CORPORATE CITIZENS UNITE!: THE CASE FOR SHAREHOLDER VOTING REFORMATION

A STUDY OF THE EFFECTIVENESS OF SHAREHOLDER VOTING AND THE NEED FOR THE LAW TO ADAPT TO THE CURRENT STATE OF INSTITUTIONAL SHAREHOLDER INVOLVEMENT IN LIGHT OF ELECTRONIC SECURITIES TRADING

MOSHE SCHWARTZ*

* J.D. Candidate, 2012, New York University School of Law; C.F.A. Candidate, 2007-09; M.B.A., 2007, Bar-Ilan University; B.A., 2005, Charter Oak State College. The author would like to thank Professor Michal Barzuza for providing invaluable guidance on all sorts of school and career issues, including helping get this note started, editing and advising throughout the writing process; Rachel Beller, Eric McLaughlin, Nina Sarraf-Yazdi and the rest of the *Journal of Law & Business* editors who shepherded this project from start to finish.

Imaged with Permission of N.Y.U. Journal of Law & Business

I.
INTRODUCTION

Much has been made of shareholder rights and the collective action problem, which inhibits shareholders from effectively reducing agency costs in corporate governance.[1] Corporate law has in place a system of central management where managers, although agents of the shareholders, have wide discretion to implement corporate policy, while shareholders have the opportunity to express their approval through elections. It is argued that this system is necessary for managers to run a successful business; however, critiques point out that it can lead to corporate waste and managerial abuses.[2]

1. *See generally* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* 107 YALE L.J. 2359 (1998); Stephen J. Choi & Jill E. Fisch, *How To Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries,* 113 YALE L.J. 269 (2003); Ernst Maug & Kristain Rydqvist, *Do Shareholders Vote Strategically? Voting Behavior, Proposal Screening, and Majority Rules,* 13 OXFORD REV. OF FINANCE 47 (2009).

2. *See, e.g.,* Choi & Fisch, *supra* note 1 at 273 (arguing that the disconnect between shareholders and corporate boards was a significant factor in the accounting scandals of the early 2000s).

Imaged with Permission of N.Y.U. Journal of Law & Business

In Part I, this article will explore the existing legal framework of shareholder voting rights, its role in corporate governance, and the collective action problem that inhibits shareholders from carrying out their responsibilities. In Part II, the paper will discuss the various trends that have emerged to combat the issue and why they have only been a partial solution. The institutional investor environment has evolved to increase shareholder activism; however, they have never reached their full potential because of regulations and conflicts of interest. Proxy reforms proposed by the SEC have fallen short because of their potential cost and the fierce opposition they face from corporations.

In Part III, this article will point out that the growing electronic and quantitative trend in the securities market exacerbates the collective action problem. First, the electronic record-keeping of shareholder registries creates a system where many proxy votes are not cast because proxies fail to be sent, fail to be recorded on time, or fail verification. Second, it is the trend of the securities market for traders to execute trades with algorithmic trading programs and to pursue quantitative strategies that do not seek to capture value from the long-term prospects of the corporation, instead seeking to capture profits from short-term price movements. Thus, many shareholders have no reason to vote proxies responsibly or at all. In Part IV, this article will examine the SEC's most recent response to the collective action problem with its adoption of the "proxy access rule," including a brief summary of the D.C. Circuit's objection to the rule. Finally, this article will propose a legal framework that allocates voting rights to shareholders who have held the security for an extended period of time so as to protect their long-term interests and armor a group that can overcome the collective action problem both directly and indirectly

Imaged with Permission of N.Y.U. Journal of Law & Business

II.
PART I - SHAREHOLDER VOTING RIGHTS AND THE COLLECTIVE ACTION PROBLEM

A. *Aspects of Corporate Governance That Require Shareholder Voting*

The voting system is the franchise in which shareholders exert their corporate governance influence.[3] The right to vote on a particular issue is set by state law. In Delaware, the law sets a "record date" that is fixed at least 10 days and no longer than 60 days in advance of any shareholder meeting.[4] Originally, these votes were cast formally at the annual shareholders meeting; later, proxy laws were developed to account for votes that could not be cast in person.[5] The policy rationale for this system is that shareholders have the residual right to the company's cash flows, and allowing them to vote aligns the interest of governance with that of value maximization; conversely, splitting the voting right and the equity right might create conflicts of interest.[6]

Shareholders vote in a variety of circumstances, the most notable of which is in appointing directors.[7] Other major aspects of shareholder voting are the right to amend bylaws and the right to approve mergers.[8] In addition, stock exchange rules require that shareholders approve management's actions that increase the company's outstanding shares by more then 20%.[9] The reason the laws and regulations require shareholder approval for these transactions is that they are of funda-

3. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 n.2 (Del. Ch. 1988) ("Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights. This concern suffuses our law, manifesting itself in various settings.").

4. DEL CODE ANN. tit. 8, § 213 (2010).

5. DEL CODE ANN. tit. 8, §211(a)(2) (2010).

6. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 410 (1983) (arguing that empowering equity owners of a corporation minimizes agency costs as their cash flow rights are directly effected by adverse governance, whereas a voter without an equity stake is more likely to extract private benefits and adversely affect the profitability of the firm).

7. DEL CODE ANN. tit. 8, § 211(b) (2010).

8. *Id.* § 109 (referring to the shareholder right to vote to introduce, amend and revoke bylaws), § 251(c) (requiring a shareholder vote for both parties in a merger).

9. NYSE Listed Company Manual § 312.03(c) (2007).

Imaged with Permission of N.Y.U. Journal of Law & Business

mental importance to corporate viability and because agency costs for shareholders far exceed monitoring costs.[10] In other words, shareholders, as the owners of the corporation, deserve the right to have a say in the transactions that are the most integral to their investment, as opposed to deferring to an agent to make crucial strategic decisions without their input. This is the idea that shareholder voting represents a form of republican democracy.[11]

B. *The Centralized Management System, Director Power and the Safety Valve of Shareholder Voting*

Delaware law states that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[12] This default law gives directors wide discretion in managing the affairs of the corporation and creates a "centralized management" regime.[13] Under this system, directors do not have to listen to demands of the majority of shareholders that are not cast through the voting procedures.[14] Shareholders express their approval or disapproval through the elections.

In addition to managing the everyday affairs of the corporation, states have developed a mechanism to increase director ability to take necessary business risks without running the threat of personal liability. At common law, directors who make business decisions that are informed, disinterested and are reasonably believed to be in the best interest of the corporation are not liable for damages.[15] In these cases, the court

10. *See* Easterbrook & Fischel, *supra* note 6, at 410.

11. *See id.*

12. DEL CODE ANN. tit. 8, § 141 (2010).

13. *See* Easterbrook & Fischel, *supra* note 6, at 410.

14. *See, e.g.*, Automatic Self-Cleansing v. Cuninghame, [1906] 2 Ch. 34 (Eng.) (holding directors were within their rights to disregard a majority of the shareholder requests because the corporate charter required a supra –majority approval).

15. *See, e.g.*, Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1052-53 (Del. Ch. 1996) ("[T]he so-called business judgment rule. That 'rule' in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty.").

Imaged with Permission of N.Y.U. Journal of Law & Business

does not second-guess business decisions that do not turn out favorably; they employ the "business judgment rule."[16] The business judgment rule's force was questioned in the landmark case of *Smith v. Van Gorkom*,[17] where the Delaware Supreme Court found directors personally liable for "gross negligence."[18] However, the Delaware legislature subsequently enacted DGCL Section 102(b)(7), which allows corporations to adopt a director liability waiver for shareholder suits that seek damages.[19] Furthermore, corporations may purchase director insurance "whether or not the corporation would have the power to indemnify such person against such liability."[20] In addition, corporations must reimburse directors for personal liability suits if the director is successful on the merits, whether or not he acted in good faith.[21]

Directors have considerable influence over the sale of the corporation as all mergers and dissolutions have to be approved by the board of directors.[22] Even tender offers, which bypass board approval, are subject to Delaware's anti-takeover statute, which makes post-takeover transactions between the new parent and subsidiary difficult.[23] To strengthen the directors' role in hostile takeovers, Delaware courts have approved of the general use of defensive tactics. In *Unocal Corp. v. Mesa Petroleum Co.*, the court upheld the use of a shareholder repurchase plan that was implemented by the board in order to disrupt a hostile bidder's tender offer.[24] In *Moran v. Household Int., Inc.*, the court approved the general use of the "poison

16. *Id.*

17. 488 A.2d 858 (Del. 1985).

18. *Id.* (holding directors personally liable for breaching the duty of care for selling their company without sufficient information and deliberations despite the fact that the directors did not have a self-interest and the company was sold for more than a 50% premium.).

19. DEL CODE ANN. tit. 8, § 102(b)7 (2010).

20. DEL CODE ANN. tit. 8, § 145(g) (2010).

21. DEL CODE ANN. tit. 8, § 145(c) (2010).

22. DEL CODE ANN. tit. 8, § 251(b) ; § 271 (2010).

23. DEL CODE ANN. tit. 8, § 203 (2010) (requiring a hostile bidder to capture 85% of the outstanding shares on a tender offer or disallows all business operations between the parent and the subsidiary unless bidder gets target board approval and 2/3 vote of approval from disinterested shareholders (i.e. minority who remain after the takeover)).

24. 493 A.2d 946 (Del. 1985).

Imaged with Permission of N.Y.U. Journal of Law & Business

pill" even without the direct threat of a coercive tender offer.[25] The court reasoned that, although directors can use the pill to entrench themselves, shareholders always have the right to approve a tender offer through the election system by replacing the board with directors who will redeem the pill.[26] Shareholders' right to appoint directors is the check of the corporate governance system. In *Blasius*, when directors sought to entrench themselves by increasing the size of the board to make the elections more difficult for the insurgency, the court "struck down board acts done for the primary purpose of impeding the exercise of stockholder voting power . . . in such a case, the board bears the heavy burden of demonstrating a compelling justification for such action."[27] Delaware's heightened scrutiny in dealing with directors who seek to undercut the voting system has been mimicked by courts around the country.[28] The centralized management system that authorizes broad director influence necessitates shareholder voting that acts as a "safety valve."[29] If shareholder voting is so crucial to corporate governance, it is important to analyze the effectiveness of its use and highlight its shortcomings.

C. *The Collective Action Problem and Management Abuses*

Despite the incentive to protect their equity investment, shareholders often do not vote their proxies efficiently or effectively.[30] The main reasons set forth for this condition in-

25. 500 A.2d 1346 (Del. 1985); *see also* Paramount Comm., Inc. v. Time, Inc., 571 A.2d 1140 (Del 1989) (holding that it is within its right as a board of directors to implement the poison pill in order to go ahead with a merger with a company that has a facially lower bid price).

26. *See* Moran, 500 A.2d at 1355; *see also* Yucaipa American Alliance Fund II v. Riggio, 1 A.3d 310 (Del. Ch. 2010) (demonstrating the process and judicial scrutiny in the instance of a poison pill in the context of a staggered board).

27. *Blasius*, 564 A.2d at 661.

28. *See* Hilton Hotels Corp. v. ITT Corp., 978 F.Supp. 1342 (D. Nev. 1997) (federal court applying Delaware take over line of cases [*Blasius,Schnell,Revlon*] to a Nevada corporation).

29. *See* Marilyn B. Cane, *The Revised SEC Shareholder Proxy Proposal System: Attitudes, Results and Perspectives*, 11 J. CORP. L. 57, 79 (1985-1986) (discussing the role of shareholders in corporate governance and the update in reformation in the proxy system).

30. *See, e.g.*, Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1093-95 (1990)

Imaged with Permission of N.Y.U. Journal of Law & Business

clude the inability of shareholders to properly act together as they are a segregated and heterogeneous group, as well as the fact that their position in the company is usually not large enough to warrant their full attention.[31] The typical minority shareholder does not think his vote will influence the election, and "no shareholder, no matter how large his stake, has the right incentives at the margin unless that stake is 100 percent."[32] Thus, the typical shareholder does not invest his resources to thoroughly research proxies.

In addition to the typical costs and inefficiencies associated with informing and convincing a large, heterogeneous group, both state and federal laws have developed in a manner that has heightened the hurdles that an insurgent proxy campaign will face. One significant feature of state law that has reduced the amount of insurgency among shareholders is the "Froessel Rule." Under this rule, directors can always pay for proxy costs with company funds while shareholders are only reimbursed for proxy contests that they win.[33] The policy behind the rule is to reduce inefficient insurgency that is not in the shareholders' interest;[34] however, it has the effect of also reducing efficient insurgents who would increase the value of the corporation by replacing underperforming management.[35] In *CA, Inc. v. AFSCME Employees Pension Plan*, the court held that a shareholder proxy proposal that creates a bylaw amendment requiring the corporation to reimburse insurgents who receive less than a majority of shareholder votes was counter to Delaware law and excludable from proxy material.[36]

On the federal front, the 1990s saw an increase in the regulation of corporate proxies, which increased the cost of proxy

(demonstrating that private and social costs of collective action can result in shareholder passivism and inefficient outcomes).

31. *See generally* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. . 520 (1990) (discussing and evaluating the traditional sources of the collective action problem in corporate share voting).

32. *See* Easterbrook & Fischel *supra*, note 6 at 402.

33. Rosenfeld v. Fairchild Engine & Airplane Corp, 128 N.E.2d 291 (N.Y. 1955) (applying New York law).

34. *See* William T. Allen, Reinier Kraakman & Guhan Subramanian, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, 181 (ASPEN PUBLISHERS,3rd ED. 2009) (2005).

35. *See id.*

36. CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227 (Del. 2008).

Imaged with Permission of N.Y.U. Journal of Law & Business

insurgency and has reduced shareholder ability to be active corporate governors.[37] Rule 14a-3 states that no one can solicit proxies unless they furnish those solicited with a statement "containing the information specified in Schedule 14A."[38] Schedule 14A is a document that a solicitor simultaneously sends out to the SEC and shareholders that provides information to the shareholders about the agenda of the solicitor. The formal requirements of the filings are set out for in Rules 14a-4 to -6,[39] and they significantly increase the cost of running a proxy.[40] Even if a solicitor is exempt under Rule 14a-2(b)(1), if the shareholder owns more than $5 million worth of stock, he must still file the communication and a "notice of exempt solicitation" after sending it out.[41]

Board complacency and a lack of shareholder involvement has led to some astonishing corporate abuses. On the extreme end there are the corporate scandals of WorldCom and Enron, where directors and officers defrauded shareholders of the true value of the corporation through accounting shenanigans.[42] With shareholders not monitoring their investment, directors and officers can create a managerial environment where they extract private benefits at the expense of the corporation. One notable phenomenon to illustrate this point is the occurrence of staggered boards, which appears in most major corporations.[43] Staggered boards have been an issue of controversy because they divide the board into classes, stripping shareholders' ability to remove directors without cause and reducing their ability to replace a majority in an annual

37. *See* John Pound, *Proxy Voting and the SEC*, 29 J. Fin. Econ. 241 (1991).

38. 17 C.F.R. § 240.14a-3(a) (2010).

39. 17 C.F.R. § 240.14a-4-6 (2010).

40. *See* Pound, *supra*, note 37.

41. 17 C.F.R. § 240.14a-6(g) (2010).

42. For a description of the Enron and Worldcom scandals and possible causes, *see* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL L. REV. 1275 (2002); *see also* J. Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 YALE J. ON REG. 207 (2003).

43. *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards; Theory, Evidence & Policy*, 54 Stan. L. Rev 887 (2002) (stating that, as of publication, 59% of a 2,421 corporation sample contained staggered boards, and, by the late 90s, 82% of corporations issuing IPOs contained staggered boards, a trend that suggests the rate of staggered boards is increasing).

Imaged with Permission of N.Y.U. Journal of Law & Business

election.[44] There are justifications for staggered boards, such as their potential to reduce the ability of a raider to bust up the corporation and to encourage directors to engage in transactions that are in the long-term interests of the corporation.[45] However, research indicates that corporations that have staggered boards have a lower value and underperform their peers.[46] This study suggests the collective action problem can lead to inefficient outcomes.[47]

III.
PART II - DEVELOPMENT OF THE INSTITUTIONAL SHAREHOLDER AND SEC REGULATIONS AS A POSSIBLE CURE.

A. *Institutional Investors Influence Corporate Governance and Reduce Shareholder Passivity*

In the 1990s, the collective action problem was mitigated by the rise of the institutional investor, such as mutual funds, pension funds and insurance companies.[48] Institutional investors have larger share stakes than the typical investor and have the incentive to engage in due diligence and promote efficient corporate governance.[49] Unlike the individual investor who might hold a nominal percentage of a corporation, institutional funds have positions that are so extensive that expending time and resources is economically justified. In addition, they employ staff that has the expertise to engage in thorough audits in order to weigh proxy dilemmas.[50] In the process of increasing value for the fund, fellow private shareholders gain through a positive externality.

There are many articles that document the effects of institutional investors; Bernard Black's 1990 article has been one

---

44. DEL CODE ANN. tit. 8 §141(k) (2010); *see also* Bebchuk et al., *supra* note 43.

45. *See id.*

46. Lucian Arye Bebchuk & Alma Cohen, *The Cost of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005).

47. *See id.*

48. Anat R. Admati et al., *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097 (1994).

49. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 827 (1992) (documenting that 53.3% of U.S. market capitalization by 1990 was owned by institutional investors and reporting a 15.3% increase from 1981).

50. *Id.*

Imaged with Permission of N.Y.U. Journal of Law & Business

of the most cited and influential. Professor Black uncovered numerous trends in the proxy system after the rise in the institutional investor environment. First, institutional investors were less inclined to vote in favor of management.[51] Second, they proposed their own corporate proposals, and the amount of shareholder proposals that beat management increased steadily.[52] Lastly, although difficult to document, many corporations have adopted shareholder proposals voluntarily by casting secret ballots out of fear of losing the vote.[53] It is now commonplace for management to conduct meetings with large institutional shareholders and to nominate one of their representatives to the board of directors.[54] Professor Black advocates a legal regime where institutional investors are allowed to increase activism. Later in this article, the limitations of traditional investors and why they never reached their full potential will be examined.[55]

B. *Hedge Funds Revolutionize the Institutional Investor Corporate Governance and Increase Activism*

In the 2000s, hedge funds realized that mutual funds, although making sure to vote proxies responsibly, had taken a passive corporate governance stance and had not looked to increase value through active management of the board and direct influence on the corporations' strategic policy.[56] In response, many hedge funds have pursued an active approach by waging proxy battles to improve the corporation by replacing board members.[57] One of the most prolific examples of this strategy is Carl Icahn, whose activism in some of the world's biggest corporations has resulted in an increase in value for some equity holders.[58] Although a new feature to the market,

51. *Id.* at 828.

52. *Id.*

53. *Id.*

54. *Id.* at 829.

55. *See infra* Part III.A.

56. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 UNIV. PA. L. REV. 1021 (2007).

57. *Id.*

58. *See* Julia Angwin, *Icahn Issues Time Warner Challenge; Financier Confirms Alliance With Other Investors to Seek Changes at Media Company*, WALL ST. J., Aug. 16, 2005, at A3.

Imaged with Permission of N.Y.U. Journal of Law & Business

this hedge fund strategy appears to increase shareholder value at least in the short run.[59]

C. *Federal Intervention to Increase Shareholder Activism*

One of the major obstacles that shareholders face when communicating with fellow shareholders is proxy regulations that require those who are soliciting proxies to file a lengthy Schedule 14D, disclosing the shareholder's intentions.[60] Before 1992, almost any form of shareholder communication was deemed to be a "solicitation" and triggered these disclosure regulations.[61] In 1992, the SEC amended Rule 14 to be more accommodating to shareholders. Rule 14a-2 exempts many institutional investors, in limited circumstances, from the schedule.[62] In addition, Rule 14a-2(b)(1) exempts ordinary shareholders from communication with other shareholders if they do not intend to seek proxies.[63] Rule 14a-2(b)(2) exempts solicitations of less then ten shareholders.[64] These amendments were set forth to allow shareholders to test the waters of shareholder sentiment before incurring major expenses.[65]

In an effort to actively encourage shareholder participation, the SEC promulgated Rule14a-8's "town hall provisions." This rule allows shareholders to recommend proposals to corporate strategy that management has to include in the proxy materials so shareholders can vote on their adoption.[66] Most of the shareholder proposals relate to corporate governance

59. *See* Alon Brav et al., Hedge Fund Activism, Corporate Governance, and Firm Performance 21-24 (Sept. 22, 2006) *available at* http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf.

60. *See supra* notes 38-39 and accompanying text.

61. Mark Mark J. Roe, *Or Free Speech for Shareholders?*, WALL ST. J., Dec. 18,1991, at A14 ("Even a simple news paper ad requires clearance from the SEC. If stockholders have doubts about the quality of their management, they must act publicly, in costly, stilted, potentially embarrassing ways.")

62. 17 C.F.R. § 240.14a-2 (2010).

63. 17 C.F.R. § 240.14a-2(b)(1) (2010).

64. 17 C.F.R. § 240.14a-2(b)(2) (2010).

65. *See* 64 Fed. Reg. 61408, 61456 (Nov. 10, 1999); 72 Fed. Reg. 4148, 4168 (Jan. 29, 2007).

66. 17 C.F.R. § 240.14a-8 (2010).

Imaged with Permission of N.Y.U. Journal of Law & Business

issues.[67] The rule sets forth thirteen grounds on which management has the right to exclude the proposal from proxy material. The most frequent exclusions invoked by management are that they are improper under state law, that they relate to matters that account for less than 5% of the corporation's total assets, or that they relate to ordinary business operations.[68] These proposals have been highly controversial, and management usually seeks to exclude them through a no-action letter from the SEC.[69]

It is not entirely clear what effect the town hall provisions have had on shareholder activism.[70] Even if they have increased shareholder input, there have been high-profile instances where proposals were not successful. In *CA v. AFSCME*, on a certified question from federal court, Delaware's Supreme Court held that a proxy would be improper under state law, and thus the corporation had a right to exclude it.[71] In another case, CalPERS proposed a change to HP's corporate strategy, and, despite the SEC refusing to grant HP a no-action letter, the proposal did not garner enough shareholder support.[72] More recently, Lucian Bebchuck's proposal to CA's proxy materials that would have limited management's use of the poison pill did not receive a shareholder quorum.[73]

Recently, there has been a resurgence in federal regulations that aid shareholder activism. In June 2009, the SEC prohibited brokers from voting shares they hold for their clients in discretionary accounts.[74] The policy rationale is that management can easily influence brokers, and discounting these shares gives non-influenced institutions concentrated voting

67. Randall S. Thomas & James F. Cotter, *Shareholder Proposals Post-Enron: What's Changed, What's the Same?* (Dec. 15, 2005) (unpublished working paper) (finding the number to be 72%).

68. 17 C.F.R. § 240.14a-8(i) (2010).

69. 17 C.F.R. § 240.14a-8(j) (2010).

70. *See* Cane, *supra* note 29 (Wachtell, Lipton, Rosen & Katz LLP conducted a study that found them to vary depending on the circumstance).

71. 953 A.2d 227 (Del. 2008) (holding a proposal requiring the corporation to reimburse insurgents for proxy costs is counter to Delaware law because management would breach their fiduciary duties to reimburse an insurgency that was not in good faith).

72. *See* Allen *supra* note 34.

73. *Id.*

74. The SEC has approved an amendment to NYSE Rule 452 (and Section 402.08 of the NYSE Listed Company Manual).

Imaged with Permission of N.Y.U. Journal of Law & Business

power. Another recent development is the ability for shareholders to distribute proxy materials through the Internet, significantly reducing costs and increasing the number of proxy contests that are cost-justified.[75] In addition, the Dodd-Frank Act has added a mandatory, nonbinding shareholder "say on pay" provision that allows shareholders to put directors on notice if they don't approve of managerial compensation.[76]

IV.
PART III - WHY THE COLLECTIVE ACTION PROBLEM PERSISTS AND WHY IT IS GETTING WORSE

A. *The Cure of the Institutional Investor Is Limited*

Traditional institutional investors are heavily regulated.[77] They have to disclose their holdings and are subject to trading limits, restrictions and diversification requirements that inhibit their ability to make swift moves within the market.[78] For example, if a fund has spotted an undervalued firm that they seek to purchase and improve through an active strategy, they may not be able to buy enough shares to gain a sufficient degree of voting control to exploit the opportunity. The relevant regulations under the Investment Advisors Act of 1940 and the Williams Act make this process more difficult and expensive as they require formal filings.[79]

Another practical limitation to traditional institutional investors is the mutual fund business model. Mutual funds charge their clients based on assets under management ("management fees") as opposed to incentive fees, which are based on fund performance.[80] In other words, mutual funds charge a percentage of the size of their portfolio and typically

75. *See* Press Release, U.S. Sec. & Exch. Comm'n, Statement by SEC Chairman Mary L. Shapiro on Proxy Access Litigation (Sep. 6, 2011), http://www.sec.gov/news/press/2007/2007-247.htm.

76. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203,§ 951.

77. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (arguing that institutional investors have increased corporate governance and that a legal regime that facilitates institutional investors is warranted).

78. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

79. *See* Kahan & Rock, *supra* note 56 at 1049-58.

80. *See id.*

Imaged with Permission of N.Y.U. Journal of Law & Business

do not charge clients based on the return on investment. While they do benefit from their enhanced ability to attract more business and increase their portfolio size, the lack of performance fees reduces their incentive to outperform the market.[81]

While hedge funds overcome these deficiencies by charging performance fees and escaping most regulation, they do pose a set of new problems. They may be more likely to seek short-term profit since their business model is dependent on the 20% incentive fee. This leads commentators to question their corporate governance strategy and ask whether it is a ploy to seek short-term price increases as opposed to a long-term value-enhancing strategy.[82] Additionally, while hedge funds have become an increasingly large part of the securities market, most do not employ an active equity approach; rather, they employ a global macro, debt or quantitative strategy.[83] General research has shown that institutional investors do play an important role in corporate governance; however, they can only partially cure the deficiencies of passive shareholders.

B. *Management Can Game the System and Ensure Victory in Highly Contested Proxy Contests*

One of the most shocking aspects of proxy contests is that, when the vote is close, management almost never loses. Empirical research shows that contests that result in a 50-51% management approval outweigh those with a 49-50% management approval by a 56 to 8 margin.[84] This means that in some of the most important, highly contested proxy contests management has a competitive advantage. The reason for this is that management is closer to the voting process and receives informa-

81. *See id.*

82. *See* Rita Raagas De Ramos, *Concerns over Hedge Funds Rise as Market Volatility Rises Globally*, WALL ST. J., June 15, 2006, at C5; *see also infra* PartII (discussing the various strategy hedge funds and how they do not necessarily increase portfolio value by increased shareholder activism).

83. For a table detailing the assets under management by various hedge fund strategies, see The Barclay Group, Hedge Fund Industry—Assets Under Management, available at http://www.barclaygrp.com/indices/ghs/mum/HF_Money_Under_Management.html (last visited Mar. 26, 2007).

84. *See* Yair Listokin, *Management Always Wins the Close Ones*, 10 AM. L. & ECON. REV. 159 (2008).

Imaged with Permission of N.Y.U. Journal of Law & Business

tion that other shareholders don't have access to.[85] For example, management oversees the proxy collector, which allows them to inquire about how the voting process is progressing and target resources to acquire the votes it needs. In contrast, an insurgent has to estimate how the proxy season is going and cannot allocate campaign resources as efficiently and precisely as management. This decreases the democratic aspect of corporate governance because, on the matters that are most contentious, management is in the position to ensure victory.

C. *Modern Securities Market Records Complicate Who Votes and Often Leave Empty Ballots*

The custodial arrangement of the modern trading system complicates who votes. For example, banks and brokers hold shares for their private and institutional clients with the Depository Trust Company (DTC), which holds the shares in bulk without differentiating which shares belong to individual clients.[86] For example, Investor A and Investor B use JP Morgan to purchase securities in Corporation X. JP Morgan uses a DTC to hold all of its clients' shares in Corporation X. The DTC creates an account called "JP Morgan Account," but the account does not clearly specify which shares belong to Investor A or Investor B. JP Morgan has agreements with their clients that allow them to use these shares to lend out for short sales and repurchase agreements. This is the growing phenomenon of the securities lending market. An investor whose shares are lent out is not entitled to vote.[87] To complicate the matter, it is not clear whose shares were lent out, and, in many cases, a shareholder will not receive proxy materials because his assets were used by the bank for an unrelated transaction.[88] The system has many layers of complexity, and when votes do not properly match up with stock registration, corporate tabulators have to go back and determine the beneficial equity holder, which often is not discovered in time to be counted in the proxy contest.

---

85. *Id.*

86. *See* Marcel Kahan & Ed Rock, The *Hanging Chads of Corporate Voting*, 96 GEO. L. REV. 1227 (2008).

87. *See id.* at 1256.

88. *See id.* at 1256-57.

Imaged with Permission of N.Y.U. Journal of Law & Business

This complicated structure has led to several sources of pathologies that upset the voting system.[89] The tight schedule created by the provision that requires the record date to not be more than 60 days before the annual meeting causes recurrent instances of shareholders not receiving proxy materials and thus not being able to vote. The system does not count votes that were cast late because of the formal voting regulations. Brokers and banks commonly over-vote their own and their clients' shares, and the post-voting audit will discount votes. Securities lending adds an additional concern because it is not clear when a broker or a bank lends out its shares or which individual client's shares they lent out.[90] The DTC will show a reduction in the account, but they often receive proxy instructions that exceed the account balance.

In addition to equity stakeholders losing the opportunity to vote their shares, there is the concept of empty voting where non-equity holders get a chance to vote.[91] The most common instance is someone who sold their security after the record date, thus they are entitled to vote, but they no longer have an equity interest. More recently, there has been a trend where someone who wants to influence an election can buy stock in the corporation while simultaneously taking short positions in a derivative of the asset to reduce the downside effect of holding the security. This scheme allows one to vote when he has no stake in the company's residual value, thus increasing agency costs.[92] All of these trends have caused a dilution and distortion of voting power. In many cases it is institutional investors who lose the chance to influence corporate governance, and it is precisely their vote that reforms have counted on to increase shareholder activism.

89. *See id.* at 1260-70.

90. *See id.*

91. *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 833-835 (2006) (discussing the process of gaining votes in a corporation without undertaking the accompanying economic risk, and also discussing the legality and need for reform).

92. *See id.*

Imaged with Permission of N.Y.U. Journal of Law & Business

D. *Algorithm and Quantitative Strategies Exacerbate the Problem of Shareholder Passivity*

In addition to the sophistication in the trading of shares, there is an increasing trend in the market that pursues quantitative and algorithmic approaches to equity investing. Under the quantitative approach to equity investing, a security is chosen not because of it long-term prospects, but because of its current pricing in the market.[93] For example, if an investor feels that a particular security is underpriced relative to its peers, he will buy it and sell as soon as the market recognizes its mispricing. These kinds of strategies are frequently employed in the most common hedge fund strategy, long-short.[94] Typical fundamentals of the corporation (i.e. the price-to-earnings ratio) often give way to statistical characteristics of the asset such as the stock's beta.

Other forms of hedge fund strategies that comprise a significant portion of the industry also do not create the incentive to trade shares as an active shareholder. For instance, some event-driven hedge funds seek to profit off the premium of a target corporation's stock price and offset the risk exposure by taking a short position in the acquirer. The strategy focuses on the short-term profit swing of a potential target premium rather than seeking long-term value by participating in the corporate governance of the new entity and seeking to maximize the potential synergy value.

Similarly, convertible arbitrage strategies look to profit on a portfolio which is comprised of equity and debt instruments that contain embedded options in order to convert the debt to equity at the right price. The strategy behind this approach is to find combinations of mispricing that allow a trader to guarantee a return that is at least equal to the risk-free rate with the potential for higher returns and without any corresponding risks. It is easy to see why the trader does not profit by investing in active proxy voting.

---

93. *See* ZVI BODIE, ALEX KANE & ALAN MARCUS, INVESTMENTS, 303 (Mcgraw-Hill/Irwin 5TH ed. 2001) (discussing the importance of quantitative strategies in today's capital markets for even those who pursue long-term strategies).

94. *See* The Barclay Group, Hedge Fund Industry—Assets Under Management Table, *supra* note 83.

Imaged with Permission of N.Y.U. Journal of Law & Business

In the same vein, algorithmic trading uses sophisticated computers that recognize various characteristics (liquidity, volume, price, volatility) and automatically execute trades based on pre-set criteria.[95] These strategies are increasing their share of the market and are becoming a driving force for trading platforms in the trading desks of financial institutions.[96] One scholar estimated that in 2005, 25% of all trades were executed through algorithmic trading. He also estimated that algorithmic trading will increase 30% over the next 10 years.[97]

Perhaps the form of alternative investing that showed the most promising ability to wage proxy battles was the private equity market. Private equity funds typically seek equity stakes in corporations that are struggling and seek to privatize them in the effort to restructure the management and turn the company around. At first glance, this seemed to be a promising effort to put a check on the current board of directors, to reduce agency costs and to govern the corporation responsibility. However, these funds relied heavily on the "leveraged buyout" model, which borrows against the corporation's assets to fund the buyout. Two market developments have made this business model increasingly difficult.

First, the levering of the target corporation's assets has caused increased risk of default to the unsecured creditors.[98] This has caused many unsecured lenders to obtain covenants in their loan agreements to prevent companies from securing

95. *See* Moving Markets Shifts in Trading Patterns Are Making Technology Ever More Important, THE ECONOMIST (Feb. 2, 2006), *available at* http://www.economist.com/node/5475381?story_id=E1_VQSVPRT.

96. *See id* .

97. *See* Ivy Schmerken, Wall Street and Technology (2005). For a detailed discussion of the widespread use of algorithmic trading, see, e.g., Felix Salmon & Jon Stokes, *Algorithms Take Control of Wall Street*, WIRED (Dec. 27, 2010) (stating that "by some estimates, computer-aided high-frequency trading now accounts for about 70 percent of total trade volume"), *available at* http://www.wired.com/magazine/2010/12/ff_ai_flashtrading/all/1.

98. By trading the security interest in the corporation's assets for a loan that allows the fund to pay off outstanding shareholders, the unsecured creditors face a more levered corporation that does not have the increased capital of a secured loan and are lower on the priority list of payoffs if the corporation were to be liquidated. For a discussion on the process of a LBO as well is its legality in light of the fraudulent transfer laws, *see* BARRY E. ADLER, DOUGLAS G. BAIRD, & THOMAS H. JACKSON, BANKRUPTCY, CASES, PROBLEMS, AND MATERIALS, 324-41 (4th ed. 2007).

Imaged with Permission of N.Y.U. Journal of Law & Business

their assets for new loans, thus there is a smaller market of target corporations that are viable candidates for a typical LBO.[99] Second, the credit crisis of 2008 has made any form of lending on a large scale nearly impossible. The combination of market forces and increased regulations following the Dodd-Frank Act decreases the chance that a fund can obtain the necessary financing to pull off a large-scale privatization.

With new innovations in how shares are traded, it is no surprise that volume and share turnover has increased. The NYSE estimates that, on average, a company has close to 100% turnover of its shares annually.[100] With a market that is in constant flux, there are plenty of shareholders who will never become aware of corporate governance issues and will not vote responsibility. This leads to greater shareholder passivity and increases agency costs. The complicated world of electronic trading and sophisticated alternative investment clouds the Easterbrook presumption that the owners of the company will vote in a "democratic scheme."

V.
PART IV - PROPOSALS, SOLUTIONS AND RESPONSES TO COMBAT MODERN SHAREHOLDER PASSIVITY

A. *Academic Solutions That Have Been Proposed for Voting Reform*

There has been considerable debate on what approach the law should take to account for the collective action problem. Some academics look to reformation in the structure of the broker and custodial model.[101] They advocate changes to when record dates are issued together with the regulation of the DTC, Institutional Shareholder Services and proxy solicitors to issue proxy material in a manner that ensures the right shareholder receives his opportunity to vote.[102] These efforts might reduce the problems that exist because of technological

99. *See id.* at 340.

100. N.Y. STOCK EXCH., NYSE OVERVIEW STATISTICS, http://www.nyxdata.com/factbook (follow "NYSE Historical Statistics" hyperlink then "NYSE Overview Statistics" hyperlink) (last visited Apr. 16, 2012).

101. *See generally* Kahan, *supra* note 86, at 1273-79 (advocating for the so-called "Spanish Model," a comprehensive reformation that would simplify the custodial model and make it uniform across the board).

102. *See id.* at 1270-72.

Imaged with Permission of N.Y.U. Journal of Law & Business

recordkeeping, but they do little to combat the issue that so many shares are traded with no motive to participate in corporate governance. However, overhaul of the players and process of the market is warranted. In addition to improving the efficiency of the system, management should not have access to the proxy system that unfairly advantages their campaign efforts. Some form of independent system that oversees the process is a requisite to have any meaningful reform.[103]

B. *SEC Proxy Access Rule, Benefits and the Controversy Behind Its Implementation*

In 2010, the SEC announced that it will implement the long-awaited proxy access rule. Under this rule, depending on the size of the corporation, significant equity holders who have held the security for a specified period of time will be allowed to nominate directors and assume a large role in corporate governance.[104] The most common scheme will allow a shareholder (or shareholder group) who has owned at least 3% of the company's shares for at least three years to place nominees on the company's proxy statement for up to 1/4 of the total board seats. The policy rationale behind the rule is to give larger and longer-term shareholders a more active role in corporate governance.[105]

---

103. *See* Listokin, *supra* note 84, at 182 (advocating an independent group to be appointed by a government or stock exchange authority to verse the proxy tabulation so as to not allow management an inside track in proxy contests).

104. . *Cf*. Kathleen L. Casey, *Speech by SEC Commissioner: Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations*, U.S. SEC. EXCH. COMM'N (Aug. 25, 2010), http://www.sec.gov/news/speech/2010/spch082510klc.htm.

105. *Cf. id.* For a brief description of the rule's characteristics see the court's summary of the federal register in Bus. Roundtable v. S.E.C., 647 F.3d 1144, 1147 (D.C. Cir. 2011) ("To use Rule 14a–11, a shareholder or group of shareholders must have continuously held 'at least 3% of the voting power of the company's securities entitled to be voted' for at least three years prior to the date the nominating shareholder or group submits notice of its intent to use the rule, and must continue to own those securities through the date of the annual meeting. The nominating shareholder or group must submit the notice, which may include a statement of up to 500 words in support of each of its nominees, to the Commission and to the company. A company that receives notice from an eligible shareholder or group must include the proffered information about the shareholder(s) and his nominee(s) in its proxy statement and include the nominee(s) on the

Imaged with Permission of N.Y.U. Journal of Law & Business

This rule has been advocated for many years and has the potential to reform corporate governance and the voting system. However, the SEC delayed the rule's implementation amid hostile resistance from corporate management organizations.[106] Some of the major critiques the rule has endured have been put forth by The Businesses Roundtable ("BRT"), a collection of the country's most influential CEOs and directors.[107] They charge that it will lead to increased costs for the issuer by having to consistently fight off insurgents and focus on short-term stock performance.[108] In addition, there will be nominees on the board who are not professional managers and do not have the expertise to run corporate affairs. This also increases the chance that nominees will seek board seats for private benefits as opposed to maximizing the corporation's value. Professor Bebchuk and other academics have complied a list of responses to the BRT's charges.[109] Even if

---

proxy voting card. The Commission did place certain limitations upon the application of Rule 14a–11. The rule does not apply if applicable state law or a company's governing documents 'prohibit shareholders from nominating a candidate for election as a director.' Nor may a shareholder use Rule 14a–11 if he is holding the company's securities with the intent of effecting a change of control of the company. The company is not required to include in its proxy materials more than one shareholder nominee or the number of nominees, if more than one, equal to 25 percent of the number of directors on the board.") (citations omitted).

106. *See* James Hyatt, *SEC Puts Proxy Access Rules on Hold*, BUS. ETHICS (October 4, 2010), *available at* http://business-ethics.com/2010/10/04/2249-sec-puts-proxy-access-rules-on-hold/.

107. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 557 & n.1 (2004-2005); Letter from Henry A. McKinell, Chairman, Bus. Roundtable, to Jonathan Katz, Sec'y, U.S. Sec. Exch. Comm'n (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/brt122203.htm; John J. Castellani & Amy L. Goodman, The Case Against the SEC Director Election Proposal, *available at* http://www.law.harvard.edu/faculty/hjackson/alumnipapers/SEC_Director_Election.Castellani.and.Goodman.pdf (last visited Apr. 18, 2012).

108. Many issuers of corporate stock argue that, under the rule's scheme, incumbent directors will be forced to focus on short-term stock appreciation to the detriment of long-term performance. *See, e.g.*, Letter from Michael J. Ward, Chairman, CSX Corp., to Mary L. Schapiro, Chairman, U.S. Sec. Exch. Comm'n. (Aug. 18, 2010), *available at* http://www.sec.gov/comments/s7-10-09/s71009-677.pdf.

109. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); *see also* Bebchuck, *supra* note 107 at 557 & n.1 (arguing that any deficiency that shareholder directors would pose would be over-

Imaged with Permission of N.Y.U. Journal of Law & Business

proxy access were implemented and the benefits of providing greater management scrutiny were realized, it would not preserve the right for smaller long-term shareholders to participate in corporate governance.

C. *The Proxy Access Rule's implementation and the D.C. Circuit's Opinion*

Despite the hostility toward proxy access, the SEC promulgated Exchange Act Rule 14a–11 to take effect on November 15, 2010. The BRT petitioned for review, arguing that it violated the Administrative Procedure Act.[110] Specifically, BRT charged the SEC with not conducting enough experimental analysis on the economic consequences of the rule's effect.[111]

The SEC argued that they considered the available economic data and, with their expertise, concluded that proxy access would reduce the cost of informing shareholders about the board's affairs.[112] With regard to competition, the SEC concluded that the potential for increased corporate governance and accountability can lead to greater shareholder value and a more efficient marketplace.[113] Furthermore, the SEC concluded that other alternatives did not provide the same potential for an effective and transparent proxy process.[114]

The D.C. circuit sided with the BRT and set aside the rule for being "arbitrary and capricious" in violation of the APA and the Exchange Act of 1934[115] because it did not adequately

---

come by more informed shareholder voting, and only the most qualified candidate would win an election).

110. Bus. Roundtable v. Sec. and Exch. Comm'n 647 F.3d 1144, 1146 (D.C. Cir. 2011).

111. Under the APA, agencies are required to inform the public of a rule's consequences in order for the public to submit appropriate comments. *See* Pub. Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1216 (D.C. Cir. 2004). For a further discussion on the implementation of the functions of administrative agencies, see LISA S. BRESSMAN, EDWARD L. RUBIN & KEVIN M. STACK THE REGULATORY STATE (2010).

112. Brief for Respondent at 19, Bus. Roundtable v. Sec. and Exch. Comm'n, No. 10-1305 (D.C. Cir. Feb. 25, 2011), 2011 WL 2014799.

113. *Id.*

114. *Id.* at 20.

115. The SEC's authority under the Exchange Act is to promulgate rules is limited by the responsibility to consider "efficiency, competition, and capital formation," and to "apprise itself—and hence the public and the Congress—

Imaged with Permission of N.Y.U. Journal of Law & Business

consider the economic effects.[116] The court reasoned that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."[117] The court cited *inter alia* the SEC's failure to quantify the cost to the issuer borne by management's distraction of fighting proxy contests against their own nominees.[118] Furthermore, the court stated that the SEC "relied upon insufficient empirical data when it concluded that Rule 14a–11 will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees."[119] The court pointed to other objections such as the SEC's failure to consider the effect on specific industries as well as the role of shareholders with specialized interests.[120]

---

of the economic consequences of a proposed regulation." 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a–2(c).

116. Bus. Roundtable v. Sec. and Exch. Comm'n, 647 F.3d at 1148.

117. *Id.* at 1148-49.

118. *Id.* at 1149-50 ("The petitioners also argue it was arbitrary for the Commission not to estimate the costs of solicitation and campaigning that companies would incur to oppose candidates nominated by shareholders, which costs commenter's expected to be quite large. The Chamber of Commerce submitted a comment predicting boards would incur substantial expenditures opposing shareholder nominees through 'significant media and public relations efforts, advertising . . ., mass mailings, and other communication efforts, as well as the hiring of outside advisors and the expenditure of significant time and effort by the company's employees.' It pointed out that, in recent proxy contests at larger companies, costs 'ranged from $14 million to $4 million' and, at smaller companies, 'from $3 million to $800,000.' In its brief, the Commission maintains it did consider the commenter's estimates of the costs, but reasonably explained why those costs 'may prove less than these estimates.'") (citations omitted).

119. *Id.* at 1150 ("The Commission instead relied exclusively and heavily upon two relatively unpersuasive studies, one concerning the effect of 'hybrid boards' (which include some dissident directors) and the other concerning the effect of proxy contests in general upon shareholder value. Indeed, the Commission 'recognize[d] the limitations of the Cernich (2009) study,' and noted 'its long-term findings on shareholder value creation are difficult to interpret.' In view of the admittedly (and at best) 'mixed' empirical evidence, we think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.") (citations omitted).

120. *Id.* at 1151-56.

Imaged with Permission of N.Y.U. Journal of Law & Business

After Rule 14a-11 was vacated, the SEC decided not to seek Supreme Court review.[121] Instead, the SEC is reviewing the court's decision and reviewing public comments to prepare a more judicially appropriate regulation. During the pending litigation, many commentators have requested the SEC to consider a version of the rule where directors are able to opt out of the rule through a bylaw amendment.[122]

D. *Proposed Solution to Shareholder Voting Rights That Should Be Included in a Reformation of the Proxy System*

A possible solution can incorporate greater regulation with regard to record dates and DTC as well as some of the principles of the proxy access rule. One of the features of the proxy access rule that is appealing and equitable is that it gives influence to shareholders who have held a security for longer periods of time. These shareholders do not have the conflicts associated with hedge funds that arguably are after short term performance.[123] In addition, these investors are not holding the security for quantitative justifications, such as hedging or mispricing. This article proposes giving increased voting power to all shareholders who hold securities for more than a specified period, ideally at least one year. The amount to which the voting influence should be increased should be directly proportional to the amount of shares that are abstained either due to shares being lent out, brokers not being allowed to vote discretionary accounts, or empty proxies. Under the proposed increase in monitoring of DTC and proxy tabulators, this can be a simple calculation to make.

---

121. *See* Press Release, *supra* note 75.

122. The most prominent letter of this sort was submitted by the nation's most recognized Wall Street law firms who provided an extensive comment on the rule. *See* Comment from Cravath, Swaine & Moore LLP; Davis Polk & Wardwell LLP; Latham & Watkins, LLP; Simpson Thacher & Bartlett LLP; Skadden, Arps, Slate, Meagher & Flom LLP; Sullivan & Cromwell LLP; Wachtell, Lipton, Rosen & Katz (Jan. 19, 2010), *available at* http://www.sec.gov/comments/s7-10-09/s71009-619.pdf).

123. *See* Kahan & Rock, *supra* note 56 (finding that hedge funds often force corporations to buy back stock to increased short term market price). Typically, individual long-term shareholders see value in the long-term prospects of the corporation, inform themselves of the underlying risk factors and could significantly contribute to corporate strategy.

Imaged with Permission of N.Y.U. Journal of Law & Business

Assume Corporation X has 100 shares; 10 owned by management, 35 owned by institutional investors and 55 owned by the general public. Say 10 shares are discounted for any reason including not voting. (Note: a shareholder can always mark abstention on the ballot.) This paper is proposing that those 10 shares should be allocated on a *pro rata* basis to all shareholders who have held the security for more than one year. By their very nature, long-term shareholders have the long-term prospects of the company in interest as well as superior knowledge compared to the average day trader. Shareholders who do not qualify as long-term do not have to be subjected to dilutive voting power so long as they take the opportunity to fill their proxies. If they are unhappy with proxy outcomes, they can always make sure to vote responsibly by at least abstaining, which would dilute long-term shareholders' voting power. This is an extra incentive for shareholders to overcome the collective action problem.

Some additional strengths of the long-term shareholder proposal are that it captures the essence of the proxy access rule without some of its drawbacks. Unlike the proxy access rule, management does not have to incur the costs of putting nominees on the ballot and fighting proxy contests with them. There are no non-managers that can create an environment of hostility towards the board or seek to capture private benefits. Additionally, long-term shareholders who do not hold a significant stake of the corporation's equity (at least 3%) are empowered to play a more active role in corporate governance.

The D.C. Circuit objected to the proxy access rule because the SEC did not conduct cost benefit analyses on the revolutionary idea of allowing shareholders to nominate their own candidates on the issuer's proxy material.[124] The long-term shareholder proposal does not disrupt the proxy process; management will still fill out their own proxies and all shareholders will vote the same way they always have. The plan just allows certain shareholders more voting power. In this author's opinion the D.C. Circuit's concern does not apply to this proposal, or, at the very least, it would be easier for the SEC to conduct economic experiments on a proposal that doesn't force management to fight insurgents on their own proxy material. Furthermore, the SEC does not need to con-

124. *See* discussion *supra* Part IV.C.

Imaged with Permission of N.Y.U. Journal of Law & Business

sider which industries have more special interest shareholders as the proposal does not run the risk of allowing private benefits that access to the ballot affords.

Most corporations have historically resisted corporate governance reformation as it reduces their influence and control. The long-term shareholder proposal has the prospect to change this trend because it cures a deficiency in some of management's proposals. Recently, one of the most popular corporate governance trends is requiring management efforts, such as re-election or compensation, to receive 51% of the outstanding shares as opposed to a majority of the shares that voted (plurality).[125] Management proposals have often failed despite receiving the majority of the votes because so many proxies go unfilled. If management has put forth worthy proposals, long-term shareholders should support their plan. The increased voting power they have will increase the odds that management will be successful in their pursuits.

The long-term shareholder voting proposal is highly reformative but it is quite simple to implement. Although this paper will not comment if this reform should be through Delaware law or federal intervention, it should be noted that the mere threat of federal intervention often has the occurrence of the Delaware legislature and courts to re-examine some of its perceived "pro-management" policies.[126]

---

125. *See New Study Details Recent Trend by Corporations to Adopt Tougher Majority Voting Standards for 2006 Proxy Season*, BusinessWire.com (Feb. 28, 2006) (discussing a study that shows supermajority proposals have gained momentum this year. Institutional Shareholder Services found that 140 majority vote proposals have been filed for the 2006 proxy season compared to 89 that were filed last year.), *available at* http://www.businesswire.com/news/home/20060228005780/en/Study-Details-Trend-Corporations-Adopt-Tougher-Majority.

126. *See generally* Steven M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REG. 32 (2003); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUSTON L. REV. 99 (2003); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections on Federalism*, 56 VAND. L. REV. 859 (2003).

Imaged with Permission of N.Y.U. Journal of Law & Business

VI.
CONCLUSION

This article has discussed the importance of shareholder voting in corporate governance. Corporate directors and officers are agents of the shareholders. The central management system of corporate law allows agents to disobey the principal in many situations.[127] It is believed that directors require broad discretion to make efficient business decisions. The shareholders, as principals, express their commands to their agents through the voting system. Shareholder complacency exists because of the collective action problem.[128]

There have been moderate reforms to combat shareholder complacency but the problem is still visible.[129] Institutional investors do have the necessary incentives to act and watch over management; however, regulations and conflicts of interest limit their ability to completely uphold a system of efficient corporate governance.[130] Proxy amendments have increased shareholder involvement, but they increase administrative and litigations costs.[131] The proxy access rule is an example of how the SEC has taken steps to address the issue, but, due to extreme resistance from both corporations and judges, it has yet to be implemented effectively.[132]

The current electronic and algorithmic system is evolving in such a way that the collective action problem only seems to be getting worse.[133] This article's solution proposes to allow long-term shareholders to make up for the proxies that are not counted. This has the effect of borrowing the shareholder proxy access rule's protection of long-term shareholders and spreads it policies to smaller investors.[134] Unlike the proxy access rule, there is no concern for increased costs to the corporation or unproductive, litigious board contests that can be waged for private benefits. This proposal modernizes the cur-

127. *See* discussion *supra* Part I.B.
128. *See* discussion *supra* Part I.B.
129. *See* discussion *supra* Part II.
130. *See* discussion *supra* Part III.A.
131. *See* discussion *supra* Part III.B.
132. *See* discussion *supra* Part IV.B.
133. *See* discussion *supra* Part III.D.
134. *See* discussion *supra* Part IV.

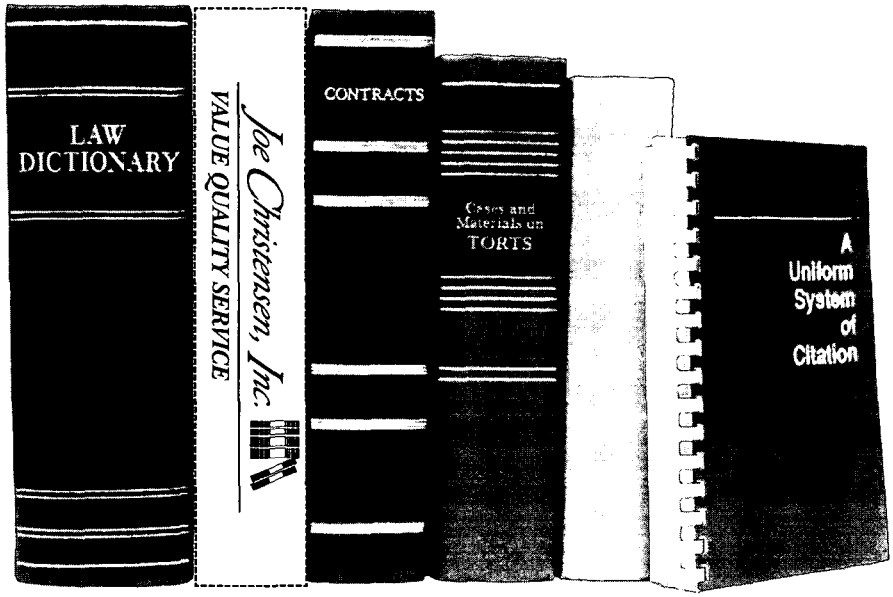
Imaged with Permission of N.Y.U. Journal of Law & Business

rent shareholder structure and increases the chance that the voting process leads corporations to act as effective republican democracies.

Imaged with Permission of N.Y.U. Journal of Law & Business

Imaged with Permission of N.Y.U. Journal of Law & Business

Imaged with Permission of N.Y.U. Journal of Law & Business



We Complete the Picture.

In 1932, Joe Christensen founded a company based on Value, Quality and Service. Joe Christensen, Inc. remains the most experienced Law Review printer in the country.

Our printing services bridge the gap between your editorial skills and the production of a high-quality publication. We ease the demands of your assignment by offering you the basis of our business—customer service.

Joe Christensen, Inc.

1540 Adams Street
Lincoln, Nebraska 68521-1819
Phone: 1-800-228-5030
FAX: 402-476-3094
email: sales@christensen.com

Value

Quality

Service

Your Service Specialists

Imaged with Permission of N.Y.U. Journal of Law & Business