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CRITIQUING THE CFA INSTITUTE'S REPORT ON PROXY ACCESS

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INTRODUCTION

Is proxy access – that is, the ability of certain privileged shareholders to have their own slate of director nominees included in the proxy-solicitation materials public companies must distribute ahead of their annual meetings – a good thing or a bad thing for corporate governance?

Finding the right answer to that question could be critical, as roughly 200 companies currently are expected to face shareholder-submitted proxy-access proposals in 2016.[1] These include 36 from the New York City Comptroller's Office and 40 submitted by the California State Teachers' Retirement System (CalSTRS).[2]

As the proposals continue to play out, a study from the CFA Institute that purports to calculate the market value of mandatory proxy access,[3] "Proxy Access in the United States: Revisiting the Proposed SEC Rule,"[4] has been elevated to center stage. The CFA report assesses the benefits to fall somewhere in the very broad positive range of $3.5 to $140.3 billion.[5] Strikingly, this range implies that proxy access can only be a good thing for shareholders. As shall be discussed, this is a very misleading impression, when one considers the entire universe of event studies the CFA report's authors had available for their analysis.

The CFA report derived its range of values not by collecting any new data, but by drawing on the empirical results of four published event studies[6] and subsequently converting each to a dollar figure. The four results the CFA report used were: $140.3 billion, based on a study by Jonathan B. Cohn, et al.; $64.9 billion, based on a study by Joanna Tochman Campbell, et al.; $14.6 billion, based on a study by Bo Becker, et al.; and $3.5 billion, based on a study by Torsten Jochem.

Proponents are using the CFA report to support their claims that proxy access will create value for shareholders. For example, as part of its proxy-access initiative, the New York City Comptroller's Office incorporated a short summary of the CFA report's results as supporting evidence for the nonbinding shareholder proposals it's submitted to targeted companies.[7] Noted shareholder activist James McRitchie also has used it as supporting evidence for his proxy-access proposals, including one he submitted at the 2016 annual meeting of Apple Inc.[8] In addition, the Canadian Coalition for Good Governance has used it as support for its endorsement of mandatory proxy access in Canada.[9]

Unfortunately, while this report is widely cited, its findings really haven't been vetted. A closer look reveals shortcomings that should disqualify the CFA report from being used as support for mandatory proxy access; for shareholder proposals on proxy access; for board discussions about whether a proxy-access bylaw should be implemented; and, perhaps most importantly, for board discussions about whether a proxy-access bylaw needs to be rescinded.

ERRORS IN THE CFA REPORT

The first fundamental error committed by the CFA report's authors was purposely excluding from the analysis two peer-reviewed event studies: a 2011 study by David F. Larcker, et al., which appeared in the *Journal of Financial Economics* and a 2012 study by Ali C. Akyol, et al., which appeared in the *Journal of Financial and Quantitative Analysis*.[10] These have, in fact, been the only two studies that have attempted to identify the shareholder wealth effects of mandatory proxy access on the entire U.S. market. Importantly, both found it to have a significant negative effect on shareholder wealth. While the studies appeared in two of what are considered to be among the top four financial journals,[11] authors of the CFA report excluded the Larcker and Akyol studies because of alleged "methodological shortcomings."[12]

Meanwhile, a good argument can be made that the Cohn study should have been excluded from the CFA report. Cohn's findings suggest the value of mandatory proxy access is driven primarily, or at least significantly, by the wealth-enhancing effects of hedge-fund activism. But this value is almost completely undone by requirements that shareholders must have held the stock in question for a minimum of three years, a holding period which has become standardized in shareholder proposals on proxy access and in the proxy-access bylaws implemented by boards. The significant contribution of hedge-fund activism in Cohn's findings therefore should have disqualified its use in the report. This is a critical point, because the results the CFA report based on the Cohn study provided the largest dollar-amount value of mandatory proxy access, $140.3 billion.

Even if the Cohn study's inclusion could be justified, the CFA report's dollar-value calculation is almost certainly significantly overstated. As we now know, there was an important error regarding the average market value of the sample firms in the version of the Cohn study used in the CFA report. This error was identified in the report and correctly reduced, but not by enough. The CFA report used $7.424 billion[13] as the average market value when the correct number should have been $3.905 billion.[14] This correction by itself reduces the dollar value from $140.3 billion to $73.8 billion.

Most importantly, the authors of the CFA report combine abnormal returns on two different dates found in the Cohn study – June 16, 2010, and June 24, 2010, 0.59 percent and 0.91 percent, respectively – to come up with a very large 1.5 percent abnormal return for mandatory proxy access.[15] Combining returns on multiple dates makes sense if you want to enhance the statistical significance of your results, which undoubtedly was the purpose in Cohn. But that approach makes little sense if one is trying to estimate how much mandatory proxy access contributed to increased shareholder value. On the other hand, averaging the differences would also be problematic, because both event returns are statistically insignificant on their own.[16] The Cohn study simply doesn't allow one to calculate with any accuracy a market dollar value for mandatory proxy access, plus or minus, on the June 16 and June 24 event dates.

The CFA report's inclusion of the Campbell study, which found mandatory proxy access enhanced shareholder wealth by $64.9 billion, also raises questions. Campbell actually used the same methodology the CFA report cited as a reason to disqualify Akyol – that it used Canadian and global benchmarks as indices to calculate expected returns.[17] The CRA report says of Akyol:

> As such, the abnormal returns on US stocks controlled only for variation stemming from price changes in the Canadian and global indices. In other words, the authors attributed the entire difference between event date returns for US stocks and event date returns for the Canadian and global indices to news about proxy access. To the extent that any events, aside from proxy access, moved US stock prices and, to a lesser extent, the benchmark indices, the authors' abnormal returns suffer from bias.[18]

But the Campbell study also utilized a Canadian index as its benchmark.[19] Why was its use acceptable in Campbell but not in Akyol?

The Campbell's study's findings also are questionable in that the event they studied – the SEC's Aug. 25, 2010 approval of mandatory proxy access – arguably was expected by the market. It therefore should not yield any announcement effects. Indeed, if there was a significant effect, it should have been negative, as the longer three-year holding period announced by the SEC on that date (it was uncertain whether the minimum holding period was going to be two or three years) would adversely affect activist hedge funds' interests.

The Campbell authors maintain the outcome of the SEC's vote on mandatory proxy access was uncertain.[20] They cited the closeness of the 3-2 vote as evidence there was "no widely held expectation of the outcome of the vote in advance."[21] But the Becker study, from which the CFA report also drew, noted the majority view was that Section 971 of the Dodd-Frank Act made mandatory proxy access inevitable.[22] In fact, according to an Aug. 5, 2010 *Wall Street Journal* article – which ran three weeks before the vote -- "people familiar with the matter" believed the SEC would approve the rule.[23]

Another egregious shortcoming of the CFA report is that it utterly neglects any attempt to reconcile the Campbell findings with those of the Akyol study. One reason the authors provided for excluding the Akyol study was that it analyzed events that "were economically insignificant, widely anticipated, confounded, and/or directionally unclear."[24] Yet, the Akyol study did evaluate the one and only event date studied in Campbell: Aug. 25, 2010. Consistent with the announcement being anticipated and having a negative wealth effect, due to affecting the wealth-enhancing activities of activist hedge funds adversely, Akyol found the event to have a small, statistically insignificant negative 30 basis-point effect on shareholder wealth.[25]

So why were Campbell's returns so large and positive (83 basis points) even though the event may have been highly anticipated and expected to be negative? The CFA report's authors erred in not attempting to discuss and reconcile these conflicting results, which perhaps would have led to adjusting the dollar value assigned to the event significantly downward.

CONCLUSION

Does calculating a dollar-value range for the purported benefits of mandatory proxy access offer any value for decision makers? At this point, it does not appear so. When there simply aren't that many studies from which to choose, deciding which to include or exclude makes all the difference in the world. The shape and range of values would change dramatically if the Larcker and Akyol studies were to be included, or the Cohn and/or Campbell studies were to be excluded.

All in all, once one looks below the surface, the CFA Institute report does not do what proxy access advocates wish it would.

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ENDNOTES

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2. Joe Cahill, "Four companies doing the right thing for shareholders," *Crain's Chicago Business*, Nov. 25, 2015. http://www.chicagobusiness.com/article/20151125/ISSUE10/151129911/four-companies-doing-the-right-thing-for-shareholders

3. Mandatory proxy access is a regulatory rule that would automatically allow certain privileged shareholders to place their nominees for the board into the proxy-solicitation materials of almost all public companies without the need for a charter amendment or bylaw.

4. Chiara Trabucchi, Ellen Fitzgerald, Matthew Orsagh, Robert W. Dannhauser and James Allen, "Proxy Access in the United States: Revisiting the Proposed SEC Rule," CFA Institute, August 2014. http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n9.1

5. Ibid, p. 4.

6. Bo Becker, Daniel Bergstresser and Guhan Subramanian, "Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable's Challenge," *Journal of Law and Economics*, Vol. 56, Issue 1, pp. 127-160, 2013. http://econpapers.repec.org/article/ucpjlawec/doi_3a10.1086_2f667411.htm; Joanna Tochman Campbell, T. Colin Campbell, David G. Sirmon, Leonard Bierman and Christopher S. Tugge, "Shareholder Influence over Director Nomination via Proxy Access: Implications for Agency Conflict and Stakeholder Value," *Strategic Management Journal*, Vol. 33, Issue 12, pp. 1431–1451, December 2012. http://onlinelibrary.wiley.com/doi/10.1002/smj.1989/abstract; Jonathan Cohn, Stuart L. Gillan and Jay C. Hartzell, "On Enhancing Shareholder Control: A (Dodd-) Frank Assessment of Proxy Access," *Journal of Finance*, forthcoming, October 2015. http://faculty.mccombs.utexas.edu/Jonathan.Cohn/papers/CGH_2015oct10_public.pdf; Torsten Jochem, "Does Proxy Access Increase Shareholder Wealth? Evidence from a Natural Experiment," April 1, 2012. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2022706

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10. David F. Larcker, Gaizka Ormazabal and Daniel J. Taylor, "The Market Reaction to Corporate Governance Regulation," *Journal of Financial Economics*, Vol. 101, Issue 2, pp. 431–448, August 2011. http://www.sciencedirect.com/science/article/pii/S0304405X11000675; Ali C. Akyol, Wei Fen Lim and Patrick Verwijmeren, "Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations," *Journal of Financial and Quantitative Analysis*, Vol. 47, Issue 5, pp. 1029-1057, October 2012. http://journals.cambridge.org/action/displayAbstract?fromPage=online&aid=8800544; See Yvan Allaire and François Dauphin, "Who should pick board members? Proxy Access by Shareholders to the Director Nomination Process," Institute for Governance of Private and Public Organizations, Policy Paper No 8 (noting the exclusion of these two studies in the CFA report), Nov. 4, 2015.

11. Russell R. Currie and Gurupdesh S. Pandher, "Finance Journal Rankings and Tiers: An Active Scholar Assessment Methodology," *Journal of Banking & Finance*, Vol. 35, Issue 1, pp. 7–20, January 2011. http://www.sciencedirect.com/science/article/pii/S0378426610003006

12. Trabucchi, *supra* note 4, p. 35.

13.Cohn, supra note 6, at 76.

14.Id., Table I, Panel A.

15. Id., pp. 70-71.

16. Id., Table II.

17. Trabucchi, supra note 4, p. 76.

18. Ibid.

19. Campbell, *supra* note 6, p. 1441.

20. Id., p. 1442.

21. Ibid.

22. Becker, supra note 6, p. 132.

23. Akyol, supra note 10, p. 1034. Citing Kara Scannell, "SEC Set to Open Up Proxy Access," *The Wall Street Journal*, Aug. 5, 2010. http://www.wsj.com/articles/SB10001424052748704741904575409680246527908

24. Trabucchi, supra note 4, p. 77.

25. Akyol, supra note 10, p. 1044, Table 3.