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ISSUE SNAPSHOT

- It's crucial that public-pension funds focus on shareholder-wealth maximization. This is particularly true for those that currently are underfunded and will be challenged to meet all obligations to their beneficiaries.
- Efforts by New York City Comptroller Scott Stringer and other public-pension-fund managers to sponsor proxy-access proposals at public companies are only worthwhile to the extent that they forward the goal of maximizing shareholder wealth.
- The evidence to date suggests political concerns and stakeholder rent-seeking are behind the drive for proxy access.

PUBLIC-PENSION FUNDS PLAY WITH NEWEST TOY IN CORPORATE GOVERNANCE

Bernard S. Sharfman

INTRODUCTION

Shareholder-wealth maximization generally is accepted as the default objective of an investment fund, though there are exceptions to the rule. For example, an investment adviser might create a fund with the purpose of only investing in companies that meet stringent criteria on greenhouse-gas emissions. Investors who decide to invest in this type of fund are revealing a preference for sacrificing returns in order to have their noneconomic investment objectives met.

However, for a public pension fund with thousands of current and future beneficiaries who count on the fund's performance to support them in retirement, it's hard to envision any other feasible objective but shareholder-wealth maximization.

During the recent proxy season, Scott Stringer – comptroller of New York City and the custodian and investment adviser to the New York City Pension Funds – took advantage of an amended Securities and Exchange Commission rule to submit 75 of the 108 proxy-access proposals that were received by publicly traded companies.[1] From Comptroller Stringer's perspective, he was wildly successful. Of the 75 proposals submitted, 63 went to a vote, with 56 percent average support.[2] Of those 63, 41 received majority support. Moreover, at six companies where withdrawal of the proxy access proposal was negotiated, management agreed to adopt proxy access or put forward a management-sponsored proposal next year.[3]

But was it a win for beneficiaries of the New York City Pension Funds or for shareholders in general? As discussed below, the answer is very much in doubt.

OPTIMAL CORPORATE GOVERNANCE

Proxy access is the ability of shareholders to have their own slate of director nominees included in a publicly traded company's proxy-solicitation materials – the proxy statement and proxy voting card. Traditionally, this has not been allowed, as the nomination of directors has been under the control of the board of directors and its nominating committee.[4] This meant that only candidates that had been screened by the board nominating committee and approved by the full board would appear in the company's proxy-solicitation materials for purposes of electing directors at the annual meeting.

Since shareholders could not place their slate of nominees in the company's proxy materials, the only alternative was to go through the cost-prohibitive process of creating their own proxy materials to nominate their slate. Therefore, board nominees nearly always were assured of winning election.

This may surprise many readers, but from the perspective of optimal decision-making efficiency, this was and is a reasonable corporate-governance arrangement. The board nominating committee is in the best position to determine which nominees are the most qualified candidates to serve as directors, as it has the greatest informational advantage in understanding the needs of the company. As I explained in an article published in the *Journal of Corporation Law*:

> The Board nominating committee has an informational advantage over even the most informed shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information. Shareholders who want to take advantage of proxy access do not have this information available to them.[5]

Proxy access undercuts the informational advantages held by "the nominating committee by failing to assign it any role in screening or approving shareholder nominations."[6] Moreover, the board nominating committee and the board as a whole must adhere to the fiduciary duties of care and loyalty that are imposed by corporate law, duties that shareholders who participate in the nomination process do not have.

That a board has a decided informational advantage over shareholders is a presumption also found in corporate law, which is governed at the state level. In corporate law, statutory default rules are used to provide boards with ultimate decision-making authority. Corporate law recognizes that a centralized, hierarchical authority is necessary to be successful in managing all the information that flows through a large for-profit organization. It may not be a fair arrangement, but corporate governance is not about fairness to shareholders; it's about maximizing their wealth.

Beginning in 1947 and ending in 2011, the ability to exclude shareholder proposals on proxy access from a company's proxy-solicitation materials was explicitly enforced under federal law through SEC regulation,[7] most recently under SEC Rule 14a-8(i)(8). However, in 2011, the SEC used authority granted by Section 971 of the Dodd–Frank Act[8] to modify Rule 14a-8(i)(8) so as to allow shareholder proposals on proxy access to become part of these materials.[9]

PUBLIC PENSION FUNDS AND PROXY ACCESS

When a public pension fund decides to submit a shareholder proposal on proxy access, it should do so for purposes of maximizing shareholder wealth. The fund has a duty to its beneficiaries to answer the following question: will proxy access add to or subtract from shareholder wealth? To answer that question, the fund must focus on the decision-making process of a public company's board.

Given that a board's decision-making authority is presumed to have great value, the process of deciding whether to submit a shareholder proposal ought be based on the following formulation from Stephen Bainbridge of UCLA School of Law: the "preservation of managerial discretion should always be the null hypothesis."[10] For purposes of proxy access, this should mean clear evidence of a governance breakdown in the nomination of board members at the board level.

It's clear that Scott Stringer's proxy-access initiative did not ask the question about shareholder wealth or apply Bainbridge's approach. Instead, the analysis begins by assuming the conclusion that the "ability to nominate directors is a fundamental shareowner right."[11] Unfortunately, while that sentiment may have a vaguely constitutional ring to it, it offers no tangible guidance in terms of shareholder value.

The rest of Stringer's analysis does not improve on that inauspicious start. Of the 75 companies targeted by the comptroller, 33 were targeted because they were in industries directly related to climate change; 24 for a lack of board diversity; and 25 were cited for having received "significant opposition to their 2014 advisory vote on executive compensation."[12] According to a press release announcing the comptroller's proxy-access initiative:

> Resolutions were filed at companies where we see risks associated with climate change, board diversity and excessive CEO pay. Especially when it comes to the environment, business as usual is no longer an option. To effect true change, you need the ability to hold entrenched and unresponsive boards accountable and that is what we are seeking to do.[13]

Stringer declared that "we expect to see better long-term performance across our portfolio"[14] because of the initiative, which is a worthy objective. But there's no evidence linking the analysis used to target firms to that stated objective. As reported in a recent study, "the firms targeted by the NYC Comptroller did not exhibit statistically significant stock market underperformance relative to the control group."[15] Clearly, other objectives were in play when the comptroller went about targeting companies for proxy access.

The lesson here is that the best case to be made for proxy access is not about increasing shareholder rights or even using the rights shareholders already have, but about shareholder-wealth maximization. Using proxy access for other purposes is harmful to the beneficiaries of a public-pension fund. Implementing proxy access with any goal but to maximize shareholder wealth creates a needless change in a target company's corporate-governance arrangements that may be wealth-reducing, as less appropriate candidates may be elected to the board.

Proxy access also may allow a shareholder to issue annual threats to nominate candidates unless the board provides concessions to the shareholder's favored stakeholders, such as labor unions. These concessions would come directly out of the pocket of shareholders and ultimately harm public-pension-fund beneficiaries. Firms with risk-averse boards who are uncertain about their own nominees' election prospects would be particularly vulnerable to such rent-seeking behavior.[16]

Finally, given the $46.6 billion underfunded status of New York City's pension funds,[17] one would think that shareholder-wealth maximization would be the comptroller's top, if not only, priority when getting involved in the area of corporate governance. This does not appear to be the case. It's no secret that the comptroller is an elected official and that political considerations may play a role in his proxy-access initiative. In a heavily Democratic city, it's helpful for a politician to establish a populist track record on such issues as climate change, board diversity and executive pay before the next or subsequent elections.

Scott Stringer might be an excellent politician and perhaps a future mayor of New York City or even governor of New York. But for the sake of the beneficiaries whose interests he is sworn to uphold, he should restrain himself from getting involved in the corporate governance of public companies. That's an area in which he clearly should defer to those who have the most expertise -- the board.

ABOUT THE AUTHOR

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Bernard also is a member of the Journal of Corporation Law's editorial advisory board. He previously was visiting assistant professor of law at Case Western Reserve University School of Law.

He has written extensively on the topic of corporate governance. That includes his most recent work, "Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?," forthcoming in the Columbia Business Law Review.

ENDNOTES

1. R.J. Lehmann, "Proxy Access: Shareholder Democracy or Creeping Mercantilism," R Street Institute, July 2015. http://www.rstreet.org/policy-study/proxy-access-shareholder-democracy-or-creeping-mercantilism/

2. Cydney Posner, "Some notes from the SEC's Investor Advisory Committee meeting," PubCo@Cooley, July 16, 2015. http://cooleypubco.com/2015/07/16/some-notes-from-the-secs-investor-advisory-committee-meeting/

3. Barry B. Burr, "Board support rising but concerns remain, study says," *Pensions and Investments*, July 27, 2015. http://www.pionline.com/article/20150727/PRINT/307279997/board-support-rising-but-concerns-remain-study-says

4.As early as 2006, it was reported that 99 percent of companies in the S&P 500 Index used a nominating committee. See Michael E. Murphy, "The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis," 5 *Berkeley Business Law Journal* 131, 147, 2008. http://scholarship.law.berkeley.edu/bblj/vol5/iss2/1/

5. Bernard S. Sharfman, "Why Proxy Access is Harmful to Corporate Governance," 37 *Journal of Corporation Law* 387, 402, 2012. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1873469

6. Murphy, supra note 6, at 144 (2008).

7. Securities Exchange Act of 1934, 12 Federal Register 8768, 8770, Dec. 24, 1947. https://www.federalregister.gov/citation/75-FR-8768

8. Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, § 971, 124 Stat. 1376, 1915, 2010. http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_971.html

9. Such proposals typically allow shareholders who have owned 3 percent of the company's voting common stock for at least three years, on an individual or aggregated basis, access to a publicly traded company's proxy-solicitation materials for purposes of nominating their own candidates for board membership. This means that, at those companies where a proxy access bylaw has been approved by shareholders or the board, a special group of shareholders may now include their own slate of nominees (typically up to 20 percent or 25 percent of the board seats that are up for election) in the companies' proxy materials.

10. Stephen M. Bainbridge, "The Business Judgment Rule as Abstention Doctrine," 57 *Vanderbilt Law Review* 83, 109, 2004. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=429260

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15. Tara Bhandari, Peter Iliev and Jonathan Kalodimos, "Public versus Private Provision of Governance: The Case of Proxy Access," U.S. Securities and Exchange Commission working paper, July 2015. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2635695

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