

# DOES SHAREHOLDER PROXY ACCESS DAMAGE SHARE VALUE IN SMALL PUBLICLY TRADED COMPANIES?

Thomas Stratmann\* & J.W. Verret\*\*

*The field of corporate governance has long considered the costs of the separation of ownership from control in publicly traded corporations and the regulatory and market structures designed to limit those costs. The debate over the efficiency of regulations designed to limit agency costs has recently focused on the SEC's new rule requiring companies to include shareholder nominees on the company-financed proxy statement to facilitate insurgent challengers to incumbent board members in board elections. A recent vein of empirical literature has examined the stock price effects of events surrounding the new proxy access rule. We present a study that focuses on small companies that expected an exemption from the rule under the Dodd-Frank legislation that preceded the adoption of the SEC rule. We consider the effect of the August 25, 2010 announcement of the proxy access rule, comparing its effect on the value of medium and large firms, which expected to be subject to the full rule, against its effect on the value of small firms, which were unexpectedly given only a temporary exemption from part of the rule (Rule 14a-11) and no exemption from another part of the rule (Rule 14a-8). Supporters of proxy access have long argued that it will enhance shareholder value. Critics of proxy access have argued that it will empower investors with conflicted agendas that will destroy shareholder wealth. The unexpected application of the rule to small-cap companies on August 25 provides a natural experiment for this question and allows us to examine the differential effect of the rule on firms above and below the arbitrary SEC cutoff of \$75 million dollars in market capitalization. We find that the unanticipated application of the proxy access rule to small firms, particularly when combined with the presence of investors with at least a 3% interest (who are able to use the rule), resulted in*

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\* Professor of Economics, George Mason University Department of Economics.

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*negative abnormal returns. We present multiple methods to measure that effect and demonstrate losses for our sample of roughly 1000 small companies of as much as \$347 million.*

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## INTRODUCTION

The separation of ownership from control has long been a focal point for debate in corporate governance literature.<sup>1</sup> Much of the academic community views shareholders as facing a collective action problem in exercising their right to vote in elections for directors of publicly traded corporations.<sup>2</sup> It is argued that finding ways to empower shareholders—for instance, by making election contests easier or less costly—will generate positive shareholder returns through a reduction in agency costs.<sup>3</sup> A few members of the academic community have urged caution, citing the benefits of a director-centric structure or the risks of conflicted shareholders using their voting rights to push so-

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1. See Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 754-55 (2007); see also Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 676 (2007); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 70-73 (2003).

2. That argument originated with Berle and Means. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 86-88 (William S. Hein & Co. 1982) (1932).

3. See *infra* Part III.A.

cial or political agendas.<sup>4</sup> The most recent and lively iteration of this debate has been over granting shareholders access to the corporate proxy. Under the status quo, incumbent directors have their election expenses, including the cost of sending out proxies, paid for by the company.<sup>5</sup> The proxy card, essentially an absentee voting card, is the primary voting and vote-solicitation vehicle for director elections because most shareholders do not attend the company's annual meeting.<sup>6</sup> Proponents of shareholder empowerment have pushed in recent years to give shareholders, under certain circumstances, the right to include nominees on the company proxy card rather than requiring challengers to send out their own proxy card.<sup>7</sup> The SEC considered proposed rules to provide for proxy access three times in the last decade, but owing to the controversial nature of the topic, did not follow through with those proposals.<sup>8</sup>

On August 25, 2010, the SEC adopted a rule granting shareholders with more than a 3% equity interest in publicly traded companies the right to place nominees on the company's proxy statement.<sup>9</sup> The rule was adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>10</sup> The Dodd-Frank Act gave the SEC authority to adopt the rule, but instructed the SEC to consider an exemption for small firms.<sup>11</sup>

The language of the Dodd-Frank Act led to three surprise events on August 25, 2010 that each increased the probability and magnitude of proxy access use at small firms compared to expectations based on the initial Dodd-Frank legislation released on June 25, 2010. The rule ultimately adopted by the SEC did

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4. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796-99 (1993); see also Lipton & Savitt, *supra* note 1, at 757-58 (citing the benefits of a director-centric structure).

5. See Bebchuk, *supra* note 1, at 688, 697-98.

6. See Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1260-61 (2009).

7. See Bebchuk, *supra* note 1, at 696; Fairfax, *supra* note 6, at 1260-61.

8. See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274) [hereinafter 2003 Proxy Access Proposal]; see also Facilitating Shareholder Director Nominations, Securities Act Release No. 9046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified in scattered sections of 17 C.F.R.) [hereinafter 2009 Proxy Access Proposal]; Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240) [hereinafter 2007 Proxy Access Proposal].

9. Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668, 56,674 (Sept. 16, 2010) (adopted Aug. 25, 2010) (to be codified in scattered sections of 17 C.F.R.), *vacated in part by* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) [hereinafter 2010 Proxy Access Rule].

10. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

11. 15 U.S.C. § 78n note (Supp. IV 2010).

not permanently exempt small firms from the proxy access rule.<sup>12</sup> Instead, it gave small firms only a temporary exemption from one part of the proxy access rule (Rule 14a-11), which provided for a minimum proxy access default rule, and provided for immediate application of another part of the proxy access rule (Rule 14a-8), which allowed shareholders to modify the SEC's default rule to make it easier for shareholders to use.<sup>13</sup> Additionally, the SEC's proposed rule in 2009 required 5% stock ownership for a shareholder to use proxy access at small firms,<sup>14</sup> but the rule adopted on August 25, 2010 would require only 3% ownership, making it much easier for shareholders to use proxy access at small firms than shareholders would have assumed based on the SEC's prior proposal. The final rule therefore increased the likelihood of small firms experiencing proxy contests or dissident board members by denying a permanent exemption for small firms from Rule 14a-11, by providing for immediate application of Rule 14a-8, and by decreasing the shareholder ownership barrier to proxy access for small firm shareholders. The unexpected nature of these events forms a suitable experiment to determine the effect anticipated by shareholders of proxy access on small firm value.

Our Article rests on the assumption that shareholders of small firms anticipated a permanent exemption from Rules 14a-8 and 14a-11, and believed that even if the proxy access rule applied to them, it would require a 5% ownership threshold, which would limit use of the mechanism.<sup>15</sup> We considered the possibility of an alternative to our assumption that the market anticipated a complete opt-out from the rule: it is possible that the market already knew of the details of the August 25 rule prior to its announcement. There are three reasons why this is unlikely. First, no publicly available comment from legislators or regulatory officials at the SEC prior to August 25 indicated the unexpected changes. Second, no available news media on the topic of proxy access hinted at the changes prior to the event,<sup>16</sup> and the SEC's news release describing the new rule was not released until the meeting at which the rule was adopted.<sup>17</sup>

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12. See Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,674.

13. *Id.* at 56,730-32.

14. 2009 Proxy Access Proposal, *supra* note 8, at 29,035.

15. The evidence supporting this assumption is described later in this Article in Part II. Stock price event studies provide a useful measure of the impact of an event on market value, but they require that the event studied was unanticipated. One example in this area is a contrary study by Becker, Bergstresser, and Subramanian, which this Article seeks to refute in part. See Bo Becker, Daniel Bergstresser & Guhan Subramanian, *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge* (Harvard Bus. Sch. Fin. Working Paper No. 11-052, 2012), available at <http://ssrn.com/abstract=1695666>.

16. We performed an extensive search on Westlaw, which we address later in this Article. See *infra* p. 1444 and accompanying text.

17. See Press Release, SEC, SEC Adopts New Measures to Facilitate Director Nominations by Shareholders (Aug. 25, 2010), available at <http://www.sec.gov/news/press/2010/2010-155.htm>.

Third, the SEC staff is subject to stringent ethics rules<sup>18</sup> which provide criminal and civil penalties in the event the staff shares information with individuals they are aware will trade on the information.<sup>19</sup> Our results will remain consistent as long as shareholders viewed it to be more likely than not that a full exemption and a higher ownership threshold would be included in the August 25 rule. Indeed, if shareholders assumed a full exemption and a high ownership threshold for small firms were just barely more likely to be included in the August 25 rule than not, then our results actually underestimate the negative impact of the rule on small firms.<sup>20</sup>

This Article considers the existing institutional literature on shareholder proxy access, which precedes the debate leading up to the adoption of the proxy access rule in 2010. It also reviews the existing empirical literature on proxy access and shareholder empowerment. Two empirical studies considered the effect of an announcement of the proxy access rule on firm value using dates prior to the Dodd-Frank Act and discovered that events that increase (or decrease) the probability of proxy access result in lower (or higher) abnormal returns.<sup>21</sup> Still another study considered the effect of the legal challenge to the rule and the resulting announcement by the SEC that it would delay application of the rule until after the legal challenge has been resolved.<sup>22</sup> None, however, have focused on the small firm exemption.

This Article's contribution to the debate is to offer a stock price event study to determine the stock price effects of the SEC's 2010 proxy access rule. It considers the date of August 25, 2010, when we assume the prevailing assumption was that firms with a market capitalization of less than \$75 million would be exempt from the rule, and a surprise announcement from the SEC revealed that they would be (1) subject to part of the rule, (2) only temporarily exempted from the remainder of the rule, and (3) subject to a lower ownership threshold for the rule to apply. Our focus is the disparate impact of the SEC's proxy access rule announcement on firms with a market capitalization of greater than \$75 million, which are subject to the rule, as compared to firms with a market capitalization of less than \$75 million, which are currently exempt for a

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18. See 5 C.F.R. §§ 4401.101 to .103 (2011); 17 C.F.R. §§ 200.735-1 to -18.

19. That is not to suggest it does not happen, but merely that there are rules to disincentivize the practice.

20. If shareholders assumed a 51% chance of a small firm exemption rather than a 99% chance of a small firm exemption, and if they expected the lack of an exemption would decrease shareholder value, then much of the damage would already be factored into the share price as of the date the rule was released.

21. David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 432 (2011); Ali C. Akyol et al., Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations (June 7, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1526081>. Abnormal returns are the difference between the actual return of a security and the expected return.

22. See Becker et al., *supra* note 15.

three-year period from part of the rule. We also consider the effect of the presence of institutional owners with greater than 3% ownership.

We provide a methodological improvement over previous event studies in this area of research. Previous studies did analyze the effect of an event, but the nature of the event did not allow them to use a control group to precisely identify the effect of the event. Given that the 2010 proxy access rule applied differentially across an artificial divide (\$75 million market capitalization), we can not only examine how the event affected the firms that were only temporarily exempted by the SEC, but also how these firms performed relative to firms for whom the SEC announcement was not a surprise.

The objective of this study is to determine the unanticipated impact of the proxy access rule on firms with less than \$75 million in market capitalization, and whether, contrary to the beliefs of the rule's proponents, the rule might actually impose a net cost on small firms. In the event proxy access is perceived by the market to result in a net cost, some support will accrue to the hypothesis that conflicted objectives of some institutional investors limit the value of proxy access.

In Part I we summarize the theoretical debate over empowering shareholders to oversee and control boards of directors. In Part II we lay out the timeline of events leading up to the SEC's adoption of the proxy access rule and the mechanics of the rule. Part III reviews the prior literature to demonstrate how our investigation elucidates the existing debate over both proxy access and a broader set of corporate governance reforms. Parts IV, V, and VI describe the experiment we use to test the impact of unanticipated application of the proxy access rule to our test group of small firms as compared against our control group of larger firms on the date the rule was adopted. Part VII explains the results of the experiment.

## I. AGENCY COSTS AND SHAREHOLDER VOTING

A significant portion of corporate governance literature has considered the consequences of the separation of ownership from control in publicly traded companies. Some have argued in favor of new rules to empower shareholders as a way to minimize agency costs in the shareholder/board relationship.<sup>23</sup> Others have argued that doing so would empower special interests like union and

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23. Lucian Bebchuck, writing on behalf of eighty professors, was among the strongest advocates of this position. *See* Comment Letter from a Bi-Partisan Grp. of Eighty Professors of Law, Bus., Econ., or Fin. to Elizabeth M. Murphy, Sec'y, SEC, at 2 (Aug. 17, 2009) [hereinafter *Bebchuk Comment Letter*], available at <http://www.sec.gov/comments/s7-10-09/s71009-282.pdf> ("In evaluating eligibility and procedural requirements, the SEC should also keep in mind that many institutional investors lack incentives to invest actively in seeking governance benefits that would be shared by their fellow shareholders.").

state pension funds in a manner that may ultimately destroy shareholder value.<sup>24</sup>

The easier it is for shareholders to run candidates, the easier it is for shareholders to threaten or challenge the existing board for control of the corporation. This threat gives board members an incentive to follow the shareholders' wishes. However, shareholder control of the corporation may damage its performance, as shareholders may not operate it in a profit-maximizing or efficient fashion. If so, proxy access may actually lower the value of a firm. The value of a corporation's shares reflects the market's valuation of the firm at any given moment, and our study examines how investors perceived a potential increase in shareholder control by observing the movement in stock prices.

The debate has its origins in the work of Berle and Means, which first considered the implications of the separation of ownership from control in publicly traded companies.<sup>25</sup> Bebchuk has argued in favor of shareholder access to the proxy as a means of limiting agency costs, such as inappropriate compensation or shirking, and as a way to legitimize the deference typically given to directors in shareholder lawsuits.<sup>26</sup> Romano was one of the first commentators to urge caution in the shareholder-primacy debate by noting that many shareholders, such as state pension funds run by elected officials, may use increased shareholder leverage as a bargaining chip to push agendas unrelated to maximization of shareholder value.<sup>27</sup> Bainbridge has argued that the director-centric nature of the corporation, characterized by little actual power for shareholders, is not actually a problem to be solved, and instead argues that the shareholder wealth maximization norm does not need, and is in fact harmed by, shareholder empowerment.<sup>28</sup> His director-primacy model instead holds that the board serves as a guardian for the various contracts that make up the corporation, and suggests that dissatisfied shareholders can always withhold their capital or sell their shares when they do not favor board decisions.<sup>29</sup>

The contents of the proxy card function as an absentee ballot in director elections. The proxy card is of primary importance in determining the election outcome, as very few shareholders actually attend the election and nearly all shares voted at board elections occur through the proxy card.<sup>30</sup> The SEC adopt-

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24. See, e.g., Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564-65 (2006); see also Lipton & Rosenblum, *supra* note 1, at 78.

25. BERLE & MEANS, *supra* note 2, at 90.

26. Bebchuk, *supra* note 1, at 676-79.

27. Romano, *supra* note 4, at 796-97.

28. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550-51 (2003) (noting the director primacy model "embraces the shareholder wealth maximization norm even as it rejects the theory of shareholder primacy").

29. See Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 604, 619 (2006).

30. See 2010 Proxy Access Rule, *supra* note 9, at 56,670.

ed Exchange Act Rule 14a-11 in August of 2010 pursuant to the Dodd-Frank Act to require, under certain circumstances, that boards of directors include nominees of large shareholders for board elections on the company proxy statement.<sup>31</sup> Supporters of proxy access urged that the election process for membership on the board of directors of publicly traded companies is unfair, as incumbents' election expenses, including mailing of the proxy statement, are paid for by the company, while challengers have to pay their own expenses.<sup>32</sup> Proponents of proxy access further argued that it would make boards more accountable to their shareholders and reduce agency costs.<sup>33</sup> Bebchuk, for example, urges that the low incidence of proxy contests demonstrates they are an underutilized mechanism for shareholder oversight of the board.<sup>34</sup>

Opponents of proxy access have focused on three distinct costs. First, they have argued that the newly empowered interest groups would use proxy access as leverage to obtain side benefits.<sup>35</sup> For example, a union pension fund might use the threat of an election contest to obtain concessions from managers during bargaining over a company's labor contract with the union.<sup>36</sup> Argawal presents evidence arguing that AFL-CIO-affiliated shareholders tailor their support or opposition to management nominees depending on whether a union within the AFL-CIO umbrella represents employees at that company.<sup>37</sup> He also argues that his findings support the thesis that the differences are more pronounced at firms with a prior history of labor disputes, and that union pension fund opposition to management nominees to the board is associated with shareholder losses.<sup>38</sup>

Second, opponents of the rule have argued that compliance with proxy access will result in a larger number of contested elections, which could cost "anywhere from \$4 million to \$14 million for large companies, and \$800,000 to \$3 million for smaller companies."<sup>39</sup>

Third, critics have considered the effect of what Grundfest has termed "megaphone externalities," or the ability of groups to use proxy contests as a platform to raise social or political agendas only tenuously related to company

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31. *Id.* at 56,670, 56,674. By "large shareholders," we refer to those with more than a 3% stake in a publicly traded company, who will be able to use the rule.

32. Bebchuk Comment Letter, *supra* note 23, at 2.

33. *Id.*

34. Bebchuk, *supra* note 1, at 682-88.

35. *See, e.g.*, Lipton & Rosenblum, *supra* note 1, at 78 & n.31.

36. *See id.*

37. Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, 25 REV. FIN. STUD. 187, 203-06 (2012).

38. *Id.* at 210-11, 216-18 & tbl.9.

39. Opening Brief of Petitioners Business Roundtable & Chamber of Commerce of the United States of America at 18-19, *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (No. 10-1305), 2011 WL 2014800.



practices, even in instances where the nominating shareholder knows with certainty that his campaign will be unsuccessful.<sup>40</sup>

By contrast, Kahan and Rock argue that proxy access is largely not important.<sup>41</sup> They argue in part that proxy access will have little effect on the full cost of a proxy contest, since the costs of hiring lawyers and advertising for one's nominee is still the responsibility of shareholder challengers, and that the restrictions on proxy access will make its use highly difficult.<sup>42</sup> They also argue that even a successful proxy access contest will have little effect on the stock value of targeted companies.<sup>43</sup>

This background to the debate helps to frame our study's consideration of proxy access by way of a stock price event study, since nearly all proponents of proxy access have argued that it will result in increased shareholder value.<sup>44</sup>

## II. THE SEC AND THE PROXY ACCESS RULE

The Dodd-Frank Act<sup>45</sup> was adopted by Congress in 2010 in response to the financial crisis of 2008.<sup>46</sup> As part of that law, Congress confirmed the SEC's authority to adopt a rule granting shareholder access to the corporate proxy.<sup>47</sup> Proxy access is one of the most controversial issues considered by the SEC over the last ten years. Unions have strongly supported the rule and business groups have strongly opposed it.<sup>48</sup> But long before the current public debate, academics were considering the question at some length.<sup>49</sup>

The academic debate over shareholder empowerment informed the adoption of a rule that makes it easier for shareholders to run alternative sollicita-

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40. Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361, 380-82 (2010).

41. Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1426, 1432 (2011).

42. *Id.* at 1390-91, 1394-1405.

43. *Id.* at 1429, 1433.

44. *E.g.*, Bebhuk, *supra* note 1, at 679.

45. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code).

46. *See* Jean Eaglesham, *Overhaul Grows and Slows*, WALL ST. J., May 2, 2011, at C1, available at [http://online.wsj.com/article/SB10001424052748703346704576295873060349068.html?mod=ITP\\_moneyandinvesting\\_0](http://online.wsj.com/article/SB10001424052748703346704576295873060349068.html?mod=ITP_moneyandinvesting_0); *see also* Edward Wyatt, *A Scale-Back Is Possible in Financial Overhaul Law*, N.Y. TIMES (Nov. 3, 2010), <http://www.nytimes.com/2010/11/04/business/04regulation.html>.

47. 15 U.S.C. § 78n(a)(2) (2006 & Supp. IV 2010); *id.* § 78n note (Supp. IV 2010) ("The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer . . .").

48. *See* 2010 Proxy Access Rule, *supra* note 9, at 56,669-71 & nn.29-36.

49. *See, e.g.*, Romano, *supra* note 4; *see also* BERLE & MEANS, *supra* note 2; Agrawal, *supra* note 37; Bainbridge, *supra* note 29; Bainbridge, *supra* note 28; Bebhuk, *supra* note 1; Grundfest, *supra* note 40; Kahan & Rock, *supra* note 41.

tions. That rule was adopted by the SEC pursuant to the specific grant of authority in the Dodd-Frank Act. The events leading up to that rule all potentially affected stock prices, and so present a unique opportunity to consider how the market anticipates proxy access will affect securities prices. Our study adds to a growing literature that takes such an approach. Knowledge of the timeline of events leading up to the proxy access rule's adoption is required in order to understand the prevailing assumptions factored into stock prices on the day of the event. This will provide context for understanding how the event we target altered the existing market assumptions about whether the proxy access rule would apply to small firms and to what degree it would be utilized.

The following timeline presents a picture of the events leading up to the Dodd-Frank legislation authorizing the SEC to adopt the proxy access rule and the SEC's attempt to adopt a proxy access rule in response:

*June 25, 2010:* The joint conference committee adds a provision to the Dodd-Frank Act in the early morning hours instructing the SEC to consider the effect of a proxy access rule on small-cap<sup>50</sup> companies.<sup>51</sup>

*June 29, 2010:* The Dodd-Frank Act is reported out of the joint conference committee.<sup>52</sup>

*June 30, 2010:* The Dodd-Frank Act is adopted by the House.<sup>53</sup>

*July 15, 2010:* The Dodd-Frank Act is adopted by the Senate.<sup>54</sup>

*July 21, 2010:* The Dodd-Frank Act is signed by the President.<sup>55</sup>

*August 25, 2010:* The SEC adopts the proxy access rule, including the small issuer three-year exemption for Rule 14a-11, but does not exempt small firms from Rule 14a-8.<sup>56</sup> It also sets a 3% ownership requirement for shareholders to use the rule, in contrast to an earlier rule proposal in 2009 that contemplated a 5% ownership requirement for proxy access at small firms.<sup>57</sup>

*September 29, 2010:* The Business Roundtable files a petition in the Court of Appeals for the District of Columbia challenging the rule.<sup>58</sup>

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50. Note that, for the purposes of this article, references to "small" firms and "small-cap" firms refer to firms with less than \$75 million in market capitalization.

51. See Dodd-Frank Act § 971(b), 124 Stat. at 1915 (codified at 15 U.S.C. § 78n note (Supp. IV 2010)); Pat Garofalo, *Congress Approves Financial Reform, Scott Brown Gets His Volcker Rule Loophole*, THINKPROGRESS ECON. (June 25, 2010, 11:00 AM), <http://thinkprogress.org/economy/2010/06/25/173353/brown-volcker/?mobile=nc>.

52. H.R. REP. NO. 111-517 (2010).

53. 156 CONG. REC. H5261 (daily ed. June 30, 2010) (vote tally).

54. 156 CONG. REC. S5933 (daily ed. July 15, 2010) (vote tally).

55. See Dodd-Frank Act, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code); see also Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, DAILY COMP. PRES. DOC. NO. 617 (July 21, 2010), available at <http://www.gpo.gov/fdsys/pkg/DCPD-201000617/pdf/DCPD-201000617.pdf>.

56. See 2010 Proxy Access Rule, *supra* note 9, at 56,668, 56,730-32.

57. *Id.* at 56,674-75.

58. Petition for Review, *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (No. 10-1305), 2010 WL 3770710.

*October 4, 2010:* The SEC announces that it will delay implementation of the rule pending the outcome of the D.C. Circuit case.<sup>59</sup>

*July 22, 2011:* The D.C. Circuit vacates Rule 14a-11 in *Business Roundtable v. SEC*.<sup>60</sup> The rule is found to be arbitrary and capricious because it does not meet the SEC's statutory obligation to consider the effect of rules on "efficiency, competition, and capital formation."<sup>61</sup> The Court finds that the SEC failed to conduct sufficient cost-benefit analysis, citing a lack of empirical support for the rule's anticipated effect on stock prices.<sup>62</sup> Experts believe the SEC is currently considering its options for either challenging the holding or reissuing the rule based on further economic analysis sufficient to meet its burden as defined in the case.<sup>63</sup>

The 2010 proxy access rule had two key operational aspects. The first created a new regulation, Rule 14a-11, which mandated certain aspects of proxy access mechanics. Rule 14a-11 required publicly traded companies covered by the rule to include in the company proxy nominees put forward by shareholders, provided that the nominating shareholder held shares for the previous three years making up at least 3% of voting stock in the company.<sup>64</sup> Shareholders making use of proxy access are required to certify that they do not intend to use their nominations to facilitate an acquisition of control.<sup>65</sup> Shareholders are permitted to pool their shares to meet the 3% ownership requirement.<sup>66</sup> The second part of the rule, an amendment to Rule 14a-8, required companies to include in their proxy materials shareholder proposals to alter the process whereby proxy contests are conducted (provided that the shareholder proposal could make the mandatory Rule 14a-11 process easier for shareholders to conduct, but not more difficult).<sup>67</sup>

The 2010 proxy access rule exempted firms with a market capitalization of less than \$75 million dollars from application of Rule 14a-11 for a period of three years, after which Rule 14a-11 would apply to them.<sup>68</sup> The 2010 proxy access rule did not exempt any firms from application of its changes to Rule 14a-8.<sup>69</sup>

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59. Bus. Roundtable, Securities Act Release No. 9149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 WL 3862548, at \*1 (Oct. 4, 2010).

60. 647 F.3d 1144, 1156 (D.C. Cir. 2011).

61. *Id.* at 1148 (citing 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c) (2006)).

62. *Id.* at 1148, 1150.

63. See Steven M. Davidoff, *Proxy Access in Limbo After Court Rules Against It*, N.Y. TIMES DEALBOOK (July 27, 2011, 3:36 PM), <http://dealbook.nytimes.com/2011/07/27/proxy-access-in-limbo-after-court-rules-against-it>.

64. Kahan & Rock, *supra* note 41, at 1356 & nn.46-47.

65. See *id.* at 1357 & n.50.

66. *Id.* at 1356.

67. See 2010 Proxy Access Rule, *supra* note 9, at 56,668, 56,676-77.

68. *Id.* at 56,668.

69. See *id.* at 56,668, 56,730-31.

To appreciate the prevailing expectations between the date of the Dodd-Frank legislation and the date of the SEC's adoption of the proxy access rule, it is useful to consider the SEC's proposal from 2009 that was never finalized (for fear of challenge to the agency's legal authority to adopt the rule, which was solved through passage of the Dodd-Frank Act). The SEC issued a rule proposal in 2009 that included changes to Rules 14a-8 and 14a-11 that were substantially similar to those adopted in 2010, but with different ownership thresholds and holding periods.<sup>70</sup> In that proposal, the SEC requested input from the public on whether it should adopt a permanent exemption for smaller issuers.<sup>71</sup> Importantly, the SEC proposal in 2009 had a 5% ownership requirement for shareholders to use proxy access at small firms,<sup>72</sup> but the 2010 final rule provided for a 3% ownership requirement.<sup>73</sup> The new threshold in the 2010 rule makes it easier for a nominating shareholder to obtain sufficient shares to nominate pursuant to the proxy access rule. The SEC stayed adoption of that proposal because its authority to adopt proxy access rules was still uncertain.<sup>74</sup> The Dodd-Frank legislation in 2010 clarified the SEC's authority under the Securities Exchange Act of 1934 to adopt rules regulating proxy access,<sup>75</sup> which spurred the SEC to adopt its final rule on August 25, 2010. The Dodd-Frank Act's proxy access provision did not differentiate between the SEC's 2009 14a-8 proposal and its 2009 14a-11 proposal, either in the amendment authorizing proxy access or in the amendment authorizing and encouraging the SEC to exempt small issuers.<sup>76</sup>

News reports circulated on June 25, 2010 describing the compromise that resulted in statutory language that instructed the SEC to consider a small business exemption.<sup>77</sup> The text of the proxy access amendment agreed to by the conference committee was:

The Commission may, by rule or order, exempt an issuer or class of issuers from the requirement made by this section or an amendment made by this section. In determining whether to make an exemption under this subsection, the Commission shall take into account, among other considerations, whether the

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70. Kahan & Rock, *supra* note 41, at 1355 & n.40.

71. See 2009 Proxy Access Proposal, *supra* note 8, at 29,033.

72. *Id.* at 29,035.

73. See 2010 Proxy Access Rule, *supra* note 9, at 56,782-83.

74. Kahan & Rock, *supra* note 41, at 1356.

75. See 15 U.S.C. § 78n(a) (2006 & Supp. IV 2010); *id.* § 78n note (Supp. IV 2010) ("The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer . . .").

76. See *id.*

77. See, e.g., Ted Allen, *Lawmakers Reach Deal on Proxy Access*, ISS: GOVERNANCE (June 25, 2010, 12:03 AM), <http://blog.issgovernance.com/gov/2010/06/lawmakers-reach-deal-on-proxy-access.html>.

requirement in the amendment made by subsection (a) disproportionately burdens small issuers.<sup>78</sup>

Though the legislation did not expressly mention \$75 million as the threshold for small issuers, it was highly likely to be the threshold for a small business exemption for many reasons. First, \$75 million was the upper boundary of the lowest market capitalization group referenced in the SEC's proxy access rule proposal in 2009.<sup>79</sup> The debate among supporters and opponents of an exemption for smaller issuers also focused on the SEC's three classifications for company size used in other rules, the smallest of which includes firms with less than a \$75 million market capitalization.<sup>80</sup> This debate would have made it clear to shareholders that a \$75 million market capitalization threshold was what Congress intended by its reference to small firms in the legislation, since the legislation itself was a response to the SEC's rule proposal of 2009. Second, \$75 million was the threshold for the SEC's previous exemptions. The SEC had adopted rules with small firm exemptions for companies with under \$75 million in market capitalization in two other notable rulemakings: the internal control reporting provisions adopted in 2004 pursuant to the Sarbanes-Oxley Act<sup>81</sup> and the movement to XBRL interactive data reporting provisions adopted in 2009.<sup>82</sup> It is also useful to note that the Sarbanes-Oxley legislation authorizing the SEC to adopt internal controls rules did not suggest or refer to a small firm exemption from the rule,<sup>83</sup> indicating the SEC might have been willing to consider a permanent small firm exemption, despite the absence of strong statutory language in the Dodd-Frank Act urging them to do so.

The SEC depends upon Congress for its annual budget authorization and, though an independent agency, astute agency chairmen coordinate with congressional overseers to limit the impact of congressional pressure, which takes the form of oversight investigations, hearings, holds placed on nominees to future positions, or statutory changes to limit agency discretion.<sup>84</sup> The result of the conference committee negotiations,<sup>85</sup> along with the eventual passage of

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78. 15 U.S.C. § 78n note.

79. See 2009 Proxy Access Proposal, *supra* note 8, at 29,038.

80. See 2010 Proxy Access Rule, *supra* note 9, at 56,686-87.

81. Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8392, Exchange Act Release No. 49,313, Investment Company Act Release No. 26,357, 69 Fed. Reg. 9722, 9722 (Mar. 1, 2004) (codified in scattered sections of 17 C.F.R.).

82. See Interactive Data to Improve Financial Reporting, Securities Act Release No. 9002, Exchange Act Release No. 59,324, Investment Company Act Release No. 28,609, 74 Fed. Reg. 6776, 6776 (Feb. 10, 2009) (to be codified in scattered sections of 17 C.F.R.).

83. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified as amended at 15 U.S.C. § 7262 (2006 & Supp. IV 2010)).

84. Cf. Roberta S. Karmel, *The Future of the Securities Exchange Commission as a Market Regulator*, 78 U. CIN. L. REV. 501, 507 (2009); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1013.

85. See *supra* text accompanying notes 50-51.

the Dodd-Frank Act in both chambers of Congress and the signature from the President, made it clear that a small issuer exemption from proxy access was at least more likely than not to be included in the SEC's proxy access rule when the SEC eventually adopted it. This Article works from that assumption even though the language of the amendment only affirmatively required consideration, but not adoption, of an exemption.<sup>86</sup> For the purposes of this Article, we rest on the assumption that at a minimum, the market assumed it was more likely than not that a small firm exemption from Rule 14a-11 longer than three years, an exemption from Rule 14a-8 application, or an ownership threshold higher than 3% for small firms would be part of the final rule. Further, the closer the market's assumption was to this minimum assumption that one of those items was more likely than not to occur, the more our estimate of shareholder losses from proxy access actually underestimates the total cost of the rule due to costs that would already be factored into market expectations.

In the release accompanying the adoption of the proxy access rule, the SEC exempted firms below a market capitalization of \$75 million from its new Rule 14a-11 procedure.<sup>87</sup> The SEC release explained that the exemption would not be permanent (as would be expected according to the Dodd-Frank legislative language), but would instead be temporary.<sup>88</sup> Of particular note is the fact that only Rule 14a-11, and not Rule 14a-8, was stayed for smaller reporting issuers.

We therefore see three unanticipated events on August 25, 2010 that had a differential effect on firms above and below the \$75 million capitalization mark. The SEC did not choose to exempt small firms from the application of changes to Rule 14a-8 at all. Further, the SEC only granted small firms a three-year delayed implementation for Rule 14a-11. Finally, the threshold for shareholders to use proxy access at small firms when Rule 14a-11 eventually did go into effect was lowered from 5% to 3% to make it even easier for shareholders to use proxy access.

We support the assumption that the limits on the small firm exemption were not already anticipated in part by searching <"proxy access" & da(aft 6/24/2010 & bef 8/24/2010)> in the ALLNEWS Westlaw database for the period from June 24, 2010 to August 24, 2010. The database includes all news sources as well as many prominent blogs and law firm white papers. The search term "proxy access" generates 138 sources for that time period, none of which speak to the small firm exemption other than to describe its presence in the legislation.

This study considers the effect of the August 25, 2010 announcement on small firms whose shareholders would have reasonably expected a full exemption from proxy access pursuant to the language adopted in the Dodd-Frank Act. The new information on August 25, 2010 was the discovery that small

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86. See 15 U.S.C. § 78n note (Supp. IV 2010).

87. See 2010 Proxy Access Rule, *supra* note 9, at 56,687.

88. *Id.*

firms would not receive an exemption from the new changes to Rule 14a-8, would only obtain an exemption from Rule 14a-11 for a limited three-year period, and would face the probability of more frequent proxy contests due to the lower ownership threshold of 3% as opposed to the anticipated 5%. In sharp contrast to the literature reviewed below, most of which relies on examination of all publicly traded firms, our study allows for a much more targeted focus because the arbitrary \$75 million market capitalization distinction allows for consideration of differential effects for firms just above and below the dividing line.

An empirical study of this rule also has legal implications. Rules promulgated by the SEC are subject to a legislative-efficiency mandate. The SEC is required by law to consider in its deliberations over proposed rules the effect they will have on “efficiency, competition, and capital formation.”<sup>89</sup> The D.C. Circuit has interpreted this statutory mandate to mean that the SEC is required to “apprise itself . . . of the economic consequences of a proposed regulation.”<sup>90</sup> Three rules promulgated by the SEC in the two decades preceding Dodd-Frank had been struck down by the D.C. Circuit for failure to adequately address this mandate.<sup>91</sup> The 2010 proxy access rule was similarly challenged on this basis.

The three-part mandate of promoting efficiency, competition, and capital formation, combined with the D.C. Circuit’s willingness to overturn SEC rules that lack sufficient empirical foundation, has undoubtedly contributed to the popularity of SEC rules as targets of empirical study. Stock price event studies have been the most popular method for commentators considering the effect of events that alter the probability that proxy access legislation or rules would be implemented.

Going forward, the demand for such work is likely to increase, as the D.C. Circuit recently issued its strongest admonition of the SEC to date. The D.C. Circuit vacated the proxy access rule on July 22, 2011.<sup>92</sup> It held that the SEC failed to meet its statutory burden to consider the effect of new rules on efficiency, competition, and capital formation:

The petitioners also maintain, and we agree, the Commission 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. The Commission acknowledged the numerous studies submitted by commenters that reached the opposite result. One

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89. 15 U.S.C. §§ 78c(f), 80a-2(c) (2006); *see also id.* § 78w(a)(2) (mandating that the SEC consider “the impact [of any rule] . . . on competition”).

90. *Chamber of Commerce v. SEC (Chamber of Commerce I)*, 412 F.3d 133, 144 (D.C. Cir. 2005).

91. *See Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010); *Chamber of Commerce v. SEC (Chamber of Commerce II)*, 443 F.3d 890, 901 (D.C. Cir. 2006); *Chamber of Commerce I*, 412 F.3d at 144.

92. *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1156 (D.C. Cir. 2011).

commenter, for example, submitted an empirical study showing that “when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest.”<sup>93</sup>

The court reviewed the empirical literature considered by the SEC—reviewed in part below<sup>94</sup>—and found the SEC’s justifications of the benefits of the rule to be insufficient in addressing the concerns of the competing literature.<sup>95</sup> This opinion means the SEC’s economic analysis of its rules will need to be more thorough in the future, and further, that the D.C. Circuit sees particular significance in stock price event studies that consider events tied to changes in the probability of a regulation’s adoption. This will be true not only for the SEC’s reconsideration of the proxy access rule but also for numerous other rules promulgated under the nation’s securities laws.

### III. LITERATURE

Corporate governance reforms have become a popular subject for empirical study. A number of studies have considered the effects of major corporate governance reforms on stock price, including the effects of the Dodd-Frank Act, the Williams Act, and the 1934 Securities Exchange Act.<sup>96</sup> This explains some of the academic community’s interest in applying empirical approaches to the proxy access debate, particularly since, until now, empirical evidence was difficult to compile, as the population of contested proxy solicitations was extremely small.

This Article’s findings will be relevant to the ongoing debate over the next generation of the proxy access rule, currently being considered by the SEC.<sup>97</sup>

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93. *Id.* at 1150-51 (citations omitted) (quoting ELAINE BUCKBERG & JONATHAN MACEY, REPORT ON EFFECTS OF EFFECTS OF PROPOSED SEC RULE 14A-11 ON EFFICIENCY, COMPETITIVENESS AND CAPITAL FORMATION (2009), available at [http://www.nera.com/nera-files/PUB\\_Buckberg\\_Macey\\_Report\\_0809.pdf](http://www.nera.com/nera-files/PUB_Buckberg_Macey_Report_0809.pdf)).

94. *See infra* Part III.

95. *Bus. Roundtable*, 647 F.3d at 1150-51.

96. *See, e.g.*, George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); James H. Fogelson et al., *Changing the Takeover Game: The Securities and Exchange Commission’s Proposed Amendments to the Williams Act*, 17 HARV. J. ON LEGIS. 409 (1980); Pankaj K. Jain & Zabihollah Rezaee, *The Sarbanes-Oxley Act of 2002 and Capital-Market Behavior: Early Evidence*, 23 CONTEMP. ACCT. RES. 629 (2006); Haidan Li et al., *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management*, 51 J.L. & ECON. 111 (2008); Paul H. Malatesta & Rex Thompson, *Government Regulation and Structural Change in the Corporate Acquisitions Market: The Impact of the Williams Act*, 28 J. FIN. & QUANTITATIVE ANALYSIS 363 (1993); *cf.* Katherine Schipper et al., *Disentangling Interrelated Effects of Regulatory Changes on Shareholder Wealth: The Case of Motor Carrier Deregulation*, 30 J.L. & ECON. 67 (1987); Ivy Xiyang Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, 44 J. ACCT. & ECON. 74 (2007).

97. The current SEC Chairman has indicated her desire to reconsider and redraft the rule. *See* Press Release, SEC, Statement by SEC Chairman Mary L. Schapiro on Proxy Ac-



These findings also have bearing for the broader debate over using the securities laws to empower shareholders to police management excess by reducing the costs of running proxy campaigns, improving disclosures to shareholders, and giving shareholders statutory rights to vote on new types of corporate policy decisions. For example, the Dodd-Frank Act gave the SEC authority to promulgate a number of rules in addition to proxy access on this same premise, such as requiring a shareholder advisory vote on executive compensation<sup>98</sup> and prohibiting broker-dealer discretionary voting on clients' behalves.<sup>99</sup>

Proxy access is one reform of corporate governance, and its pros and cons inform the wisdom of adopting other reforms, such as broker-dealer voting and limiting staggered boards. What all these reforms have in common is that they increase the power of shareholders over the corporation through board election. As such, the market's reaction to the expansion of proxy access may predict how it would react to other reforms increasing shareholder electoral power, particularly where it applies to small firms and where it empowers conflicted owners with significant stakes in the company.

### A. *Three Prior Modes of Scholarship in Corporate Governance*

Our analysis will therefore also inform debates about other corporate governance practices, such as the ongoing academic and policy debates over the impact of staggered boards.<sup>100</sup> Coates, Subramanian, and Bebchuk have argued

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cess Litigation (Sept. 6, 2011), available at <http://www.sec.gov/news/press/2011/2011-179.htm>.

98. Dodd-Frank Act, 15 U.S.C. § 78n-1(a)(1) (Supp. IV 2010) ("Not less frequently than once every 3 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives . . ."); see also Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9178, Exchange Act Release No. 63,768, 76 Fed. Reg. 6010, 6010 (Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 229, 240, 249) (adopting the release of the SEC rule implementing Dodd-Frank Act section 951, which added section 14A to the Exchange Act).

99. Dodd-Frank Act, Pub. L. No. 111-203, § 957, 124 Stat. 1376, 1906 (2010) (codified at 15 U.S.C. § 78f(b) (2006 & Supp. IV 2010) (amending section 6(b) of the Exchange Act to require that the rules of each national securities exchange prohibit any broker-dealer from voting on its clients' behalves in certain shareholder votes); see also Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Amend NYSE Rule 452 and Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting on Executive Compensation Matters, Exchange Act Release No. 62,874, 75 Fed. Reg. 56,152, 56,152-53 (Sept. 15, 2010) (providing notice of the SEC's approval of the New York Stock Exchange's rule change that implemented Dodd-Frank Act section 957).

100. A *Stanford Law Review* symposium considered the implications of Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) [hereinafter Bebchuk et al., *Theory, Evidence, and Policy*], on staggered boards. See Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Primary Reflections*, 55 STAN. L. REV. 791, 807 n.92 (2002); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of*

that staggered boards decrease shareholder wealth by limiting the ability of shareholders to replace a majority of the board in one election.<sup>101</sup> Our analysis adds to the literature by calling that conclusion into question, particularly with respect to smaller firms, as the same shareholders who would make use of proxy access would also see their challenges facilitated by destaggering the board.<sup>102</sup> Thus, our study urges a reexamination of the staggered-board question to consider the impact of destaggering the board for smaller, publicly traded companies and taking into account the types of investors in those companies.<sup>103</sup>

One of the principal challenges that academics and regulators have faced in weighing the benefits and costs of proxy access is the dearth of naturally occurring instances of proxy access in financial markets. The principal use of our work will be to provide a thoroughly novel method for measuring the impact of proxy access over the rougher approaches in the prior literature. One early study of self-financed proxy contests, which looked at 185 such contests, found significant negative returns of roughly twenty percent in the two-year period following those contested elections in which the dissident shareholders were successful.<sup>104</sup> But the limited sample size was a barrier to study significance.<sup>105</sup> It also focused on the incidence of self-funded proxy contests, which represents one of the central limitations of the corporate governance literature preceding our study. Arguments in the law, economics, and finance literature since then have focused on three methodological approaches. The first approach relied

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*Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002); Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 823, 837 (2002); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 856-57 (2002). The arguments raised by the various participants did not focus on the impact of firm size or on the type of shareholders in a firm as a determinant of the effect of staggered boards, but this Article suggests that both of those variables will inform the future of the debate over the effect of staggered boards on corporate governance.

101. See Bebchuk et al., *Theory, Evidence, and Policy*, *supra* note 100, at 890.

102. See *supra* note 100.

103. A mandatory provision requiring affirmative shareholder votes to institute a staggered board (using the same vote threshold required to amend the charter, which would effectively mean a majority of all outstanding shares) was originally included in the legislation that became the Dodd-Frank Act, but that provision was ultimately eliminated from the final text. Compare S. 3217, 111th Cong. § 974 (discussion draft, Nov. 10, 2009), available at [http://banking.senate.gov/public/\\_files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/_files/AYO09D44_xml.pdf) (“No issuer may have a board of directors with staggered terms of service, unless the issuer has obtained the approval or ratification of the shareholders of the issuer . . .”), with Dodd-Frank Wall Street Reform and Consumer Protection Act, tit. 9.G, 124 Stat. at 1915 (containing no comparable provision). Given the importance of destaggering to the institutional investor community, the issue seems likely to continue to be part of the debate.

104. See Michael J. Fleming, *New Evidence on the Effectiveness of the Proxy Mechanism* 3, 22 tbl.1 (Fed. Reserve Bank of N.Y., Research Paper No. 9503, 1995), available at [http://www.newyorkfed.org/research/staff\\_reports/research\\_papers/9503.pdf](http://www.newyorkfed.org/research/staff_reports/research_papers/9503.pdf).

105. See *id.* at 4-7.

principally on institutional, transaction-cost-based arguments.<sup>106</sup> The second demonstrated decreased abnormal returns at companies with governance provisions associated with entrenchment, or the impact of activism more generally.<sup>107</sup> Given these results, the authors would infer that proxy access would resolve any problems demonstrated, or would present similar benefits to those demonstrated, by studying related phenomena.<sup>108</sup> The third approach studied the effect and incidence of self-financed proxy contests.<sup>109</sup>

The first method was useful to generate the debate and will remain important in interpreting the empirical data that future studies are able to derive, but considered alone it left a degree of imprecision and could not incorporate the comparative statics essential to regulatory cost-benefit analysis.<sup>110</sup> The second method was limited in that even if the authors could demonstrate the existence of net agency losses from entrenchment, it did not necessarily follow that proxy access or an increase in the incidence of contested elections could alleviate those investor losses. The third method was limited in that a study of self-financed proxy contests does not show that contests taking place on the issuer's proxy would function similarly or attract use by the same types of shareholders with the same focus that an entirely self-financed contest would attract.<sup>111</sup>

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106. See, e.g., Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1784-85 (2006); see also Anabtawi, *supra* note 24, at 564-65; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813-17 (1992); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248-50 (1999); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1022 (2007); Lipton & Rosenblum, *supra* note 1, at 67-70; Jonathan R. Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's Seraglio*, 93 VA. L. REV. 759, 759-60 (2007); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); Romano, *supra* note 4, at 795-98; Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1759-62 (2006).

107. See, e.g., Bebchuk et al., *Theory, Evidence, and Policy*, *supra* note 100, at 936-39.

108. See, e.g., Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUD. 939 (2010); Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007); Paul Gompers et al., *Corporate Governance and Equity Prices*, 18 Q.J. ECON. 107 (2003).

109. See, e.g., Bebchuk, *supra* note 1, at 688-94; see also *id.* at 698 n.39, 712 n.68 (citing a number of prior studies on the expense, incidence, and effect of election contests).

110. For the importance of comparative statics in regulatory cost-benefit analysis, see DONALD WITTMAN, ECONOMIC FOUNDATIONS OF LAW AND ORGANIZATION 70-71 (2006).

111. For example, hedge funds seeking control of a company would not be able to use the proxy access rule promulgated by the SEC, because it forbade them from seeking control

### B. *Empirical Studies of Proxy Access*

Studying the impact of events that lead to proxy access allows a more direct measurement of the impact of proxy access on stock prices. This advantage led to four prior academic studies of events leading up to proxy access that precede our argument.

Cohn, Gillan, and Hartzell studied the events surrounding the passage of the Dodd-Frank Act and the 2010 proxy access rule with reference to the effect on companies that have shareholders classified as being among the top forty-one activist shareholders on the “SharkWatch50” list, compiled by SharkRepellent.net.<sup>112</sup> Their first event date is the announcement by Senator Christopher Dodd that he would push to increase the threshold ownership requirement for using proxy access to 5% of the company’s securities. The SEC’s then-current proposal envisioned 1% for large companies, 3% for medium-sized companies, and 5% for small companies.<sup>113</sup> They argued that Senator Dodd’s proposal made proxy access more difficult for large- and medium-sized firms.<sup>114</sup> They demonstrated their argument by showing that the announcement was associated with lower abnormal returns for large- and medium-sized firms that also had a SharkWatch50 investor than for similarly sized firms without such an investor.<sup>115</sup> The authors also noted that the predictive power of their method was limited for small stocks, since only 133 of the firms under the \$75 million market capitalization level have a SharkWatch50 investor.<sup>116</sup>

Many of the companies in the SharkWatch50 list used in the study are hedge funds that have actively engaged in self-funded proxy contests in the past.<sup>117</sup> The list does not include many of the large institutional investors, like public and union pension funds, who lobbied in favor of the proxy access rule.<sup>118</sup> The study thus does not capture the stock price effects on firms that have institutional investors who do not often self-finance proxy contests but who will likely use the SEC’s new free proxy access regime in the future. The authors also admitted that they did not capture the implicit influence of institutional investors who use the threat of shareholder action as part of a larger ne-

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of the company. Thus, those funds may be willing to fund their own proxy fights, but would not share an interest in using proxy access.

112. Jonathan B. Cohn, Stuart L. Gillan & Jay C. Hartzell, On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access 2 (July 14, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1742506>.

113. *Id.* at 16-17.

114. *Id.* at 4.

115. *Id.* at 18-19 (noting that the difference in the large firm group was not statistically significant); see also *id.* at 19 (finding statistically significant differences in both medium- and large-sized firms after controlling for other firm characteristics, but only in large firms after controlling and bootstrapping to enhance the reliability of the standard errors).

116. *Id.* at 19-20.

117. See *id.* at 44 tbl.A.1.

118. See *id.*

gotiation over other issues, like labor disputes.<sup>119</sup> One hypothesis that may be consistent with their findings, for example, would be that firms with hedge fund shareholders experienced positive abnormal returns from the proxy access rule, and firms with union or state pension fund shareholders experienced negative abnormal returns from announcements that increased the probability of the proxy access rule's adoption.

Larcker, Ormazabal, and Taylor focused on events associated with changes in the probability of proxy access prior to the adoption of the Dodd-Frank Act.<sup>120</sup> They found that events associated with an increase in the probability of proxy access are associated with significant but weak negative abnormal returns for firms with large institutional shareholders who are likely to make use of proxy access.<sup>121</sup> They used two measures of ownership to estimate the likelihood of existing institutional investors using proxy access, including the number of institutional investors with a greater than 1% interest (the threshold for ownership associated with the 2009 SEC rule proposal that is the focus of their event study) and the number of possible coalitions of small institutional investors that could meet the 1% threshold.<sup>122</sup>

Becker, Bergstresser, and Subramanian considered the stock price effect of a discrete event on October 4, 2010, when the SEC agreed to stay implementation of the proxy access rule pending adjudication of the court challenge to the rule.<sup>123</sup> They found that firms with low institutional ownership outperformed firms with high institutional ownership by forty-four basis points on that day.<sup>124</sup> Notably, the authors did not find that firm governance characteristics affected the value of proxy access.<sup>125</sup> They did, however, find that activist institutional ownership had a stronger impact for "firms with poor recent performance."<sup>126</sup> They argued that their results demonstrated that "financial markets placed a positive value on shareholder access, as implemented in the SEC's August 2010 Rule."<sup>127</sup> There are two alternate explanations for this result: the market could have assumed (1) that the challenge in court would be successful and that the SEC would subsequently promulgate a rule that would be even more friendly to conflicted institutional investors, or (2) that the costs of uncertainty about proxy access were value-diminishing in and of themselves, no matter what was ultimately decided. The latter explanation could flow from boards'

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119. *See id.* at 23-25 (acknowledging that union voting incentives may explain their results); *cf. id.* at 10 (predicting that broadening proxy access will negatively impact institutional activist investors).

120. Larcker et al., *supra* note 21, at 432.

121. *Id.* at 432-33; *see also* Cohn et al., *supra* note 112, at 2, 6.

122. Larcker et al., *supra* note 21, at 439.

123. Becker et al., *supra* note 15, at 3.

124. *Id.* at 4.

125. *Id.* at 29-31.

126. *Id.* at 31-32.

127. *Id.* at 4.

need to change the bylaws, charter, or organizational structure of the firms they control in order to deal with multiple potential iterations of a future proxy access rule.<sup>128</sup> The study also fails to break down firms into different sizes, thus raising the possibility that the effect on firms of different sizes is heterogeneous.

Akyol, Lim, and Verwijmeren presented an event study that considered seventeen events that either increased or decreased the probability of proxy access adoption.<sup>129</sup> They found consistently negative stock price reactions associated with ten events that increased the probability of proxy access adoption and consistently positive reactions associated with events that decreased the probability of proxy access adoption.<sup>130</sup> They worked under the assumption that financial firms have an increased likelihood of being targeted for proxy fights and stronger shareholder reactions, which is consistent with their findings for all firms.<sup>131</sup> They similarly found stronger stock price reactions against proxy access at firms with more shareholders eligible to use proxy access.<sup>132</sup> They also considered factors that they assumed make firms more prone to shareholder activism, like low market-to-book ratios, and found that these factors—aside from a firm's number of eligible investors—did not have a significant effect on the stock price effects of events that changed the probability of a proxy access rule passing.<sup>133</sup> They further found that firm size is not significantly related to stock price effects of events that change the probability of proxy access occurring, which would speak to a broader applicability of our findings to larger firms.<sup>134</sup>

### C. *The Advantages of a Control-and-Treatment-Group Comparison*

One of the challenges to the prior studies is that they consider similar effects on a large group of firms but have a difficult time controlling for existing agency costs and other effects. Some use proxies for residual losses from agency costs, like market-to-book ratios, that offer a tenuous relation at best.<sup>135</sup> But

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128. Note that at the time the rule was adopted on August 25, it seemed unlikely that a challenge to the SEC's authority would proceed and, if it did, that it would result in significant changes to the rule. It wasn't until October that the legal challenge was announced. *See* Stay of Effect of Commission's Facilitating Shareholder Director Nominations Rules, Securities Act Release No. 9149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 WL 3862548 (Oct. 4, 2010); *see also* Becker et al., *supra* note 15, at 2-3. The proxy access language in the Dodd-Frank Act was intended to clear up confusion about the SEC's legal authority to promulgate the rule.

129. Akyol et al., *supra* note 21, at 2.

130. *Id.* at 2.

131. *Id.* at 25-26.

132. *Id.* at 3.

133. *Id.* at 25-27, 45 tbl.5.

134. *Id.* at 26.

135. *See, e.g., id.* at 14.

the residual losses of agency costs exist precisely because they are characterized by the presence of unverifiable information; if that were not the case, firms would have created appropriate monitoring and bonding mechanisms (which may or may not include proxy access) already.<sup>136</sup> They also consider events that have mixed effects on the probability and effectiveness of proxy access, as well as events based on legislative developments, even though legislators are free to, and frequently do, engage in insider trading on information that affects the stock market—unlike agency officials, who are subject to rigid civil and criminal penalties.<sup>137</sup> Our study takes advantage of a natural experiment in the small issuer exemption that uses differential effects to limit the challenges faced in the existing literature.

While our study also offers an event study of proxy access regulation, it improves on the prior four studies in that it offers a unique natural experiment that compares an unexpected impact on a treatment group against the expected impact on a control group across an artificial dividing line. This natural experiment eliminates the impact of any events other than the proxy access rule that would impact securities prices on the event date. This advantage is something the other four empirical studies of events leading up to the adoption of proxy access were unable to achieve.

Our design offers an improvement over the prior empirical literature because it views the actual event of proxy access passage. Thus, we do not have the problems that the four prior studies face of uncertainty over the future directional impact of proxy access. We have the advantage of a discrete event at a date certain with differential impact over a randomly assigned threshold. We also have the advantage that application to one of the groups is unexpected. Thus we can construct a treatment and a control group to test the impact of proxy access on small firms, since any other events affecting stocks market-wide on that date would be expected to affect firms just above and below the artificial \$75 million threshold with equal force. The prior institutional literature offers an informative foundation for our study as it provides an explanation for our results, which favor the conflicted-shareholder explanation explored by numerous authors.<sup>138</sup>

#### IV. STUDY DESIGN

Our study focuses on the announcement of the SEC's 2010 proxy access rule on August 25, 2010. The proxy access rule had two parts as designed by the SEC and announced in August. One is a mandatory regime that governs

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136. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308, 328 (1976).

137. Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 & n.23 (2011).

138. See *supra* notes 24, 27, and accompanying text.

how candidates are to be added to the corporate proxy. The second allows shareholders to put bylaws onto the corporate ballot to alter the federally mandated procedure and make it even easier (but not more restrictive) for shareholders to use proxy access.<sup>139</sup> The August 25 announcement delayed application of the first part for small firms, but not the second.<sup>140</sup> That result was unexpected because of legislative developments on June 25, 2010. On June 25, it appeared that small firms would likely be exempt altogether based on the text of the Dodd-Frank Act.<sup>141</sup> The original SEC release issued in 2009 mentioned modifications to Rule 14a-8 as well as a new Rule 14a-11 procedure.<sup>142</sup> The text of the legislation agreed to by the conference committee in June 2010 requested consideration of a small business exemption to proxy access procedures as a general matter, not merely for a Rule 14a-11 procedure.<sup>143</sup> Thus, the novel data affected firms differentially across the \$75 million market capitalization threshold: issuers under \$75 million in market capitalization would not receive an exemption from the application of changes to Rule 14a-8, and small firms would be exempted from 14a-11 only for a three-year period.

We test whether abnormal returns for companies with a market capitalization under \$75 million were negative on August 25, 2010. We assume that, prior to August 25, the market expected that a permanent exemption from the proxy access rules was highly likely for firms with a market capitalization below \$75 million. The unexpected development on August 25 was the news that small firms would only obtain a temporary exemption from Rule 14a-11, would obtain no exemption from changes to Rule 14a-8, and would face a lower 3% ownership threshold for proxy access use. We hypothesize that this development resulted in significant abnormal negative returns for small firm stock prices, particularly for those firms with institutional investors able to use proxy access (those investors with greater than 3% ownership in a given firm).

Schipper and Thompson were among the first commentators to use the event study methodology to consider the effect of events on abnormal stock price returns.<sup>144</sup> Empirical work in corporate governance has suffered from the challenge that corporate governance attributes tending to change the powers of shareholders or the board are endogenous, which in this context could mean that shareholder power may influence corporate governance characteristics,

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139. See 2010 Proxy Access Rule, *supra* note 9, at 56,677.

140. See Bus. Roundtable, Securities Act Release No. 9149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,456, 2010 WL 3862548, at \*1-2 (Oct. 4, 2010) (staying, temporarily, “Rule 14a-11 and related amendments to the [SEC] rules, including the [August 25] amendment to Rule 14a-8”).

141. See Dodd-Frank Act, Pub. L. No. 111-203, § 971(c), 124 Stat. 1376, 1915 (2010) (codified at 15 U.S.C. § 78n note (Supp. IV 2010)).

142. See 2009 Proxy Access Proposal, *supra* note 8, at 29,032-33, 29,055-56.

143. See H.R. REP. NO. 111-517, at 549 (2010).

144. See Katherine Schipper & Rex Thompson, *The Impact of Merger-Related Regulations on the Shareholders of Acquiring Firms*, 21 J. ACCT. RES. 184 (1983).



while those characteristics may also impact shareholder power.<sup>145</sup> Our method provides an opportunity to consider the effect of the SEC's 2010 proxy access rule on firms below an artificial market capitalization threshold of \$75 million against firms above that amount and limits the endogeneity challenge in our study.

One requirement for event studies is that they be based on an unexpected event. Here, the announcement of the SEC rule on August 25 was the first time the market learned about the rule's unexpected application. Further, it is less likely that information leaked from this event than from the events surrounding the legislation's passage targeted in other studies because the SEC has strict rules against insider trading by staff that do not apply for members of Congress.<sup>146</sup>

A small company will be able to make use of the proxy access rule's three-year exemption if it meets the SEC's preexisting definition of a "smaller reporting company," which—based on an annual determination—includes an issuer that

(1) Had a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter, computed by multiplying the aggregate worldwide number of shares of its voting and non-voting common equity held by non-affiliates by the price at which the common equity was last sold, or the average of the bid and asked prices of common equity, in the principal market for the common equity; or

(2) In the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than \$75 million as of a date within 30 days of the date of the filing of the registration statement, computed by multiplying the aggregate worldwide number of such shares held by non-affiliates before the registration plus, in the case of a Securities Act registration statement, the number of such shares included in the registration statement by the estimated public offering price of the shares; or

(3) In the case of an issuer whose public float as calculated under paragraph (1) or (2) of this definition was zero, had annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available.<sup>147</sup>

This convoluted definition presents a unique challenge for studying firms that expect to be subject to the exemption against firms that do not, since firms could not know for certain whether or not they would meet the definition in future years, because they do not know for certain what their market capitalization will be. Firm market capitalization is not static, and particularly those firms

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145. Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 96 (1998) ("The CEO's bargaining power over the board-selection process comes from his *perceived* ability relative to potential successors." (emphasis added)).

146. See *supra* notes 16-18, 137, and accompanying text.

147. 17 C.F.R. § 240.12b-2 (2011).

just above or below the exemption will not know with certainty whether they will meet the exemption in future years. For this reason, we compare groups of firms with market capitalizations above and below \$75 million market capitalization in symmetric groups. We compare ranges of firms abutting the \$75 million threshold and ranges of groups somewhat removed from that threshold, assuming that uncertainty about whether a firm's market capitalization will exceed \$75 million is related to the proximity of current market capitalization to \$75 million.

Some might argue that since small-cap stocks are traded less regularly than large-cap stocks and have less extensive analyst followings, the focus on stock returns to small firms is flawed. Kahan and Rock note that the market for small firms is inefficient compared to that for large- and mid-cap companies because of reduced liquidity and analyst attention.<sup>148</sup> But such a challenge here would not hold. Mere argument that some markets are more efficient than the small-cap market doesn't put the validity of the test in jeopardy. Indeed, many of the other empirical studies available that support the proxy access rule include small-cap firms in their study and make observations about the effect of the rule on small-cap firms.<sup>149</sup> We report the average volume trades per stock in our samples for August 24 and August 25 in an Appendix and afford readers an opportunity to determine whether they think average daily trading volume of between 80,000 and 120,000 shares represents a market so inefficient as to prohibit meaningful inference.<sup>150</sup>

We have considered the presence of institutional investors with greater than 3% ownership, a population that includes union and state pension fund investors. Kahan and Rock note that hedge funds are the dissidents in a large percentage of proxy contests at firms.<sup>151</sup> They also describe how hedge fund investors have the highest success rates for all proxy contests; they additionally state that other types of investors rarely attempt proxy contests and—aside from former insiders of very small companies—rarely succeed when they do.<sup>152</sup> This description of existing contests is useful but should be considered with the caveat that the types of investors interested in self-financed proxy contests are not necessarily the types of investors interested in contests using the corporate proxy as provided in the proxy access rule. The investors using the

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148. See Kahan & Rock, *supra* note 41, at 1369-70.

149. See, e.g., Cohn et al., *supra* note 112, at 18.

150. Assuming determinations of market efficiency by courts in securities class actions claims are relevant to this question, we note that some courts have used average daily trading volume as an indicator and found that average turnover in excess of 1% or the presence of active analysts or market makers is sufficient to make a market efficient (without distinguishing between trading platforms like the NYSE and smaller OTC platforms), while other courts have avoided bright-line rules. See Paul A. Ferrillo et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN'S L. REV. 81, 83, 90-100 (2004).

151. See Kahan & Rock, *supra* note 41, at 1370.

152. *Id.* at 1370-71.

proxy access rule will be required to certify away any control purpose and are limited in the number of candidates they can nominate; the self-financed investors will not be so limited.<sup>153</sup> Kahan and Rock also describe how active union pension funds and employee organizations are in using the company proxy for shareholder proposals; these groups account for nearly forty percent of shareholder proposals in a typical proxy season.<sup>154</sup> This speaks to the likelihood that union and pension fund investors would be more likely to nominate candidates to the corporate proxy than to fund their own solicitations, whereas hedge funds are far more likely to self-finance their proxy contests.

Other empirical examinations of the proxy access rule have performed a check of the *Wall Street Journal* the day after the event being studied to consider whether macroeconomic events could have skewed their results.<sup>155</sup> A similar examination of headlines from the *Wall Street Journal*'s Money and Investing section for August 25 and August 26, 2010—listed in Appendix A—reveals no obvious events that would be likely to cause a consistent differential effect across firms just above and below a market capitalization of \$75 million. Though there were many events that might have affected firms generally, for our purposes the only event that could confound our study would be one that affected firms with market capitalization just above \$75 million in a different way than it affected those firms just below that threshold.

## V. EMPIRICAL MODEL

To compute abnormal returns, we first estimated one set of regressions based on the 2005 estimation window and one based on the 2006 estimation window. We chose windows in those years, rather than in late 2009 or early 2010, because market volatility in the latter years is greater than in the earlier years. We also used two more recent estimation windows to check the sensitivity of our results to our choice of windows. The time frames for these other two windows are August 2009 to April 2010 and November 2009 to July 2010.<sup>156</sup>

After computing abnormal returns, we test whether firms with between \$25 million and \$75 million in market capitalization experienced negative returns on August 25 that are statistically different from zero. To test the sensitivity of our results to the choice of firms, we also tested whether firms with between \$25 million and \$60 million in market capitalization experienced negative and statistically significant abnormal returns on August 25.

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153. See 2010 Proxy Access Rule, *supra* note 9, at 56,713-14, 56,716.

154. Kahan & Rock, *supra* note 41, at 1372 & tbl.3.

155. See, e.g., Akyol et al., *supra* note 21, at 48 tbl.8.

156. We followed the procedures described in *Event Studies with Stata*, PRINCETON U. DATA & STAT. SERVS., [http://dss.princeton.edu/online\\_help/stats\\_packages/stata/eventstudy.html](http://dss.princeton.edu/online_help/stats_packages/stata/eventstudy.html) (last updated May 20, 2008), to select the event window and analyze the data.

Contrary to many event studies that examine whether an event leads to an increase or decrease in abnormal returns for a particular firm, we have a control group to identify the abnormal return. Having a control group allows us to be more confident in giving our findings a causal interpretation, that the proposed SEC rule caused changes in security prices. In our empirical model, firms with a market capitalization of \$75 million or less constitute the treatment group, while the group of firms with more than \$75 million and less than \$125 million in market capitalization form the control group.

This estimation strategy is motivated by the possible concern that all firms in the market experienced a shock that led to negative returns. Therefore, we constructed a control group to test whether the returns of firms that we focus on are different from those of our treatment groups, companies with less than \$75 million in market capitalization. In these specifications, we test whether firms with a market capitalization of between \$25 million and \$75 million performed differently on August 25 compared to firms with a market capitalization between \$75 million and \$125 million. Again, to test the sensitivity of our results, we also compare firms with between \$25 million and \$60 million in market capitalization to firms with between \$90 million and \$125 million in market capitalization.

## VI. DATA

We obtained data for publicly traded companies from The Center for Research in Security Prices (CRSP).<sup>157</sup> We downloaded daily data for all publicly traded companies included in the CRSP database that were traded over the time period we study in our empirical model and which had less than \$125 million in market capitalization on August 25, 2010. We computed market capitalization as the shares outstanding times the end-of-day share price, as of August 25, 2010.

To compute abnormal returns, we retrieved daily return data for the companies in our sample, for the periods February 1, 2005 to November 31, 2005; February 1, 2006 to November 31, 2006; August 1, 2009 to April 30, 2010; and November 1, 2009 to July 31, 2010.

For each of these four estimation windows we used a simple regression to regress daily return of the firms (*ret*) on the market return (the value-weighted return variable (*ywretd*)) from CRSP. We then used the coefficients from this estimation to calculate the predicted daily firm returns during the event window. As is standard in the literature, we computed the abnormal return as the predicted return minus the actual return.

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157. CRSP data are available with a subscription through Wharton Research Data Services. See WHARTON RES. DATA SERVS., <http://wrds-web.wharton.upenn.edu/wrds/ds/crsp/index.cfm> (last visited June 13, 2012).

Further, we dropped observation from the dataset for which the share price was negative, the trading volume was zero, the share price was not listed, the trade volume was not listed, the return was not listed, or *vwretd* was not listed.

## VII. RESULTS

Table 1 shows the effects of the announcement of the proxy access rule on abnormal returns for our four estimation windows. It shows the results from testing the hypothesis that abnormal returns for small firms were negative on August 25. The first column shows estimates for the companies with between \$25 million and \$75 million in market capitalization and the second column shows estimates for companies with between \$25 million and \$60 million in market capitalization. Standard errors are in brackets.

TABLE 1  
Testing Whether the August 25, 2010 Average Abnormal Return Is Statistically Different from Zero

	Market Cap	All Firms				Firms with at Least 3% Institutional ownership			
		\$25M-\$75M		\$25M-\$60M		\$25M-\$75M		\$25M-\$60M	
Estimation Window		Coefficient	SE	Coeff.	SE	Coeff.	SE	Coeff.	SE
2005		-0.0384***	[0.140]	-0.371**	[0.177]	-0.543***	[0.164]	-0.551***	[0.203]
N		558		413		364		272	
2006		-0.0492***	[0.141]	-0.489***	[0.177]	-0.563***	[0.167]	-0.558***	[0.207]
N		606		454		399		300	
8/09-4/10		-0.590***	[0.126]	-0.593***	[0.159]	-0.616***	[0.148]	-0.614***	[0.188]
N		770		574		490		360	
11/09-7/10		-0.474***	[0.127]	-0.461***	[0.159]	-0.479***	[0.148]	-0.474**	[0.186]
N		777		579		495		364	

Robust standard errors in brackets.

\* 10% of statistical significance, \*\* 5% level of statistical significance, \*\*\* 1% level of statistical significance.

Table 1 shows that firms with a market capitalization between \$25 million and \$75 million had statistically significant negative abnormal returns on August 25, regardless of the estimation window considered. All estimates are statistically significant at the 1% level. Depending on the estimation window considered, these firms' stock market value decreased between 0.39 and 0.59 percentage points. Column 2 of Table 1 shows that we find very similar results when we examine firms with a \$25 to \$60 million market capitalization. These results provide some evidence that the SEC announcement on August 25 lowered the returns of firms with less than \$75 million market capitalization.

We also examined firms that had at least one institutional investor who held 3% of the shares. In Column 3 and Column 4 of Table 1 we reestimate the specifications in the first two columns using only firms with institutional investors who have at least a 3% stake in the firm. Here we find that the point estimates on the interaction terms are larger than the corresponding point estimates in the first two columns. All point estimates on the interactions are statistically significant, providing evidence that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional investors with at least a 3% ownership stake. This is relevant given that in order to make use of the proxy access mechanism, a shareholder would need to have at least a 3% ownership stake or be able to assemble a group of shareholders constituting 3% ownership.

Our model in Table 2,  $AR(i) = b_0 + b_1 * D + e$   $AR(i)$ , is the abnormal return of firm  $i$  on August 25 if the firm has a market capitalization between \$25 million and \$125 million on that date,  $b_0$  is the intercept,  $b_1$  is the slope parameter to be estimated on  $D$ , and  $D$  is defined to equal one if the firm has a market capitalization between \$25 million and \$75 million and zero otherwise. The variable  $e$  is an identically and independently distributed error term. The variable  $b_1$ -hat is an estimate of the difference in the abnormal return between small and large firms. A simple  $t$ -test would have given us the difference in means between the abnormal return between small and large firms. That difference (obtained from the  $t$ -test for differences in means) is identical to the estimated  $b_1$ . We chose to estimate the regression because this gives us standard errors adjusted for the possibility that standard errors are not identically distributed. The  $t$ -test does not give us this option. The columns in Table 2 differ in that the regression in the first column uses the entire sample, while the regression in the second column uses only the subsample of firms that have at least one institutional investor owning at least 3% of the firm. Table 3 has the same specifications as Table 2, but excludes firms with between \$60 million and \$90 million in market capitalization.

TABLE 2

Testing Whether the Average Abnormal Return on August 25, 2010 Differs Between Companies with \$25 Million to \$75 Million in Market Capitalization Versus Companies with \$75 Million to \$125 Million in Market Capitalization

		All Firms		Firms with a Shareholder Holding at Least 3% Institutional Ownership	
Estimation Window		Coefficient	SE	Coefficient	SE
2005	\$25M-\$75M v. \$75M-\$125M	-0.702***	[0.212]	-1.050***	[0.256]
	Intercept	0.318**	[0.159]	0.507***	[0.196]
	N	905		602	
	R-squared	0.01		0.03	
2006	\$25M-\$75M v. \$75M-\$125M	-0.753***	[0.207]	-1.045***	[0.252]
	Intercept	0.262*	[0.153]	0.482***	[0.188]
	N	980		655	
	R-squared	0.01		0.02	
8/09-4/10	\$25M-\$75M v. \$75M-\$125M	-0.670***	[0.191]	-0.812***	[0.233]
	Intercept	0.080	[0.144]	0.197	[0.180]
	N	1225		800	
	R-squared	0.01		0.01	
11/09-7/10	\$25M-\$75M v. \$75M-\$125M	-0.644***	[0.194]	-0.792***	[0.237]
	Intercept	0.171	[0.147]	0.313*	[0.185]
	N	1236		808	
	R-squared	0.01		0.01	

Robust standard errors in brackets.

\* 10% level of statistical significance, \*\* 5% level of statistical significance, \*\*\* 1% level of statistical significance.

Table 2 shows results based on the same four estimation windows as those in Table 1 but also compares firms with a market capitalization between \$25 million and \$75 million against those with a market capitalization between \$75

million and \$125 million. We expect that the results from this sample definition have higher precision than those in Table 1. This is because, for example, it is more uncertain whether firms that on August 25 have a market capitalization of \$75 million, as opposed to \$60 million, will, upon implementation of the SEC rule, have a capitalization below or above \$75 million. There is no reason to suggest that this uncertainty regarding future market capitalization differs between the treatment group and the control group, so we assume in designing our ranges of market capitalization that this uncertainty is associated with proximity to the \$75 million threshold. The point estimates in Table 2 are statistically significant using all four estimation windows. Further, the point estimates on this interaction term are larger than are their counterparts in Table 1. Table 2 shows that firms in the treatment group of firms with market capitalization between \$25 million and \$75 million had statistically significant negative abnormal returns on August 25 relative to the control group of firms with \$75 million to \$125 million market capitalizations, regardless of the estimation window considered. All estimates are statistically significant at the 1% level. Depending on the estimation window considered, the differential impact of the August 25 event ranges from -0.64% to -0.7%. These results provide further evidence that the SEC announcement on August 25 lowered the returns of firms with less than \$75 million in market capitalization.

It is of interest to quantify by how much the SEC announcement lowered market capitalization of firms with between \$25 and \$75 million in market capitalization. We do this by multiplying the coefficient 0.753%, found in Table 2, by the average market capitalization of the sample of those firms (\$47 million) and by multiplying that product by the number of firms in the sample (980 firms). This leads us to conclude that the SEC announcement lowered market capitalization of those firms by up to \$347 million.

We also examined the differential impact on firms that had at least one institutional investor who held 3% of the shares. In Column 2 of Table 2, we reestimate the specifications in the first column, using only firms with institutional investors who have at least a 3% stake in the firm. Here we find that the point estimates on the interaction terms are larger than the corresponding point estimates in the first column. All point estimates on the interactions are statistically significant, providing evidence that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional investors with at least a 3% ownership stake.

Table 3 shows results based on the same four estimation windows as those in Table 1 and 2. It compares firms with a market capitalization between \$25 million and \$60 million against those with a market capitalization between \$90 million and \$125 million. The point estimates in Table 3 are statistically significant using all four estimation windows. Further, the point estimates on this interaction term are larger than are their counterparts in Table 2. This is consistent with our hypothesis that the unanticipated impact on small firms of the proxy access rule caused the differential impact. It is also consistent with our



hypothesis that the proximity of firm market capitalization to \$75 million is associated with the probability that a firm will exceed the \$75 million market capitalization threshold and, thus, whether or not it expected, prior to August 25, that it would be subject to the proxy access rule in the future.

TABLE 3

Testing Whether the Average Abnormal Return on August 25, 2010 Differs Between Companies with \$25 Million to \$60 Million in Market Capitalization Versus Companies with \$90 Million to \$125 Million in Market Capitalization

		All Firms		Firms with a Shareholder Holding at Least 3% Institutional Ownership	
Estimation Window		Coefficient	SE	Coefficient	SE
2005	\$25M-\$60M v. \$90M-\$125M	-0.810***	[0.251]	-1.271***	[0.304]
	Intercept	0.439**	[0.178]	0.721***	[0.227]
	N	654		443	
	R-squared	0.01		0.04	
2006	\$25M-\$60M v. \$90M-\$125M	-0.919***	[0.246]	-1.271***	[0.300]
	Intercept	0.430**	[0.171]	0.713***	[0.217]
	N	715		485	
	R-squared	0.02		0.03	
8/09-4/10	\$25M-\$60M v. \$90M-\$125M	-0.752***	[0.229]	-1.031***	[0.287]
	Intercept	0.159	[0.165]	0.417***	[0.217]
	N	889		580	
	R-squared	0.01		0.02	
11/09-7/10	\$25M-\$60M v. \$90M-\$125M	-0.670***	[0.228]	-0.962***	[0.285]
	Intercept	0.209	[0.164]	0.487**	[0.216]
	N	897		586	
	R-squared	0.01		0.02	

Robust standard errors in brackets.

\* 10% level of statistical significance, \*\* 5% level of statistical significance, \*\*\* 1% level of statistical significance.

Table 3 shows that firms in the treatment group of firms with market capitalization between \$25 million and \$60 million had statistically significant negative abnormal returns on August 25 relative to the control group of firms with market capitalization between \$90 million and \$125 million regardless of the estimation window considered. All estimates are statistically significant at the 1% level. Depending on the estimation window considered, the differential impact of the August 25 event ranges from -0.67% to -0.92%. These results provide further evidence that the SEC announcement on August 25 lowered the returns of firms with less than \$75 million in market capitalization.

We also examined the differential impact on firms that had at least one institutional investor who held 3% of the shares. In Column 2, we reestimate the specifications in the first column, using only firms with institutional investors who have at least a 3% stake in the firm. Here we find that the point estimates on the interaction terms are larger than the corresponding point estimates in the first column. All point estimates on the interactions are statistically significant, providing evidence that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional investors with at least a 3% ownership stake.

If the prevailing assumption was that proxy access was a net benefit to small firms, then the news that (1) small firms would in fact not be permanently exempt from the Rule 14a-11 mandatory proxy access procedure, (2) that investors could begin proposing proxy access bylaws right away, and (3) that the ownership requirement was only 3% of outstanding shares, rather than 5%, should have resulted in abnormally positive returns for firms below the \$75 million threshold, as compared to our control group. That was not the case. If the prevailing assumption was that proxy access was a net cost to stock price returns at small firms, then the news that proxy access under Rule 14a-11 would in fact apply in three years and that changes to Rule 14a-8 would apply immediately should have resulted in significant negative abnormal returns for small firms. This was precisely what we found.

Our focus on small firms offers a particularly acute test for the market's understanding of the value of proxy access. The 3% ownership threshold is much easier to meet in a smaller firm because many large institutional shareholders are legally restricted in how much of their portfolio they can invest in any one company.<sup>158</sup> Thus, it becomes easier for any one shareholder to amass a sufficient stake to run a contest. It also becomes easier for a group of shareholders to coordinate as a group to initiate a proxy nomination, since a smaller number of shareholders will be required to meet the ownership threshold. Some commentators have suggested that proxy nominations are least likely at the

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158. See Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 *BUS. LAW.* 95, 95 (2003); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *GEO. L.J.* 445, 478 & n.121 (1991).

largest firms in the S&P 500. Kahan and Rock note that “proxy contests are overwhelmingly a phenomenon of small and very small publicly-held firms.”<sup>159</sup> Thus, in addition to demonstrating that proxy access actually damages shareholder value at firms with less than \$75 million in market capitalization, our results also call into question whether proxy access is a net cost to firms with higher market capitalization.

#### CONCLUSION

Our results serve to inform the ongoing debate over the proxy access rule adopted by the SEC in the summer of 2010 under its new authority under the Dodd-Frank Act. That rule was the subject of a successful challenge in the D.C. Circuit.<sup>160</sup> Since the challenge to the proxy access rule was successful, and the D.C. Circuit in effect remanded the rule to the SEC for further consideration, our results urge the SEC to consider a permanent exemption for small firms. Our results do not, however, demonstrate that a market capitalization threshold as low as \$75 million is required, and an optimal exemption may in fact be higher than that amount. Further, our results caution against reliance on the existing empirical literature to justify a future proxy access rule for larger firms. Investors are more likely to be able to actually amass ownership stakes sufficient to meet the requisite thresholds for proxy access in smaller firms. If the impact of any benefits associated with proxy access is concentrated among such firms, then our finding of negative abnormal returns after application of the proxy access rule to small firms calls into question whether a broader cost-benefit analysis of the full rule results in a net benefit to efficiency, competition, and capital formation and is thus consistent with the outcome of *Business Roundtable v. SEC*.

#### APPENDIX A: CONTEMPORANEOUS FINANCIAL-MARKETS NEWS ON AUGUST 25 AND AUGUST 26, 2010

##### A. *List of Headlines Not Solely Involving Individual Companies from the Money and Investing Section of the Wall Street Journal for August 25, 2010 and August 26, 2010*

###### 1. *August 25, 2010*

*Dow Industrials Fall to 7-Week Low: Global Economic Fears Push Investors out of Stocks, Commodities and into the Safety of U.S. Debt*, at C1

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159. Kahan & Rock, *supra* note 41, at 1369.

160. *See* *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1146 (D.C. Cir. 2011).

*“Jingle Mail”*: *Developers Are Giving Up on Properties*, at C1

*When Chips Are Down, Bad Things Follow*, at C1 (describing Cisco Systems’ failure to meet quarterly earnings expectations and possibility of demand shocks causing chip developers to cut prices)

*What’s the Beef? Food-Inflation Fears*, at C1

*Bondholders Face a Push to Impose Bank Bail-Ins*, at C2

*LSE: Circuits Helped Avert Market Crash*, at C2

*Japan’s Yen Fuels Bear Market: Nikkei Stands Down 20.7% from Recent Peak; Calls to Rein In Currency’s Gains*, at C2

*Dollar Falls Broadly; Franc Hits High on Euro*, at C2

*Europe, Asia Fall Broadly; Materials Pace Declines*, at C2

*S&P Lowers Ireland Rating*, at C2

*The M&A-Stock Dichotomy*, at C3

*Bearish Bets Rise on NYSE, Fall on Nasdaq*, at C5

*Jumbo Yields Fall to 0.38%*, at C5

*Off 3.7%, Boeing Hits Dow*, at C6

*Home Builders Get a Bump as Investors Sense a Bottom*, at C6

*VIX Jump Gives Investors a (Brief) Scare*, at C6

*Sturdy Houston Sees Its Market Go Wobbly: Aviation and Energy Have Boosted the Bayou City During the Downturn, but Changes in the Industries Loom*, at C8

*“Crisis of Confidence” Sparks a Commodities Selloff: Rotation Out of Riskier Bets Leads Investors to Dump Crude, Copper and Even Cocoa; Gasoline at Lowest Since Dec. ‘09*, at C12

*Treasury Yields Hit New Depths: Record Low for Two-Year as Housing Data Sparks Buying*, at C14

*Gross: U.S. Role in Housing a “Necessity,”* at C14

*The 30-Year of Living Dangerously*, at C16

*Cashing In on Tech Sector’s Acquisitiveness*, at C16

*Housing’s Witching Hour*, at C16

## 2. August 26, 2010

*Stocks’ Skid is Stopped; Dow Up 19.61*, at C1 (describing a four-day stock slide in the Dow Jones Industrial Average and attributing the day’s trading to record-low new-home buying)

*Not Cash to Burn, but Money in the Bank*, at C1 (describing growth in the U.S. money supply)

*Behind the Allure of Japan: Stagnancy*, at C1

*Tokyo Hints at Action on Yen*, at C2

*Chinese Fund Raises Billions for Use at Home*, at C2

*Europe, Asia Fall Further; Toronto Rises*, at C2

*Portugal Sees Strong Sale of Its Debt*, at C2

*U.S. Thrifts Show Profit; Dangers Lurk*, at C3

*Investors Brace for “Extended Pause,”* at C5

*Auction Slows Rally in Treasuries*, at C8

*More Flows to Bond Funds*, at C11

*Taxing Times for U.S. Investors*, at C12

*Dollar Mixed as Central Banks Are Watched*, at C12

APPENDIX B: AVERAGE VOLUME TRADES PER STOCK BY MARKET  
CAPITALIZATION ON AUGUST 24 AND AUGUST 25, 2010

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Date	Market Capitalization			
	\$25M-\$75M	\$75M-\$125M	\$25M-\$60M	\$90M-\$125M
Aug. 24	94,426	131,040	80,188	130,251
Aug. 25	87,835	152,373	91,981	147,847

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