly the meaning of their own rules—but not if their own interpretations are inconsistent with one another.

The Court Decision

Since Chairman Cox cited a decision of the Second Circuit as the reason for the SEC's adopting a new rule on proxy access, it is necessary to look with some care at what the court decided—and what it did not. The case, *American Federation of State, County & Municipal Employee Pension Plan (AFSCME) v. American International Group (AIG)*,[2] was decided on September 5, 2006. AFSCME had requested that AIG place a shareholder proposal for a bylaw amendment on the ballot for its annual meeting. The bylaw would have required AIG to include in its own proxy statement the nominees of one or more shareholders who met certain conditions, either individually or as a group. When the request was made, the SEC's proxy rules permitted shareholders to place proposals in the company's proxy statement for annual meetings, but not if any such proposal "relates to an election" for the company's board of directors. In other words, shareholders were not forbidden from offering director nominees in opposition to those of the company, but to do so they were required to pay the costs of preparing and filing their own proxy statement.

After receiving the AFSCME request, AIG, arguing that the AFSCME proposal "relates to an election," asked the SEC for a no-action letter (that is, a confirmation that the SEC would take no action if the proposal were excluded from AIG's proxy statement). The SEC agreed that the bylaw proposal "relates to an election" and granted the no-action request. AIG then refused to include AFSCME's bylaw amendment in its proxy statement, and AFSCME brought suit against AIG in federal court. The district court found for AIG, and AFSCME appealed. Although the SEC was not a party to the suit, the court asked the SEC for guidance on what the agency meant by the phrase "relates to an election" in its proxy rules. Among other things, the court was puzzled by a series of SEC staff interpretations over the years that seemed first to narrow and then to broaden the scope of the term. Thus, the court wanted to know why the staff had concluded that the AFSCME proposal "relates to an election," when at other times it seemed to have favored a much narrower interpretation. The AFSCME proposal was not, after all, an electoral challenge to the AIG's nominees, but rather only a proposal to set up a procedure that *could* result in a contested election.

The SEC replied by explaining its policy as an effort to ensure adequate disclosure for shareholders in the course of a board election contest. "[I]f proposals like AFSCME's were allowed," the staff argued, "it would be possible for shareholders to wage election contests without conducting a separate proxy solicitation, and thus without providing the disclosures required by the Commission's present rules governing such contests, and potentially without liability . . . for misrepresentations made in proxy solicitations."[3] Thus, the staff letter attempted to justify the exclusion of the AFSCME proposal as inconsistent with the SEC's proxy rules, but it did not explain why the rules were structured this way or why the term "relates to an election" should be interpreted—as a matter of policy—to cover a proposal that would merely have set up the possibility of a contested election.

The letter did not persuade the court, which was trying to understand why the SEC had seemingly changed its interpretation of the rule over the years. Finally, the court concluded:

> The SEC has not provided, nor to our knowledge has it or [the staff] ever provided, reasons for its changed position regarding the excludability of proxy access bylaw proposals. Although the SEC has substantial discretion to adopt new interpretations of its own regulations in the light of, for example, changes in the capital markets or *even simply because of a shift in the Commission's regulatory approach*, it nevertheless has a "duty to explain its departure from prior norms."[4]

The language emphasized above is important. The court was clearly saying that the SEC could change its interpretation of its own rules for any reason, including something as discretionary as a change in its "regulatory approach," but in order to do so it must provide a policy justification. This is consistent with the way the federal courts usually review administrative rulings. Regulatory agencies such as the SEC are given deference in their interpretations of their authorizing statutes—and certainly the meaning of their own rules—but not if their own interpretations are inconsistent with one another. In the latter case, the courts sense arbitrary or capricious behavior rather than the consistent application of a policy. Because the SEC had not provided any policy explanation for broadening the term "relates to an election" so as to cover AFSCME's proposal, the court adopted the SEC's original, narrower interpretation of the term and held that the SEC could not exclude a bylaw amendment that merely set up the possibility of a contested election. The court emphasized that, in taking this position, it was not attempting to prevent the SEC from applying the broader interpretation as long as it explained its position:

> In deeming proxy access bylaw proposals non-excludable under Rule 14a-8(i)(8), we take no side in the policy debate regarding shareholder access to the corporate ballot. There might be perfectly good reasons for permitting companies to exclude proposals like AFSCME's, just as there may well be valid policy reasons for rendering them non-excludable. However, Congress has determined that such issues are appropriately the province of the SEC, not the judiciary.[5]

The court's language makes clear that the SEC did not have to change its policy on proxy access. With no more than an explanation of its policy, the SEC could have interpreted its proxy rules so as to exclude a bylaw proposal like the one advanced by AFSCME. Indeed, the court was saying that the SEC had virtual plenary authority to make this decision. Since the SEC was not a party to the case, it was not even bound by the court's decision, although without any further action by the SEC, it was clear that SEC no-action letters excluding bylaw proposals similar to AFSCME's would henceforth be invalidated in all Second Circuit cases. Nevertheless, after the court's decision, the SEC simply could have reaffirmed its rule by explaining its underlying policy rationale and pointing out that the proposed bylaw amendment undercut the rule's policy foundation.

> A far better system for obtaining full and fair disclosure—which has always been the SEC's guiding principle—would be to require that the company and the challengers each file and distribute their own proxy statements, *separately* making the same arguments they would make in a jointly prepared proxy statement.

A Firm Policy Foundation

Justifying the rule would not have been difficult. The SEC's authority as an agency expert in disclosure to investors and shareholders is unchallenged, and its thirty-year policy of requiring election contests to be carried on through separate proxy statements was clearly the most effective way to inform shareholders about the issues involved in a challenge to the company's board nominees. The AFSCME proposal, if adopted by AIG's shareholders, would have required the company to include shareholder nominees in the company's proxy statement any time a qualifying shareholder or group of shareholders made the request. Although it was not an election itself, the bylaw proposal was certainly tantamount to it. In other words, the proposal required that election contests for board seats be fought out in the same proxy statement. This raises serious issues about adequate disclosure.

Proxy solicitations for contested board seats can become heated. The challengers inevitably have complaints about the existing board and management. In attempting to garner the support of other shareholders, both the company and the challengers will seek to discredit the positions, arguments, and qualifications of the other. This would become very difficult if carried on in the company's own proxy statement. Not only might there be statements in the document that the company believes to be untrue—that might subject it to liability under the securities laws—but the company would want to defend its existing board and the board's decisions over time. The company's defense and its challenge to the qualifications of the challengers' nominees would naturally generate objections and counterarguments by the challengers—a battle of lawyers during the proxy statement drafting process that would be expensive for both sides and unduly prolong the preparation of the company's proxy statement.

In addition, including the challengers' nominees in the company's own proxy statement would seriously complicate the process of soliciting support from shareholders. In that case, the company and the challengers might both be sending to shareholders a document that contains the arguments, allegations, and charges of the other. Accordingly, both sides would try to develop additional solicitation material attempting to explain to shareholders why they should disregard the arguments of the other side made in the original proxy statement. This material would itself be proxy solicitation material, which—depending on the language of the bylaw authorizing the contest—might require the company or the opposition to include the arguments of the other side. This welter of conflicting material would be confusing to shareholders and a source of endless litigation.

> What is really at stake in the proxy access debate are three relatively mundane things: the quality of disclosure to shareholders, the practical and financial burdens placed on corporations, and who pays for offering the shareholders an opportunity to vote for nominees other than those on the company's slate.

Finally, once such a bylaw had been adopted, there is no reason why a determined group of shareholders could not offer their own nominees year after year, charging the company with various forms of dereliction and requiring the company to defend itself. This might be especially true if the dispute is really about political issues such as the company's outsourcing of production, its health-care policies for employees, or its policy on global warming—policies that might be of interest to some shareholder groups but not necessarily in the interests of the shareholders who had invested solely for the purpose of seeing an increase in the value of their shares.

A far better system for obtaining full and fair disclosure—which has always been the SEC's guiding principle—would be to require that the company and the challengers each file and distribute their own proxy statements, *separately* making the same arguments they would make in a jointly prepared proxy statement. This was almost certainly the basis for the SEC's exclusion of shareholder nominees from the company's own proxy statement and could have been the basis for a policy statement—in response to the Second Circuit's decision—reaffirming its exclusion of the AFSCME proposal. In this connection, the agency also could have noted that requiring shareholders who have their own nominees to pay for their own proxy statement creates a disincentive for frivolous challenges to the company's nominees.

The SEC's Response

The Second Circuit decision, however, seemed to paralyze the SEC. The court decision came down in early September 2006. An open meeting to deal with the issue was scheduled for October, then moved to December, and then cancelled entirely. Thus, the SEC moved into the 2007 proxy season without a response to the court's relatively simple question. When other requests for no-action letters came in, as a result of similar bylaw proposals at other companies, the agency refused to provide any guidance. Companies were then faced with a choice of including the bylaw proposal in their proxy statements or fighting it out in court. All chose to include the proposed language, although none of the proposals was ultimately adopted at a shareholder meeting.

The reason for the SEC's delay became clear, however, in the discussion at the open meeting and in the release that accompanied the Proxy Access Proposal. In both cases, the issue was seen not as a question of adequate disclosure (the usual issue for the SEC), but rather as implicating two broader issues (federalism and shareholders'

rights) that are only tangentially related to what was really at stake.

Thus, the agency's release accompanying the Proxy Access Proposal noted:

> [T]he Commission is proposing that the current proxy rules and related disclosure requirements be revised and updated to more effectively serve the essential purpose of facilitating the exercise of shareholders' rights under state law.

It described the proposed rule as a way of promoting federalism by removing SEC obstacles to the working out of state corporate law. It is unusual, to say the least, to describe the SEC's purpose as facilitating the exercise of shareholders' rights under state law. To be sure, the SEC's objective should be to perform its federal role with only minimal impact, if possible, on state corporate law. But the SEC's objective is supposed to be adequate disclosure to shareholders and investors, not the vindication of federalism. What is more, the SEC's Proxy Access Proposal was not even consistent with federalism or state law, since it proposed two requirements—that shareholders proposing a bylaw for a nominating process have held their shares for more than a year, and that they constitute at least 5 percent of the outstanding shares of the company—neither of which is required by state law. Unless related to disclosure or some other SEC objective, the agency's authority to impose such requirements on the states is questionable.

Similarly, in his remarks at the open meeting, Chairman Cox stated:

> There can be nothing more central to our mission of promoting healthy capital formation than defending the rights of capital and the property interests of shareholders. . . . [U]pholding the rights of ownership is fundamental to the maintenance of investor confidence and the workings of our entire free enter-prise system.[6]

This raises the issue to yet another level of abstraction. It is not at all clear that shareholders view corporations as anything other than investments, or that—if they are unhappy about the way a company is managed—they will want to add one or more directors to a board instead of simply selling their shares. Unfortunately, the statement repeats the inaccurate idea that shareholders are the "owners" of corporations.[7] Although this is commonly repeated, it is not true in any precise sense under corporate law. Shareholders who actually use their power to control the actions of a corporation—in other words, who exercise one of the key elements of "ownership"—are likely to lose their insulation from personal liability. The directors of a corporation owe their duties of loyalty and care to the corporation, and only indirectly to the shareholders. They are fiduciaries for the shareholders in the same way that trustees of a trust must manage the trust corpus in the interests of the beneficiaries. Shareholders of corporations are thus much closer to being beneficiaries of a trust than they are to being owners. And who are these shareholders anyway? Most shareholders today are institutions—agents, as my AEI colleague Alex J. Pollock has pointed out, for mutual fund investors, pension beneficiaries, and other principals.[8] In most cases, these principals do not have a vote and are not even consulted about what their "agents" are doing, so providing these agents with a vote is not a meaningful vindication of the rights of anyone's "ownership" in the capitalist system. The oft-repeated idea about shareholders as owners of corporations is a useful slogan for those who are calling for "shareholder democracy," but it is really a reminder of the truth of Oliver Wendell Holmes's remark that "[a] good catchword can obscure analysis for fifty years."

Companies would pay the costs of proxy statements prepared by challengers if the shareholder effort were successful in electing a member to the board.

What Is Really at Stake

If we can come down for a moment from the great questions of federalism and capitalism, what is really at stake in the proxy access debate are three relatively mundane things: the quality of disclosure to shareholders, the practical and financial burdens placed on corporations, and who pays for offering the shareholders an opportunity to vote for nominees other than those on the company's slate.

As between the two inconsistent rules that the SEC proposed on July 25, the best policy, given the purpose and authority of the SEC, would be to reaffirm the existing rule by showing that it is essential to ensure adequate disclosure to shareholders. This should always be the SEC's first priority. If shareholders want to change the

makeup of the board of directors badly enough, they always have the option to do so simply by banding together and sharing the cost of preparing and circulating a proxy statement that offers different nominees. This is not such an undemocratic idea in an age when most shares are held by large institutions such as pension funds, foundations, and mutual funds—institutions that could easily afford to challenge the company's nominees if they thought it worthwhile. With the development of the Internet, the costs of this effort can be substantially reduced while still preserving the disclosure value inherent in separate proxy statements.

Moreover, the best argument in favor of changing the SEC's existing policy is that large institutional shareholders cannot always sell their interests if they are disappointed with the results of the company's operations. Their investments are so large that they cannot easily replace them without suffering losses on the sale and reinvestment. Thus, it is argued, these institutional investors must reform corporations from within. As noted above, however, large institutional shareholders can certainly afford to pay for a proxy statement to advance their interests, and, in any event, these institutions are frequently only agents for principals who are given no voice in deciding whether the individual members of a corporation's board should be replaced by others.

A Compromise Proposal Is Available

The underlying rationale for the SEC's Proxy Access Proposal is to save shareholders' costs of preparing, submitting to the SEC, and circulating their own proxy statement on behalf of their nominees. As Chairman Cox noted at the open meeting:

> [S]ome say that the company's proxy materials, which are produced at the shareholders' expense, should under all circumstances be inaccessible to the shareholders, when it comes to nominating directors. That would seem to stand the principle of "fair corporate suffrage" on its head.[9]

But if the chairman wants to save shareholders the cost of a proxy contest, he need not give shareholders access to the company's proxy statement. There is a way to accomplish the same result without sacrificing the important policy of requiring separate proxy statements.

A sensible and moderate compromise was suggested several years ago by Charles Elson of the University of Delaware's Lerner School of Business. Under Elson's proposal, outlined informally in a 2006 seminar at the university, companies would pay the costs of proxy statements prepared by challengers if the shareholder effort were successful in electing a member to the board.[10] The election of a shareholder nominee would indicate that the concerns about the company's board were not frivolous. Some reimbursement would also be possible if the challengers' effort resulted in a significant shareholder vote in favor of the challengers' nominees, even if none of them were actually elected. Interestingly, this idea was initially picked up by AFSCME itself, which offered the proposal in modified form at several corporate annual meetings in 2006. The proposal was then in the form of a request to the board of directors for an amendment to the bylaws, but it could be offered—if the corporate charter were to permit it—as a shareholder bylaw amendment, as in the AIG case.

Although the formula for reimbursement could take many forms, the 2006 AFSCME proposal for Citigroup contained the following pertinent provisions:

> [I]f any candidate nominated by the [shareholders] is elected to the Board, 100% of the [shareholders'] Expenses shall be reimbursed; (ii) if no such candidate is elected, the Reimbursable Percentage shall be determined by (A) dividing the highest number of votes received by an unelected candidate nominated by the [shareholders] by the lowest number of votes received by an elected candidate, and (B) multiplying the Reimbursable Percentage by the Expenses; provided, however, that if the Reimbursable Percentage is less than 30%, no Expenses shall be reimbursed.[11]

If this idea were to attract support during the comment period on the SEC's new proposed rule, it would amount to a practical, effective compromise between the differing views among the commissioners.

As a compromise, the Elson proposal has much to recommend it. First, it supports the principle of full and fair disclosure through separate proxy statements; this was probably the SEC's original policy reason for excluding shareholder board nominees from company proxy statements. Second, it provides a mechanism for shareholders to be reimbursed for the costs of a legitimate effort to nominate one or more directors in opposition to the company's candidates, even if their effort is ultimately unsuccessful. This addresses Chairman Cox's

concern that the shareholders are ultimately paying for the company's proxy statement, and so should not have to pay for their own. And third, by requiring challengers to the company's nominees to pay the cost of an unsuccessful challenge, it creates a financial disincentive for any group of shareholders to engage in a frivolous proxy contest. Frivolous contests would be possible under the SEC's Proxy Access Proposal and could cause years of confrontation and costs to companies that would prefer to spend their time and money on creating value.

In order to implement this compromise proposal, the SEC could adopt a rule not substantially different from its existing rule. In other words, with modifications that explain its underlying policies more fully, it could adopt the Current Policy Proposal with the following modifications. Like the current rule, the new rule would forbid bylaw amendments that obligated the company to include shareholder nominees in the company's own proxy statement as well as shareholder nominations that are intended to be included in the company's proxy statement. But the rule would permit bylaw amendments that provide for reimbursement—under certain circumstances—of shareholder costs for preparing, filing, and circulating a *separate* proxy statement. The SEC would not have to specify the circumstances under which reimbursement would be permitted; this would be left to state corporate law and the language of particular bylaws. Reimbursed costs would include not only the legal fees the shareholders might incur in preparing the proxy statement, but also any costs of soliciting the support of other shareholders. The legal authority for such a rule would be the SEC's obligation to ensure effective disclosure to shareholders—through separate proxy statements—and would almost certainly pass muster under the standards articulated by the Second Circuit.

The arguments in favor of modifying the SEC's current policy and adopting its Proxy Access Proposal are exceptionally weak. The Second Circuit court of appeals did not require it, and it is not clear that institutional investors—the ultimate beneficiaries of what the SEC is now proposing—really need the help they are being offered. Most important, if it results in the adoption of bylaws that permit shareholder nominees to be placed in proxy statements, it would substantially reduce the quality of disclosure available to shareholders. But if, as appears likely, the SEC is moving in the direction of a change in policy, it makes more sense to adopt a plan that reimburses the challengers for their costs in preparing and circulating their own proxy statement than to adopt the Proxy Access Proposal.

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Notes

1. Christopher Cox, "Opening Remarks at the SEC Open Meeting" (remarks, U.S. Securities and Exchange Commission, Washington, DC, July 25, 2007), available at www.sec.gov/news/speech/2007/spch072507cc.htm (accessed August 1, 2007).

2. *American Federation of State, County and Municipal Employees (AFSCME) v. American International Group*, 462 F.3d 121 (2nd Cir. 2006).

3. SEC staff, letter to Roseann B. MacKechnie (clerk, U.S. Court of Appeals for the Second Circuit), March 24, 2006, 12.

4. 462 F.3d 121, at 129 (emphasis added).

5. Ibid. at 131.

6. Christopher Cox, "Opening Remarks at the SEC Open Meeting."

7. Peter J. Wallison, "Are Corporations Democracies?" *Financial Services Outlook* (December 2006), available at www.aei.org/publication25239/.

8. Alex J. Pollock, "Will the Real Shareholders Please Stand Up? Principals and Agents in the Sarbanes-Oxley Era," *Financial Services Outlook* (July 2007), available at www.aei.org/publication26512/.

9. Christopher Cox, "Opening Remarks at the SEC Open Meeting."

10. Elson worked with R. Franklin Balotti, a prominent Delaware lawyer, in developing this idea.

11. AFSCME, "Citigroup 2006" (company-specific shareholder proposal, 2006), available at www.afscme.org/issues/4980.cfm (accessed August 1, 2007).