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**Proxy Contests in an Era of Increasing Shareholder Power:
Forget Issuer Proxy Access and Focus on E-Proxy**

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**Proxy Contests in an Era of Increasing Shareholder Power:
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The current debate over shareholder access to the issuer's proxy statement for the purpose of making director nominations is both overstated in its importance and misses the serious issue in question. The Securities and Exchange Commission's new e-proxy rules, which permit reliance on proxy materials posted on a website, should substantially reduce the production and distribution cost differences between a meaningful contest waged via issuer proxy access and a freestanding proxy solicitation. The serious question relates to the appropriate disclosure required of a shareholder nominator no matter which avenue is used. Should the nominator be subject to the broad-ranging disclosure requirements now associated with the free-standing contest? Or should there be curtailed disclosure for a nominator (who disavows control motives) of a limited number of directors whose election will not change control? The inescapable costs lie in disclosure, not so much because of the drafting costs, but because of the liability standard associated with the current proxy solicitation rules. A party may be subject to a private suit for material misstatements or omissions in connection with a solicitation even without a showing of scienter. Disclosure under such a regime entails not only the up-front costs of precaution, but also the uncertain

¹ Alfred W. Bressler Professor of Law, Columbia Law School; research associate, European Corporate Governance Institute. Many thanks for comments on an earlier draft to Jesse Fried, Jill Fisch, and Randall Thomas.

(and potentially high) costs of litigation. These costs, not the production, distribution, or other solicitation costs in an e-proxy-eligible world, will constrain director nominations made by a “good governance” activist without a large stake or a control motive. In my view, the current regulatory round associated with the SEC’s side-stepping of the Second Circuit’s ballot access opinion in *AFSCME v. AIG*² has been a diversionary sideshow from this issue.³

Part I of this paper briefly describes what is entailed by “shareholder access to the issuer proxy statement.” Part II summarizes how we have come to the present regulatory moment. Part III describes the e-proxy rules that should lead us to refocus the debate. Part IV sets up the key question: what is the appropriate disclosure (in content and liability risk) that should be required of a shareholder nominator? One obvious possible distinction is between nominators with and without control motives and between cases in which the election of shareholder nominees would or would not shift control of the board.

Packaged into the disclosure question are concerns about the rising influence of institutional investors and the newly fashionable issue of “agency capitalism,” which focuses on the distinctive motives and incentives of the agents for these institutions.⁴ The longstanding tradition in U.S. corporate law is that “a shareholder may vote as he pleases,”⁵ subject to a set of constraints on controlling shareholders who use the corporate machinery for self-dealing or other purposes.⁶ This view was sustained by a long mid-century period in which shareholder voting (outside of a contest for control) diminished in significance in favor of board-centric governance constrained (if at all) by control markets. The move to board-centric governance was, in important part the result

² 462 F.3d 121 (2d Cir. 2006).

³ The SEC recently moved to “codify” what it regarded as its “longstanding interpretation” of the applicable rules to permit exclusion of shareholder proposals that would permit shareholder access to the issuer proxy to nominate directors. SEC Press Release 2007-246 (Nov. 28, 2007); SEC Rel. No. 34-56914, *Shareholder Proposals Relating to the Election of Directors*, reprinted at 72 FR 70450 (Dec. 11, 2007) (effective Jan 11, 2008).

⁴ Ronald J. Gilson, Leo Strine’s Third Way: Responding to Agency Capitalism, 30 J Corp. L (forthcoming 2008).

⁵ Earl Sneed, The Stockholder May Vote as He Pleases: Theory and Fact, 22 U. Pitt. L. Rev. 23, 25 (1960).

⁶ E.g., *Omnicare, Inc. vs. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. Supt Ct. 2003).

of increasingly diffuse shareownership, in which the free-rider and other collective action problems provoked “exit” rather than “voice” by the disgruntled shareholder.⁷

But with the rise of institutional investors, the diffusion of stock ownership has reversed course. The Berle-Means corporation of the 21st century exhibits the separation of ownership from control, in that the owners play no role in management. But the separation now has taken on a new form: instead of millions of dispersed retail investors, we have hundreds (or perhaps thousands) of institutional investors who serve as financial intermediaries. The ability of such institutional actors to coordinate at much lower cost changes the collective action equation and rejuvenates a shareholder activism that depends on shareholder voting as a credible mechanism even outside of a control contest. At the risk of some overstatement, shareholder voting now matters for the canonical large U.S. public firm in ways it has not for seventy-five years. The ramshackle voting system itself needs reengineering.⁸ Are we also in need of a new law of “shareholder duties” to offset potential pathologies? A new set of disclosure obligations? More narrowly, in the director nomination context, should we be content with disclosure whose principal touchstone is control? And outside of contests for control, should we compel disclosure about motives, objectives, and the competences of the various actors?

Part V concludes with some advice to institutional investor activists. In particular: preoccupation with access to the issuer proxy has been a diversion from development of more effective shareholder activism. The e-proxy rules as now drafted permit low cost waging of a proxy contest. Do not mourn the non-adoption of the SEC’s proxy access proposal. Celebrate it, for it might well have *raised* the cost of waging a proxy contest for activist institutions by suggesting that disclosures relevant to “agency capitalism” were necessarily material even in the case of an independent proxy solicitation. Shareholder activists should devote energies to working through the practical mechanics of undertaking e-proxy contests. Instead of “just vote no,” the next step should be “short slate” proxy contests via e-proxy: “just vote for Joe [or someone].” First best choice for most institutional shareholders would be to work with independent nominating committees, particularly where board change seems appropriate. But to induce a fruitful negotiating climate, institutional investors need to make a short-slate campaign a credible alternative. The most significant e-proxy cost is the potential litigation and liability risks associated with allegedly faulty disclosure. But under the rules that are likely to emerge, those disclosure costs will not be much

⁷ Albert O. Hirschman, *Exit, Voice and Loyalty: Response to Decline in Firms, Organizations, and States* (1970).

⁸ Marcel Kahan and Edward B. Rock, “The Hanging Chads of Corporate Voting” (August 13, 2007). U of Penn, Inst for Law & Econ Research Paper No. 07-18, available at <http://ssrn.com/abstract=1007065>.

lower (if at all) in the case of a proxy contest run through the issuer proxy statement. Moreover, in many cases the issuer will refuse to include the relevant materials in the issuer proxy statement on the ground that they are materially misleading, which will lead to protracted litigation in any event. Access to the issuer proxy statement (and the issuer's proxy card) has symbolic value, but if the institutional investors who are, collectively, majority stockholders in many firms, cannot figure out how to send in the contestant's pink card rather than the issuer's blue card (figuratively speaking), then shareholder activism is not ready for prime time.

Part I – Shareholder Access to the Issuer Proxy Statement: A Brief Account

The annual shareholders meeting is the governance crucible of the large public firm. Given the large number of shareholders in most public corporations, it is infeasible for the shareholders to assemble in a physical space for the vote; yet the validity of the vote requires a large turnout, if only to satisfy quorum requirements. The practical solution is the corporation's solicitation of "proxies" that designate corporate agents to vote on the shareholder's behalf. The proxy solicitation process has become a kind of absentee voting system that gives the voter the right to change a vote until the polls close on election day. The SEC's use of its broad regulatory authority over the proxy solicitation process, set forth in the 1934 Securities and Exchange Act, has been one of the major corporate governance drivers for the U.S. public corporation.⁹ As recently demonstrated by the new "Compensation Discussion and Analysis" requirement, the SEC has used its power to assess what information is material to investors in connection with the proxy grant decision to serve broad corporate governance objectives.¹⁰ In addition to disclosure of issuer-specific information, the SEC has determined that the issuer's proxy statement must contain information about upcoming shareholder proposals. In particular, the issuer's proxy card must identify any shareholder proposal and provide shareholders with an opportunity to vote on it.¹¹

A shareholder may undertake an independent proxy solicitation on behalf of any matter to be voted on at the annual meeting, but access to the issuer's proxy statement is nevertheless highly prized. The shareholder proponent can avoid the costs of producing and distributing the proxy statement and, under SEC rules, is not subject to the

⁹ For good discussions of the proxy process in American corporate governance on which some of the following discussion relies, see Melvin A. Eisenberg, *Corporations and Other Business Organizations Cases and Materials* (9th ed. 2005); Jesse Choper et al., *Cases and Materials on Corporations* (6th ed. 2004), and 4 Louis Loss & Joel Seligman, *Securities Regulation* ch. 6 (3d ed. 2000 and supplements).

¹⁰ See generally, SEC Rel. No. 33-8732A, *Executive Compensation and Related Person Disclosure* reprinted at 71 FR 53158 (Aug. 29, 2006) (effective November 7, 2006).

¹¹ See Rule 14a-4(a), (b)(1), (e); Schedule 14A Appendix (forms of sample proxy card).

disclosure obligations of a party who is formally soliciting proxies.¹² Moreover, the ownership requirements to make a shareholder proposal are low, in some cases as little as \$2000 in shares held for one year.¹³ Simply put, most shareholder proposals that find their way into the issuer's proxy statement would not otherwise be made. Two groups have made extensive use of shareholder access to the issuer's proxy statement: corporate social responsibility ("CSR") activists and corporate governance activists. Beginning in the 1970s, CSR activists have presented proposals on a wide-range of public policy issues that corporate actions affect, including matters as diverse as apartheid in South Africa and global climate change. Beginning most prominently in the 1980s, corporate governance activists have presented proposals relating to diverse internal governance issues, including board structure (e.g., classification), takeover defensive tactics (e.g., the poison pill), executive compensation (e.g., "golden parachutes"), and the vote required for director election (majority vs. plurality). Shareholder proposals have become so much part of the customary practice in US corporate governance as to create a market niche for governance service intermediaries, most notably Institutional Shareholder Services ("ISS"), that provide analysis, advice, and mechanical assistance in proxy-voting.¹⁴

The terms and conditions of access to the issuer's proxy statement have been a major corporate governance battleground for several decades. Picking up the general allocation of powers between shareholders and management in corporate law, the SEC permits an issuer to exclude a proposal "if it deals with a matter relating to the company's ordinary business operations."¹⁵ Moreover, the SEC access rule forces most proposals to be framed as recommendations for corporate action--as "precatory" rather than obligatory. Thus, even a proposal approved by a majority of shareholders is typically not self-executing. Nevertheless ballot access has been a potent mechanism in the hands of CSR and corporate governance activists. This is because managements are often eager to avoid the publicity associated with the proponent's campaign, which reaches not only other shareholders but also consumers of the company's products (particularly important in CSR campaigns), as well as legislators and regulators. Managements may particularly want to avoid the embarrassment of rejecting a recommendation that has substantial shareholder support, or potentially majority

¹² See Rule 14a-2(b)(1).

¹³ See Rule 14a-8(b).

¹⁴ For a description of the range of services, see generally the ISS website, www.issproxy.com/issgovernance.html. ISS produces annual reports that summarize the year's important proxy issues, including the degree of shareholder support. See <http://www.issproxy.com/bookstore/index.html>.

¹⁵ Rule 14a-8(i)(7)

support. Being visibly at odds with shareholders is never a good thing. Thus proxy access often opens the way to a negotiated settlement with the shareholder proponent on a host of CSR and governance issues. The desirability of the agenda influence provided by proxy access and the meaningfulness of the negotiated concessions have been hotly debated.

Part II – Our Regulatory Moment

The current regulatory debate is over shareholder access to the issuer proxy (and proxy card) in connection with the nomination of directors. One “red line” that the SEC has maintained throughout various formulations of the access conditions has been that the shareholder proposal cannot relate to a particular election of directors. Justifications for this constraint have varied over time, but the effect has been to rule out a low-cost mechanism for a shareholder insurgent to reach fellow shareholders in a director election. The SEC rule is thus in synch with the standard state law rules that produce reimbursement only if the insurgent wins control of the board; together these rules maintain a high-cost barrier to the waging of a proxy contest. Critics would say that the state law rule is classic incumbent entrenchment, providing evidence that jurisdictional competition for incorporations is geared toward appealing to managerial interests. The SEC’s position, on this view, flows from similar managerial pressure, albeit applied in a different rule-making venue. Friends of the SEC’s position would see the constraint as recognizing potential disruption from an ever-present threat of a director election contest, and thus as legitimately ruling-out a low-cost workaround to the desirable barriers of state reimbursement rules. In its recent public pronouncements, the SEC has articulated a narrower policy claim, asserting that the constraint is necessary to assure that a nominator could not evade the disclosure requirements that are appropriate in an election contest.¹⁶

Over the past 15 years corporate governance activists have paid increasing attention to the election of directors. Joe Grundfest’s 1993 article, *Just Vote No, A Minimalist Strategy for Dealing with Barbarians Inside the Gates*,¹⁷ was an important intervention. Writing in the wake of judicial decisions and state statutes that appeared to permit management to “just say no” to a hostile bid, Grundfest proposed that institutional investors could signal their dismay with poor corporate performance by withholding their vote for the reelection of directors as a group: in other words, to “just

¹⁶ See Sec. Rel. No. 34-56161, *Shareholder Proposals Relating to the Election of Directors*, reprinted at 72 Fed. Reg. 43488, 43490-43493 (Aug. 3 2007)

¹⁷ 45 Stanf. L. Rev. 857 (1993). The article is based on a proposal that Prof. Grundfest first made to the Council of Institutional Investors in November 1990. Id. at 866 n.32.

vote no.” Grundfest contemplated that this public display of disapproval would be symbolic only, “but symbols have consequences.”¹⁸

Over time, “just vote no” or “withhold vote” campaigns have become an important element of the governance landscape. In an important evolutionary twist, the campaigns moved away from an omnibus rejection of the entire board to a targeted rejection of particular directors. This development was spurred by the governance failures that became apparent in the late 1990s and early 2000s. Governance troubles at the Walt Disney Company provide two instructive examples. Shareholders distressed by the roughly \$100 million severance payment received by short-time president Michael Ovitz could “just vote no” against the members of the compensation committee. Similarly, shareholders who thought Disney’s flagging performance showed the declining effectiveness of long-time CEO Michael Eisner could “just vote no” on his reelection to the board. Shortly after receiving a substantial fraction of negative votes, Eisner did indeed depart.¹⁹

Similarly, following the wave of financial restatements that came after Enron-related reforms, angry shareholders turned on audit committee members who had either failed to oversee the audit process adequately or otherwise failed in their disclosure monitoring duties.²⁰ Specific audit committee members became the target of “withhold vote” campaigns. These targeted withhold vote campaigns had more sting precisely because of their *ad hominem* character, which could inflict reputational harm on the director in question. Withhold vote campaigns were also used to back up general corporate governance standards.²¹ So, for example, an institutional investor might withhold its vote for a director who served on more boards than the institution believed wise as a good governance matter.

The limits of targeted withhold vote campaigns produced the next election-related governance reform. Under the charter or bylaw provisions of the typical firm, election of a director required only a plurality vote. So long as a quorum was present, a simple majority of those voting “for” or “against” was sufficient to elect a director, even if a large fraction of shareholders withheld its vote. A director who was not formally

¹⁸ Id. at 866.

¹⁹ Laura M. Holson & Geraldine Fabrikant, Transition at Disney: The Overview; Disney Chief to Leave, Setting Off Race for Job, *New York Times* (Sept. 11, 2004), p.A1, available at 2004 WLNR 5373297.

²⁰ Suraj Srinivasan, 2005. Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements. 43 *J. Accct’g Res* 43, 291 (2005)

²¹ Descriptive evidence on withhold vote campaigns is provided by See Diane Del Guercio, et al., Do Boards Pay Attention when Institutional Investors ‘Just Vote No’?: CEO and Director Turnover Associated with Shareholder Activism, available on SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=575242.

defeated was in fact elected, and might set aside the embarrassment of shareholder disapprobation to take the board seat. This led governance activists to push firms to adopt voting rules that required majority support for director election. So, to provide a simple example, if 100 shares were present and voting at the meeting, a withhold vote of fifty-one percent would, under this governance proposal, defeat a candidate's election. Some large public firms complied with this request, formally changing their voting rule. Other firms adopted a variant, in which the failure to obtain majority support would oblige a director to tender his or her resignation. The board could then decide whether or not to accept the resignation.²²

By the early 2000s, withhold vote campaigns--although by now an accepted governance tool--felt like too anemic a countermeasure for the governance abuses that seemed to unravel daily in the business press.²³ Even if withhold vote campaigns might force out particular directors, they could not install their successors. Governance activists (particularly institutional investors) wanted shareholders to have more power over director nominations as a way of ensuring the election of a group of directors who would be independent from management. Their goal was not a board majority, because the institutions did not have a control motive. Yet the only available route, a regular proxy contest, was unpromising because of standard cost and free rider problems. A prior reform adopted in 1992 to facilitate such institutional investor nominations was regarded as ineffective. Although a contestant could make a solicitation that filled out a "short slate" of its nominees with management's (even without the consent of such nominees),²⁴ the contestant's solicitation was otherwise within the regular frame.

In response to the building sense of a governance crisis, the SEC tabled a proposal designed to facilitate institutional voice in the nomination of directors.²⁵ In a

²² For a useful summary of the issue, see Council on Institutional Investors, Majority Voting Primer, available at www.cii.org/policies/MajorityVotingPrimer.pdf. See also Claudia Allen, Study of Majority Voting in Director Elections, November 2007, available at <http://www.ngelaw.com/files/upload/majoritystudy111207.pdf> (finding that as of November 2007 approximately 66% of the S&P 500 firms had adopted majority vote policy, bylaw, and/or charter amendment (compared to 16% in February 2006), although only roughly 40% made majority vote an absolute requirement for director election). For discussion of a recent amendment to Delaware corporate law which enables shareholders to adopt bylaw amendments relating to majority voting that cannot in turn be diluted by the board, see J.W. Verret, Pandora's Ballot Box, or a Proxy With Moxie? The Majority Voting Amendment to Delaware Corporate Law, 62 Bus.Law. 1007 (2007).

²³ The evidence in Del Guercio et al, *supra* note 21, suggests that "withhold vote" campaigns may be more successful at forcing director turnover than institutional investors fully appreciated.

²⁴ See Rel. No. 34-31326, reprinted at 57 Fed. Reg. 48276 (Pct. 16, 1992), reflected in Rule 14a-4(d), 17 C.F.R. § 240.14a-4(d).

²⁵ See Sec. Rel. No. 34-48626, Security Holder Director Nomination, reprinted at 68 Fed. Reg. 60784 (Oct. 23, 2003).

nutshell, the proposal would have given a right of “direct access” to the issuer proxy statement for a five percent shareholder (or group) to make director nominations. This right was quite constrained, however. First, the access right was conditioned on certain “triggering events”: either a large (greater than thirty-five percent) withhold vote for a director nominee in the year immediately preceding the nomination, or majority shareholder approval of a direct access proposal made by a significant (greater than one percent) shareholder in a prior year. Second, direct access would be limited to longtime holders (more than one year) without a control motive. Third, the maximum number of nominees ranged from one (for a board of no more than eight) to three (for a board of at least 20).

The proposal stirred intense debate.²⁶ Proponents saw the SEC’s proposal as a modest effort to inject director independence and accountability into the corporate governance system by empowering a class of long term stakeholders in U.S. public equity markets. Opponents saw the proposal instead as SEC meddling in corporate governance that would have an unpredictable, and likely deleterious, effect on the efficient functioning of U.S. public firms and thus the U.S. economy. A divided SEC did not adopt the proposal, and the proposal ultimately faded away despite never being formally withdrawn. After the 2004 election, when Chairman Cox replaced Chairman Donaldson, the proposal was definitively taken off the table.²⁷

The countermove by corporate governance activists was to look to self-help, pursuing shareholder adoption of bylaws that would open up the issuer proxy to director nominations by shareholders, that is, direct access via bylaw amendment rather than SEC rule.²⁸ The *AFSCME v. AIG* litigation arose out of such a campaign. A public employees union, an established corporate governance activist, offered such an amendment via a shareholder proposal to be included in the issuer’s proxy, pursuant to Rule 14a-8.²⁹ AIG sought SEC staff blessing to exclude the proposal, on the grounds

²⁶ For a sample, see Symposium on Corporate Elections, 59 Bus. Law. 43 (2003). Comment letters received by the SEC are posted at www.sec.gov/rules/proposed/s71903.shtml and summarized at www.sec.gov/rules/extra/s71903summary.htm and www.sec.gov/rules/extra/s71903suppsumm.pdf.

²⁷ This is apparent from the 2007 issuer proxy access proposals discussed below, see text accompanying notes ---, which refer to the 2003 proposal but go off in different directions.

²⁸ Shareholders ordinarily have concurrent power with the board to amend the corporation’s bylaws. E.g., Del. Gen. Corp. L §109. What happens if the board in turn amends the bylaws so as to undermine the shareholder initiative, a “battle of bylaw amendments,” is not resolved. See Jeffrey N. Gordon, “Just Say Never?” Poison Pills, Deadhand Pills, and Shareholder-Approved Bylaw Amendments, 19 Cardozo L. Rev. 511 (1997).

²⁹ 17 C.F.R. § 240.14-8. For convenience, the shorthand Rule reference will be used, all of which are found in 17 C.F.R. § 240.

that the proposal fell within a provision that permits exclusion of a proposal that “relates to an election for membership on the company’s board of directors or analogous governing body.”³⁰ AFSCME argued that its proposal was just a bylaw amendment, a governance change that did not relate to “*an* election,” meaning a *particular* election, unlike a nomination of an opposing director candidate. The SEC, joining AIG’s cause through an amicus brief, argued that the exclusion meant to cover a shareholder proposal “that would result in contested elections.”³¹ The Court, after conducting a detailed review of the administrative history of the exclusionary language, decided that the SEC’s current position conflicted with the Commission’s 1976 adopting release, which had targeted particular elections, not election reform like AFSCME’s proposal, which “would establish procedural rules governing elections generally.”³²

The Second Circuit opinion could have “opened the floodgates” to direct access to the issuer proxy for shareholder nominations on terms much broader than the failed 2003 SEC proposal.³³ Subject to shareholder approval, of course, the nominator ownership threshold might well be lower than the five percent figure in the SEC’s 2003 proposal and the number of possible nominations would not necessarily be capped. Note how the process would work. In year one, assume that shareholders adopt a direct access bylaw. In year two, the issuer is *obliged*, per the bylaw, to include the shareholder nominations in its proxy statement. The exclusionary provisions of Rule 14a-8 are, after all, *permissive*: an issuer can always choose to include a proposal that it could otherwise exclude.³⁴ The effect of the bylaw would be to establish as a matter of corporate policy that proposals should be included.

The Court made it clear, however, that it was not taking sides in the policy debate, indeed that the SEC was free to act to amend or clarify the rule through appropriate administrative action.³⁵ The SEC immediately faced pressure and counter-pressure from management and institutional investors. After nearly a year’s cogitation, the SEC offered two proposals. The first followed the Second Circuit’s invitation to adopt its preferred interpretation of the Rule 14a-8 election exclusion via reasoned

³⁰ Rule 14a-8(i)(8).

³¹ 462 F.3d at 126.

³² 462 F.3d at 130.

³³ Georgeson Annual Corporate Governance Review 2006 at 2, available at www.georgeson.com/en_uk/download/news/2006_ACGR_FINAL.pdf.

³⁴ See 462 F.3d 130 n.9.

³⁵ *Id.* at 131, 130 n.9.

administrative action.³⁶ The second would have permitted a five percent shareholder (or group) without a control motive to propose a proxy access bylaw similar to the AFSCME proposal and, upon shareholder adoption of the proposal, would have permitted similar proponents to nominate director candidates through the issuer proxy.³⁷ As discussed below, the proposal would have required rather extraordinary disclosure from both the proponent of the election reform and the actual shareholder nominator. For this reason the direct access proposal was rejected by the activist investor community as well as the business community. Instead, a divided SEC adopted the proposal that codified its asserted “longstanding policy” that limited the Rule 14a-8 route to issuer proxy access.³⁸ Chairman Cox defended the proposal as merely “maintain[ing] the status quo of the past decade” while gamely promising “to move forward and re-open the discussion in 2008.”³⁹ The encroaching political season makes the necessary consensus an unlikely prospect. Thus it could be that possible entrée to the issuer’s proxy statement for shareholder nominations first raised by the 2003 proposal will be precluded by the 2007 determinations.

III. E-proxy as a Substitute for Shareholder Access to the Issuer’s Proxy Statement

If the window to the issuer proxy statement is slammed shut does it matter? The answer, after the recent adoption of so-called “e-proxy rules” that permit an insurgent to post materials for internet access, is “not so much.”

Effective as of the 2008 proxy season, the SEC has adopted rules that require issuers to post all proxy materials on a public website (in addition to the standard EDGAR postings on the SEC’s site), and to provide shareholders with the option of “paper delivery” or “notice and access.”⁴⁰ In terms of mechanics, speaking, the issuer

³⁶ SEC Rel. No. 34-56161, *Shareholder Proposals Relating to the Election of Directors*, reprinted at 72 Fed. Reg. 43488 (Aug. 3, 2007).

³⁷ SEC Rel. No. 34-56160, *Shareholder Proposals*, reprinted at 72 Fed. Reg. 43466 (Aug. 3, 2007).

³⁸ SEC Press Release 2007-246 (Nov. 28, 2007); SEC Rel. No. 34-56914, *Shareholder Proposals Relating to the Election of Directors*, reprinted at 72 FR 70450 (Dec. 11, 2007) (effective Jan 11, 2008). Subsequent to *AFSCME v. AIG*, a unanimous U.S. Supreme Court reversed another Second Circuit case that had held an administrative agency to a prior interpretation of its rules, *Long Island Care at Home, Ltd. v. Coke*, 127 Sup. Ct. 2339 (2007). This would make it more likely that other circuits would refuse to follow *AFSCME v. AIG*, including the Second Circuit itself in a subsequent case.

³⁹ SEC Press Release 2007-246 (Nov. 28, 2007).

⁴⁰ SEC Rel. No. 34-56135, *Shareholder Choice Regarding Proxy Materials*, reprinted at 72 Fed. Reg. 42222 (Aug. 1, 2007). Large public issuers (i.e., those with a public float of at least \$700 million who otherwise qualify as “accelerated filers”) are subject to the rules for the 2008 season. Coverage for all other public companies kicks in for the 2009 season. The rules replace a recently-adopted program in which issuers could voluntarily opt into a regime that would give shareholders a choice of whether to

sends a notice to all shareholders that informs them of the availability of the web-posted proxy materials and their right to receive a paper copy (via a request by mail, phone, email, or a web-form). The notice must also give shareholders the opportunity to permanently opt into paper delivery. Web-posting of proxy materials via the “notice and access” model must include a means to vote, which can be either a downloadable proxy card or direct electronic voting. The “paper delivery” model looks very much like the traditional proxy solicitation.⁴¹

A “soliciting person other than the issuer”--like a shareholder nominator--must also comply with the notice and access model.⁴² The model gives the nominator the flexibility to solicit some shareholders via notice and access and others via paper delivery.⁴³ One crucial difference is that the shareholder nominator, unlike the issuer, is not obliged to solicit *every* shareholder; the nominator need not supply a proxy statement to shareholders not being solicited. For example, the nominator “can choose to send Notices only to those shareholders who have not previously requested paper copies.”⁴⁴ This means that the nominator can simply post its proxy materials on a website and limit its solicitees to those whose solicitation costs are probably low. To reach that group, the nominator’s initial costs are printing and postage for a one-page notice only. Although the notice must give the shareholder recipient the right to request paper delivery, the shareholder’s initial selection of web access for the issuer’s materials is likely to carry over to a proxy contest.⁴⁵ Additionally, institutional investors (who may generally request paper delivery to minimize own printing costs) could agree to web delivery for such solicitations as a way of encouraging them. A

receive proxy materials in paper form or electronically. See Rule 14a-16, 17 C.F.R. 240.14a-16 (described in SEC Rel. No. 34-55146, *Internet Availability of Proxy Materials*, reprinted at 72 FR 4148 (Jan. 29, 2007)).

⁴¹ The notice of web-availability is simply one additional element of the paper proxy materials, the same except there is of course no need to inform the recipient of the right to receive paper proxy materials.

⁴² This account is based on the SEC release, specifically 72 Fed. Reg. at 42227-28.

⁴³ Under the prior regime the nominator could have solicited specific institutional investors (by paper) without undertaking an obligation to print and mail to every shareholder.

⁴⁴ *Id.* at 42228 & n88. The footnote refers to the issuer’s obligation to send out the notice to the tailored shareholder group that has not previously sought paper delivery, if the nominator so choose, or to supply the tailored mailing list.

⁴⁵ Under the original e-proxy proposal, such a nominator would have been able to condition a solicitation on the notice recipient’s opting for web-access, unlike the rule, which requires the nominator to provide paper delivery to anyone who receives the original notice. See SEC Rel. No. 34-55146, *supra* note 40, 72 FR at 4158.

trade association such as the Council of Institutional Investors could help create the practice. Further tailoring could come from a screening process for nominators run through the Council or a proxy advisory service like ISS.

The avoided printing and mailing costs look substantial. The SEC cites the leading proxy services provider's estimate of average printing and mailing costs of \$5.64 per set of proxy materials in the 2006 proxy season.⁴⁶ By contrast, the SEC estimates that printing and mailing a notice costs \$0.43 per solicitee, and that the costs of setting up a website are negligible.⁴⁷ For a nominator who wants to solicit 1,000 institutional investors via the notice and access method only, this can bring the distribution element of solicitation costs into the \$1,000 range, not much of a budgetary strain for any serious corporate governance activist. In any event, the SEC believes that the "flexibility" of the e-proxy system "ultimately may reduce the costs of engaging in proxy contests, thereby increasing the effectiveness and efficiency of proxy contests as a source of discipline in the corporate governance process."⁴⁸

So what is the difference to shareholder nominators in losing access to the issuer proxy but having resort to an independent solicitation waged via e-proxy? Is the symbolic difference a substantive one? If the principal consequence, aside from relatively small cost differential, is only to exclude the gadfly nominator who cannot handle the additional complexity, then the difference cannot count for much (and may even be desirable from a policy perspective). There is also, however, the loss of a side-by-side comparison of the nominator's case (limited to 500 words under Rule 14a-8) and management's response and, perhaps more importantly, the loss of a proxy card or e-form that looks more like the familiar ballot that shows competing candidates. Realistically, however, the large firm that has typically been targeted by institutional investor activism will have a high percentage of institutional holders. Many of them will look to ISS or other advisory firms for guidance on how to vote in a contested election. Other significant shareholders, who may rely on internal deliberation, should be able to

⁴⁶ Id. at 42230-31 (estimate by ADP, the leading intermediary, now known as Broadridge Financial Solutions, Inc.).

⁴⁷ Id. at 42232.

⁴⁸ Id. at 42231. The SEC hastens to add that this particular rule change will nevertheless "not change significantly the number" of proxy contestants because the preexisting "voluntary" model already permitted use of an access and notice model for proxy contestants. This may be a cute way of deflecting objection that the Commission is with this mandatory e-proxy rule lending aid and comfort to the shareholder empowerment advocates. Of course the voluntary model went into effect only for proxy solicitations after July 1, 2007, i.e., after the 2007 proxy season, see id. at 42222, so governance activists simply have no experience with the e-proxy system. One important difference under the mandatory program is that a firm will not be able to avoid generating experience on which shareholders would opt for web-access only; i.e., the pool of low cost solicitees.

put competing sets of materials side-by-side. If large shareholders (or their intermediaries) cannot manage to fill out and send back the “pink” card rather than the “blue” card (or make similar adjustments in e-voting), then shareholder activism still has a long way to go.

One possible response to a “triviality” argument for issuer proxy access focuses on the other costs of free-standing proxy contests, in particular the costs of drafting a proxy statement that meets the disclosure requirements under Rule 14a-9, given the potential litigation risks of management “push-back.” By contrast, the only affirmative representation required of a shareholder proponent under 14a-8 is with respect to its ownership interest in the issuer’s stock.⁴⁹ But this response rests on a faulty premise: it assumes that a direct access system might evolve in which a nominator could *avoid* a significant disclosure obligation. Why would shareholders vote for such a system? Even the proposed shareholder bylaw controverted in *AFSCME v. AIG* required the nominator to make disclosures that tracked and referenced important elements of a freestanding proxy statement and assume “all liability of any violation of law or regulation arising out of the Nominator’s communication with stockholder including the Disclosure.”⁵⁰

Moreover, there is no reason to think that for a shareholder-adopted direct access regime, the SEC would passively rely on an issuer bylaw to assure adequate disclosure. In this regard, the SEC’s policy-based defense of the exclusion of the bylaw proposal in *AFSCME v. AIG*--that it could lead to an election contest without adequate disclosure--was disingenuous.⁵¹ It is true that under the current rules a shareholder nominator would not have engaged in a “solicitation” merely by presenting a director alternative in the issuer’s proxy statement, (and on the issuer’s proxy card) and thus would have assumed no additional disclosure obligation. The current rules make the issuer the party soliciting the proxy; the nominator just wants to add another name.⁵² Indeed, a nominator can engage in significant campaigning on behalf of the nominee without triggering a further disclosure obligation.⁵³ But the SEC could protect the

⁴⁹ See Rule 14a-8(b)(2).

⁵⁰ 462 F.3d at 124 n.3.

⁵¹ *Id.* at 129 n. 9.

⁵² This is spun out in the SEC’s release “codifying” its “longstanding practice,” *supra* note 3, 72 FR at 70450-70451.

⁵³ In general, efforts to persuade a shareholder to “execute or not to execute a proxy” count as a “solicitation,” which could lead to a disclosure obligation. See Rules 14a-1(l) (1) (defining a solicitation); Rule 14a-3 (obligation to file a proxy statement prior to making a solicitation). But the nominator’s publicizing its own voting intentions and its reasons would not be a “solicitation.” Rule 14a-1(l)(2)(iv). Moreover, a nominator without a control motive *could* make a solicitation without incurring a disclosure

important policy objective of assuring disclosure appropriate for director elections without constraining shareholder choice over direct access. In the simplest version, it could add a provision to Rule 14a-8 that made a direct access bylaw excludable unless it contained a disclosure undertaking like the proposed resolution in *AFSCME v. AIG*.⁵⁴ Alternatively, it could prescribe a form of disclosure that a shareholder nominator would prepare for inclusion in the issuer proxy statement in the event that shareholders had adopted a direct access bylaw. So the key policy questions are, first, what kind of disclosure is appropriate in the case of a shareholder nomination, and second, should the answer be different for a shareholder using access to the issuer proxy versus a free-standing proxy contest?

IV. The Disclosure Dilemma

In the case of a shareholder nomination, there are two potential areas for disclosure: disclosure about the director *nominee* and disclosure about the *nominator*. That there should be extensive disclosure about the director nominee is not controversial. In its initial release responding to *AFSCME v. AIG*, the SEC described the salient items of nominee disclosure under a freestanding proxy contest as follows:

- Any arrangement or understanding between the nominee and any other person(s) (naming such person(s)) pursuant to which the nominee was or is selected as a nominee;
- Business experience of the nominee;
- Any other directorships held by the nominee in an Exchange Act reporting company;
- The nominee's involvement in certain legal proceedings;
- Certain transactions between the nominee and the company; and
- Whether the nominee complies with independence requirements.⁵⁵

The shareholder resolution in *AFSCME v. AIG* called for disclosure of this information.⁵⁶ A freestanding proxy contest also requires disclosure of certain

obligation so long as the nominator did not seek “the power to act as proxy.” Rule 14a-2(b)(1). This means that under current SEC rules, a shareholder activist using issuer proxy access could run a spirited campaign without making significant disclosure of its motives or indeed its net economic position in the issuer (after giving effect to hedging and other derivative transactions).

⁵⁴ This was pointed out by Commissioner Nazareth in her dissent to the SEC's “codification” rule. Speech by SEC Commissioner: Opening Statement – Shareholder Proposals Relating to the Election of Directors (Nov. 28, 2007) (statement by Commissioner Annette L. Nazareth), available at <http://www.sec.gov/news/speech/2007/spch112807aln.htm>.

⁵⁵ 72 Fed. Reg. at 43490.

nominator-specific information. In the same release, the SEC described the salient disclosure items as follows:

- By whom the solicitation is made;
- The methods to be employed to solicit;
- Total expenditures to date and anticipated in connection with the solicitation;
- By whom the cost of the solicitation will be borne;
- Any substantial interest of each participant in the solicitation;
- The name, address, and principal occupation or principal business of each participant;
- Whether any participant has been convicted in a criminal proceeding within the past 10 years;
- The amount of each class of securities of the company owned by the participant and the participant's associates;
- Information concerning purchases and sales of the company's securities by each participant within the past two years;
- Whether any part of the purchase price or market value of each securities is represented by fund borrowed;
- Whether a participant is a party to any contract, arrangements or understandings with any person with respect to securities of the company;
- Certain related party transactions between the participant or its associates and the company;
- Whether the participant or any of its associates have any arrangement[s] or understand[ings] with any person with respect to any future employment with the company or its affiliates, or with respect to any future transactions to which the company or its affiliates will or may be a party; and
- With respect to any person who is a party to an arrangement or understanding pursuant to which a nominee is proposed to be elected, any substantial interest that such person has in any matter to be acted upon at a meeting.⁵⁷

Nominator-specific information is more costly to provide because it provides more fertile ground for the exploration of possible disclosure violations. Extensive disclosure seems appropriate where the nominator may have a control motive--indeed, may solicit on behalf of a full slate of director nominees--and may have a strong economic interest in making good on a substantial investment in the issuer's stock, perhaps as the result of

⁵⁶ 462 F.3d 124 n. 3. The referenced SEC release is describing the Schedule 14A, Item 7(a), (b), and (c) disclosure referred to in the resolution.

⁵⁷ 72 Fed. Reg. 43489-90.

recent accumulation (or through derivatives). The shareholder resolution in *AFSCME v. AIG* did not call for disclosure of this information, however.⁵⁸ What disclosure should be required of a nominator seeking access to the issuer's proxy?⁵⁹ One possible set of distinctions might be based on the disavowal of any control motive on the part of the nominator. Presumably this would distinguish between nominations by an investor and a control entrepreneur, but also between elections where the nominator presented a "short slate" instead of a majority slate, and where control would necessarily be at stake. The SEC has tacitly approved this distinction by permitting a summary filing on a Form 13G by a five percent holder who disavows a control motive rather than on a Form 13D, which has much more extensive shareholder-specific disclosure that is reminiscent of nominator-specific disclosure in a free-standing proxy contest. Indeed, the current proxy rules apparently permit a Form 13G filer to make a "solicitation" without thereby triggering a further disclosure obligation (so long as the filer does not seek "power to act as proxy for a security holder" and does not distribute proxy cards).⁶⁰

As part of its response to *AFSCME v. AIG*, the SEC proposed a new version of issuer proxy access, as noted above. Qualifying shareholder proponents could use direct access to propose a bylaw that would permit direct access for similarly qualifying proponents to make director nominations in a subsequent year.⁶¹ The eligibility requirements were stiff: five percent shareownership for at least a year and no control motive. Quite remarkable were the proposed disclosure requirements themselves, which appeared to encompass matters extending beyond those subject to disclosure in a freestanding proxy contest--including contacts with a proxy advisory firm, detailed history as to when the shareholder formulated plans to make its proposal or nomination, and an account of contacts between the proponent and management (or directors) of the targeted issuer.⁶² The proposal also called for extensive disclosure about natural persons who are the agents of shareholder proponents or nominators, including how such

⁵⁸ 462 F.3d at 124 n.3. The only required nominator-specific disclosure for access to the issuer proxy was with respect to the nominator's ownership stake in the issuer. My surmise is that the proponents are counting on the proxy rules to block disclosure-free access by a control entrepreneur. Such parties are likely to want to engage in a "solicitation" to increase the chance of a success and will have crossed the five percent ownership threshold that will make them a 13D filer and thus subject to a disclosure obligation if they solicit. See Rule 14a-2(b)(1)(vi); compare *supra* note 45.

⁵⁹ Note that

⁶⁰ Rule 14a-2(b). See *supra* note 53.

⁶¹ SEC Rel. No. 34-56160, Shareholder Proposals, reprinted at 72 Fed. Reg. 43466 (Aug. 3, 2007).

⁶² *Id.* at 43472.

persons are selected (including whether by election of the ultimate beneficiaries of the entity), the fiduciary duty of such agents to the beneficiaries, the “qualifications and background of such person or persons relevant to the plan or proposals,” and any interests not shared with other shareholders of the issuer.⁶³ The proposal would have required specific disclosure about contracts with the issuer, including in particular “any employment agreement, collective bargaining agreement or consulting agreement.”⁶⁴

As noted before, the costs to a proponent (or nominator) directly increase in the scope and detail of disclosure because of the liability exposure. Nominee-disclosure seems highly relevant to a shareholder decision. Shareholders need to know the background, experience and possible conflicts of any director candidate. Disclosure tailored to a proponent (or nominator) is much less straightforward, since in significant measure such disclosure is premised on the view that the proposed action is less about the substance--the actual director election--than about a bargaining game between proponent/nominator and the issuer over a side issue other than the optimal governance of the firm or perhaps some other self-interested, even impermissible, motive of the proponent/nominator. Those concerns seems attenuated where the proponent/nominator is, by hypothesis, a substantial long-term holder without a control motive. It is ironic indeed to insist upon more demanding disclosure criteria for access to the issuer proxy statement than the case of a freestanding proxy contest. Is there any reason not to turn to e-proxy solicitations over a more costly alternative?

V. Conclusion

Some of the implications of this analysis are straightforward. Institutional investors were right to line-up en masse against the SEC’s issuer ballot access proposal. It was fools’ gold and dangerous. The detailed disclosure called for by the SEC proposal was an invitation to litigation. Since some of the disclosure pertained to the natural persons who controlled the institutional nominator, they faced personal litigation risk. Given that an institution benefits from improved corporate performance only in proportion to its shareownership and the institution’s officers hardly at all, the costs of pursuing or using issuer ballot access on these terms would easily outweigh the benefits. What’s dangerous was the possibility that the “agency capitalism” disclosures of issuer ballot access would find their way into disclosure requirements in a free-standing proxy solicitation. This could happen implicitly through an expanded conception of

⁶³ Id. at 43473.

⁶⁴ Id. at 43472.

“materiality” or through explicit rule changes as managements in particular noticed the asymmetry between the disclosure regimes.

By contrast, the SEC’s closing the door on Rule 14a-8 by-law proposals for issuer proxy access was not a great loss. Under any sort of SEC-adopted issuer proxy access rule, the SEC will surely seek to regulate the disclosure associated with director nominations. To behave otherwise would arguably be inconsistent with the SEC’s core mandate under section 14(a) of the 1934 Act. As the SEC’s most recent shareholder ballot access proposal suggests, the disclosure requirements may be a poison pill. Even the more institutionally-friendly SEC ballot access proposals of 2003 were a cumbersome tangle borne of political compromise.⁶⁵ Moreover, because of the focus on “long term” investors, both the 2003 and 2007 proxy access proposals excluded (by design) activist shareholders who might run “short slate” campaigns with more focused economic objectives.⁶⁶ Nor does issuer proxy access address many of the longstanding sources of institutional investor reluctance to nominate directors – for example, the threat of “short swing sale” liability under section 16(b) of the 1934 Securities and Exchange Act because of directors who they have “deputized.”⁶⁷

Institutional investors and other shareholder activists should instead focus their energies on working through the mechanics of waging short-slate proxy contests using e-proxy solicitations.⁶⁸ The Council on Institutional Investors and public interest law firms could play a significant role in this regard. Activist institutions need to prepare the disclosure package required under the existing proxy rules. An institution’s disclosure may be tested (and refined) through litigation, but a standardized package should emerge relatively quickly that the institution could generally use in proxy contests without a control motive. Activist institutions need to become facile with the web-access model and appreciate the extent to which proxy advisory services will do much of the actual solicitation work. It may be that few institutions will have sufficient

⁶⁵ See TAN 25-27 *supra*.

⁶⁶ See Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance (forthcoming *Journal of Finance* 2008).

⁶⁷ See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 545-48 (1990).

⁶⁸ Alternatively, or as a supplement, institutions should also consider waging e-proxy campaigns on behalf of shareholder bylaws that would mandate issuer proxy access, see TAN note 34 *supra*, but should also appreciate that success will likely induce further (and appropriate) SEC response to protect its disclosure regime. On the other hand, the outcome of the 2008 election could affect any proposal that eventually emerges.

incentives to make the relatively modest investment to master the mechanics necessary to undertake an e-proxy contest.⁶⁹ Or that few shareholders will take the trouble to engage with the substance of the proxy contest if it involves going beyond the four corners of the issuer proxy. If so, the role of institutional investors in corporate governance will necessarily be limited.

Behind the SEC's response to *AFSCME v. AIG* is deep unease over "agency capitalism." We might be more concerned about the motives of agents of institutional investors precisely because those agents do not face high-powered economic incentives. When Carl Icahn makes the solicitation, we understand what he is about and the risks of which shareholders ought to be apprised. Institutional investors in this emerging new world of concentrated diffuse ownership do not fit the paradigm so easily. Their agents cannot earn enormous salaries or take profits from a successful investment. What exactly will they maximize? Thus begins the tough analysis of the consequences of "shareholder empowerment," which seems, to me, inevitable.

⁶⁹ See Stephen Choi & Jill Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance* (WP Aug. 2007), available on SSRN at <http://ssrn.com/abstract=1010330>. (little non-litigation-related institutional governance activity).