

# THE POLITICIZATION OF CORPORATE GOVERNANCE: BUREAUCRATIC DISCRETION, THE SEC, AND SHAREHOLDER RATIFICATION OF AUDITORS

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## TABLE OF CONTENTS

I.	INTRODUCTION .....	000
II.	RULE 14A-8 AND THE “ORDINARY BUSINESS” EXCLUSION ...	000
	A. <i>The Development of the “Ordinary Business”</i>	
	<i>Exclusion</i> .....	000
	B. <i>Arbitrating Disputes Between Shareholders and</i>	
	<i>Managers</i> .....	000
III.	SHAREHOLDER APPROVAL OF THE OUTSIDE AUDITOR .....	000
	A. <i>The SEC and Shareholder Approval of Auditors</i> .....	000
	B. <i>A Shift in Time</i> .....	000
IV.	THE SEC AND A REDUCTION IN GOVERNANCE VOLATILITY ..	000

## I. INTRODUCTION

One of the most profound changes in corporate governance over the last decade has been the shift in the role of the Securities and Exchange Commission (“SEC”). Initially limited primarily to the task of ensuring adequate disclosure, the SEC mostly played a marginal role in the substance of corporate governance.<sup>1</sup> It was left to the states to determine the rights and obligations of directors and shareholders. Aborted efforts by the SEC in the 1980s to engage in substantive rulemaking through the medium of listing standards were met with emphatic rejection by the courts.<sup>2</sup>

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<sup>1</sup> Much of the history of the SEC’s role in the corporate governance area, including the emphasis on disclosure, is discussed in J. Robert Brown, Jr., *Essay: Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure*, 57 CATH. U. L. REV. 45 (2007).

<sup>2</sup> See *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (invalidating Rule 19c-4 on the basis that it exceeded the Commission’s rulemaking authority through the imposition of substantive corporate governance requirements).

The distinction between disclosure and substance, to the extent one ever really existed,<sup>3</sup> has largely been dismantled. Over the last decade, Congress repeatedly transferred to the SEC direct substantive authority over the corporate governance process, first in the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”),<sup>4</sup> then in the Dodd-Frank Wall Street Reform Act of 2010 (“Dodd-Frank”).<sup>5</sup> While Sarbanes-Oxley was harshly criticized and viewed by many as an anomaly arising out of the perfect storm of the Enron scandal and rapidly approaching congressional elections,<sup>6</sup> Dodd-Frank confirmed that principles of federalism in the realm of corporate governance had been permanently eroded. The Act made clear the absence of any meaningful congressional reservation on the transfer of governance authority from the states to the SEC.<sup>7</sup>

The cumulative effect of these changes has been to thrust the SEC into the center of the corporate governance debate. Rather than merely addressing the informational needs of investors, the SEC has increasingly been called upon to develop substantive standards and to arbitrate the often irreconcilable positions of interest groups vying to influence the governance process.<sup>8</sup>

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<sup>3</sup> See Brown, *supra* note 1, at 51-2 (noting that the Commission was expected to play a role in the governance process and disclosure was expected to be the main method of addressing abuses of authority by directors since shareholders had the substantive authority to limit management’s misbehavior and excesses).

<sup>4</sup> Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002). See Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1149-50 (2004) (noting that Sarbanes-Oxley acceded to the Commission’s control over audit committees, financial qualifications of directors, and some compensation practices).

<sup>5</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). See J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* (3D ED. 2005 & SUPP 2011) (noting that the Dodd-Frank Act added to the Commission’s regulatory bailiwick the right to oversee compensation committees, define the term “independent director,” allow shareholder access to the proxy statement for board nominees, and oversee advisory votes on executive compensation).

<sup>6</sup> See J. Robert Brown Jr., *Essay: Criticizing the Critics: Sabarnes-Oxley and Quack Corporate Governance*, 90 MARQ. L. REV. 309, 316-18 (2006).

<sup>7</sup> See Dodd-Frank Act § 951 (rulemaking authority to implement “say on pay”). Dodd-Frank continued the process of shifting corporate governance authority from states to the SEC in a number of respects. Most noticeably, the Act gave shareholders the federal right to an advisory vote on executive compensation. The SEC implemented the provision in Rule 14a-21. 17 C.F.R. § 240.14a-21 (2011). Congress also gave the SEC the authority to regulate compensation committees, see Dodd-Frank Act § 952 (rulemaking authority to require stock exchanges to regulate compensation committees as part of listing standards), expanded the circumstances when boards were required to “clawback” performance based compensation, see Dodd-Frank Act § 954, and required the boards of large financial institutions to put in place “risk” committees, see Dodd-Frank Act §165(h).

<sup>8</sup> See *infra* notes 171-9, 184 (discussing the efforts by the Commission to navigate the issue of shareholder access to the proxy statement). Shareholder access has been opposed by companies and favored by shareholders, with little middle ground. Similarly, Dodd-Frank thrust the Commission into the debate over corporate social responsibility. See Dodd-Frank Act § 1502 (requiring rules providing for disclosure by manufacturers of “conflict minerals”). See also J. Robert Brown, Jr., *The SEC, Social Responsibility, and Conflict Minerals: Crossing the Disclosure Rubicon (Part 1)*, THE RACE TO THE BOTTOM (Dec. 29, 2010, 6:00 AM), <http://>

The transfer of governance authority to the SEC will have significant consequences. For one thing, the regulatory philosophy is likely to change. Unlike the management-friendly approach employed by Delaware in determining governance standards,<sup>9</sup> the SEC has as its regulatory mission the protection of shareholders and investors.<sup>10</sup> The agency also has a statutory obligation to examine regulatory initiatives for their impact on efficiency, competition, and capital formation.<sup>11</sup> The result will probably be, for the most part, more balanced policies.

The transfer will, however, cause increased politicization of the governance process. With changes in administration, the political makeup of the Commission typically shifts.<sup>12</sup> As a result, the regulatory philosophy of the SEC more closely tracks the political philosophy of the party in power. With governance increasingly seen as a zero-sum game between investors and issuers, pressure will build with each change in administration to undo the practices of the prior SEC.<sup>13</sup> The result will be increased volatility.

The volatility will be less apparent with respect to rulemaking. Rules must be adopted pursuant to notice and comment under the Administrative Procedures Act<sup>14</sup> (“APA”) and are difficult to undo once implemented.<sup>15</sup> Moreover, efforts to change rules will be susceptible to legal challenge in an increasingly interventionist D.C. Circuit.<sup>16</sup>

Staff interpretations, however, are an entirely different matter. Issued on an informal basis, often through so-called “No-Action letters,” these positions are not subject to the notice and comment process mandated by the

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[www.theracetothetbottom.org/the-sec-governance/the-sec-social-responsibility-and-conflict-minerals-crossing-3.html](http://www.theracetothetbottom.org/the-sec-governance/the-sec-social-responsibility-and-conflict-minerals-crossing-3.html).

<sup>9</sup> See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317 (2003–04) (noting that this behavior is a product of the race to the bottom).

<sup>10</sup> See Brown, *supra* note 1, at 50-2.

<sup>11</sup> See 15 U.S.C. §78c(f) (2011) (“Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”). Section 3(f) of the Exchange Act requires that the SEC consider the effect of certain proposed rules on efficiency, competition and capital formation.

<sup>12</sup> See *infra* note 22. For actual examples, see *infra* notes 78 and 132.

<sup>13</sup> See *infra* notes 171, 184 (noting that this was apparent, for example, with respect to shareholder access to the proxy statement).

<sup>14</sup> See 5 U.S.C. § 553 (2011).

<sup>15</sup> See *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42 (1983). See also *infra* notes 171, 184 (for an example of the difficulty with shareholder access rule).

<sup>16</sup> See, e.g., *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (striking down Rule 14a-11); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010) (striking down Rule 151A of the Securities Act of 1933); *Fin. Planning Ass’n v. SEC*, 482 F.3d 481, 493 (D.C. Cir. 2007) (striking down Rule 202(a)(11) under the Investment Advisors Act); *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133, 144-45 (D.C. Cir. 2005) (striking down rules that would provide exemptions from the Investment Company Act in certain circumstances); *Bus. Roundtable v. SEC*, 905 F.2d 406, 416-17 (D.C. Cir. 1990) (striking down Rule 19c-4 under the Exchange Act).

APA and in many cases are not subject to legal challenge.<sup>17</sup> Moreover, the letters rarely contain meaningful analysis of the legal positions taken by the staff. They can, as a result, be changed or abandoned with little explanation.

This can be seen from shifts in the SEC staff's position under Rule 14a-8, the shareholder proposal rule.<sup>18</sup> The rule allows shareholders to submit proposals to companies for inclusion in the proxy statement. Management may, under certain circumstances, exclude proposals, including those that interfere with the "ordinary business" of the company.<sup>19</sup> This exclusion does not apply, however, where the proposal involves matters of important public policy.<sup>20</sup>

An examination of staff interpretations under the exclusion show that they shift significantly from administration to administration, particularly with changes in the political makeup of the agency. Congress contemplated that the five-person Commission would include representatives of both major parties.<sup>21</sup> When at a full complement, the Commission typically consists of three members from the party of the current administration and two members from the other major party.<sup>22</sup> The replacement of a single member can cause the regulatory philosophy of the administrative agency to change.

During Republican administrations, interpretive views under Rule 14a-8 tend to minimize or eliminate consideration of social policy and more broadly allow for exclusion of shareholder proposals. During Democratic administrations, the situation is reversed. Social policy is read broadly to favor shareholders and effectively restricts management's ability to exclude proposals. Given these countervailing views, the positions of the staff often

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<sup>17</sup> For a discussion of No-Action letters, see Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921 (May 1998).

<sup>18</sup> 17 C.F.R. § 240.14a-8 (2011).

<sup>19</sup> *Id.* (allowing for exclusion if "the proposal deals with a matter relating to the company's ordinary business operations").

<sup>20</sup> See *infra* note 44.

<sup>21</sup> 15 U.S.C. § 78d(a) (2011) ("Not more than three of such commissioners shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as nearly as may be practicable.").

<sup>22</sup> See <http://www.sec.gov/about/sechistoricalsummary.htm>. Although this is the practice, the statute does not actually require representation of both parties; it only requires that one party not have more than three positions. The President could, for example, insert persons who describe their affiliation as "independent." Thus, Mary Schapiro, who was appointed to the Commission in 1988, and again as chair in 2009, is listed as independent. When a new administration takes office, a president can theoretically confront a Commission with three members from the party of the prior administration. Moreover, the President cannot unilaterally remove those commissioners. Although Section 4 of the Exchange Act does not specifically limit removal to cause, the restriction has generally been assumed. *But see* Free Enterprise Fund v. PCAOB, 130 S. Ct. 3138 (2010) (assuming President could only remove commissioners appointed to the SEC for cause); see *id.* (dissenting opinion by Justice Bryer) (arguing that law was not clear that President could only remove commissioners for cause). As a practical matter, however, the chairman appointed by the prior administration typically resigns, providing the new President with an immediate appointment and ability to shift the political balance of power on the Commission. See *infra* note 132. Nonetheless, the assertion of control by the new administration can take time. See *infra* note 78.

change following the advent of a new administration, sometimes leading to the reversal of previously adopted policies.

Political influence does not operate in a straight-line fashion.<sup>23</sup> The ability to alter staff positions depends upon a variety of factors, including the importance of the issue, the particular views and personalities of the incumbent Commissioners, and the dynamics associated with collaborative decision making. Commissioners may need time to build coalitions favoring a particular position.<sup>24</sup> Moreover, with Commissioners serving five year terms,<sup>25</sup> a newly elected President often must wait several years before appointing a majority to the Commission.<sup>26</sup> Finally, political influence has a logistical component, with the opportunity to intervene affected by the particular proposals submitted by shareholders and management's response.<sup>27</sup>

This Article will examine the phenomenon of political influence in the context of shareholder proposals. After providing a bit of history on Rule 14a-8 and the "ordinary business" exclusion, this Article will look at shifts in interpretations that occurred from administration to administration. This Article will use as a case study the administrative approach taken with respect to proposals seeking shareholder ratification of outside auditors. Although the SEC supported and encouraged shareholder involvement in this area for more than a half century, the staff quietly abandoned the policy in 2005 by concluding that the practice amounted to an "ordinary business" activity of the company.<sup>28</sup>

The staff never provided any rationale for the shift.<sup>29</sup> Nonetheless, the altered position had two possible explanations. It could have been a consequence of the adoption of the Sarbanes-Oxley Act in 2002. The Act assigned

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<sup>23</sup> Although each administration typically has three members of its own party on the Commission, *see supra* note 22, these individuals do not always have the same regulatory philosophy and do not always vote as a block. *See* Investment Company Act Release No. 26520 (July 27, 2004) (approving governance requirements for investment companies by a 3-2 vote, with commissioners Donaldson (R), Goldschmid (D) and Campos (D) favoring the proposal and commissioners Atkins (R) and Glassman (R) opposing it).

<sup>24</sup> This appears to have occurred, for example, with respect to the positions taken by the Commission with respect to *Cracker Barrel*. While one Commissioner favored change, it took a number of years before the entire Commission agreed on an appropriate strategy and reversed the position taken by the prior Commission. *See infra* note 80.

<sup>25</sup> *See* 15 U.S.C. § 78d(a) (2011).

<sup>26</sup> *See infra* note 78. Of course, presidents can get control more quickly if Commissioners resign before completing their five-year terms. Thus, President Bush succeeded in appointing all five commissioners by 2002. *See infra* note 132.

<sup>27</sup> *See* 17 C.F.R. 240.14a-8(j) (specifying procedures that must be undertaken to obtain staff approval of the right to omit a shareholder proposal from the proxy statement). Management seeking to delete a proposal generally must obtain staff permission. Companies do not always challenge shareholder proposal. *See* J. Robert Brown, Jr., *Rule 14a-8, the Ordinary Business Exclusion, and the Need for Reform: Bank Policies and Loan Foreclosures (Part 4)*, THE RACE TO THE BOTTOM (Apr. 1, 2011, 6:00 AM), <http://www.theracetothetbottom.org/the-sec-governance/2011/4/1/rule-14a-8-the-ordinary-business-exclusion-and-the-need-for-1.html> (discussing shareholder proposal submitted to large banks where some sought exclusion and some did not).

<sup>28</sup> *See infra* note 139.

<sup>29</sup> *See, e.g.*, Rite Aid Corp., *infra* note 145.

to audit committees of listed companies the power to select the firm's auditor.<sup>30</sup> Some issuers seeking exclusion argued that shareholder ratification interfered with the carefully crafted role of this committee.<sup>31</sup> The justification was, however, an exceedingly thin reed on which to rest such a significant shift in a longstanding policy. Moreover, the approach conflicted with actual practice and did not take into account the ongoing public debate over auditor independence.<sup>32</sup> The more likely explanation was the shift in the political composition of the Commission following the elections in 2000.<sup>33</sup> The Article will end with some recommendations on reforms designed to reduce governance volatility, which mostly center around a reduction in staff discretion. In the context of the "ordinary business" exclusion, this foremost means the development of transparent standards. Alternatively, it means a fundamental redesign in the nature of the exclusion in order to reduce the staff's interpretive role.

## II. RULE 14A-8 AND THE "ORDINARY BUSINESS" EXCLUSION

### A. *The Development of the "Ordinary Business" Exclusion*

Rule 14a-8 emerged in 1942, eight years after Congress gave the SEC the authority to adopt proxy rules.<sup>34</sup> The Rule extended to shareholders the right to include proposals in the company's proxy statement. Commonly viewed as an enfranchising mechanism, the rule was in fact designed to assist management by resolving a significant disclosure issue under the antifraud provision in the proxy rules.<sup>35</sup>

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<sup>30</sup> See Sabarnes-Oxley Act § 301; see also 17 C.F.R. § 240.10A-3 (2011) (implementing Section 301).

<sup>31</sup> See the discussion of Rite Aid in Section III.B.

<sup>32</sup> See the discussion in Section III.B.

<sup>33</sup> See the discussion of Rite Aid in Section III.B.

<sup>34</sup> Exchange Act Release No. 3347, 1942 WL 34864 (Dec. 18, 1942). To some degree, these rights had already existed, but more informally. See Exchange Act Release No. 2376, 1940 WL 7144, at \*4 (Jan. 12, 1940) (amending Schedule 14A to require the person making a proxy solicitation to identify, in item 16, any other matters he is aware will be raised at the meeting and his proposed disposition of the proxies solicited with respect to those matters).

<sup>35</sup> Rule 14a-9 prohibits misleading disclosure in the context of the proxy process. See 17 § C.F.R. 240.14a-9 (2011). In the early days of the proxy rules, management aware that shareholders intended to submit proposals or nominees at the meeting had an obligation under this antifraud provision to disclose the fact in their proxy materials. See J. Robert Brown, Jr., *The SEC, Corporate Governance, and Shareholder Access to the Boardroom*, 2008 UTAH L. REV. 1339, 1343 n. 19 (2008). The shareholder proposal rule was adopted at least in part to alleviate management's obligation in this area. *Id.* at 1345. ("More immediately, they solved a serious problem, providing ground rules for the disclosure of shareholder proposals but shifting the burden from management back to the proposing shareholders."). The concern can still occasionally surface. See *Grimes v. Ohio Edison Co.*, 992 F.2d 455, 458 (2d Cir. 1993) ("*American Brands* stands for the proposition that the omission of a proposal from proxy materials that was not properly excluded under Rule 14a-8(c) makes the proxy inherently misleading under Rule 14a-9.>").

From the outset, the Rule contained exclusions for certain categories of shareholder proposals. The earliest was the right to delete proposals not deemed to be “a proper subject for action” by shareholders. The exclusion was a narrow one. The burden of establishing availability fell to management and required affirmative evidence.<sup>36</sup> With the contours of the exclusion mostly turning on the parameters of state law, the staff retained little interpretive discretion.<sup>37</sup>

That changed with the addition of the “ordinary business” exclusion in 1954.<sup>38</sup> The exclusion arose out of principles of state law.<sup>39</sup> With states assigning day-to-day oversight of the company’s business to the board,<sup>40</sup> proposals could be excluded if they interfered with management’s authority.<sup>41</sup>

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<sup>36</sup> See Exchange Act Release No. 4979, 1954 WL 5772 (Jan. 6, 1954) (“The rule places the burden of proof upon the management to show that a particular security holder’s proposal is not a proper one for inclusion in management’s proxy material. Where management contends that a proposal may be omitted because it is not proper under state law, it will be incumbent upon management to refer to the applicable statute or case law and furnish a supporting opinion of counsel.”). Thus, in *In re Union Electric Company*, 38 SEC 921 (1959), the SEC approved the omission of proposals as not proper subjects for shareholders. Both involved proposals that would have violated state law. See *id.* (“One proposal would permit a minor stockholder to vote by proxy. Union has submitted an opinion of counsel indicating that under Missouri law a minor may not appoint an agent. The second proposal would require the company to accord to the parent or guardian of a minor stockholder all rights incident to the ownership of stock. The opinion of Union’s counsel indicates that such rights may not in all instances legally be exercisable by the parent or guardian.”).

<sup>37</sup> See The SEC Today Released an Opinion of Baldwin B. Bane, Exchange Act Release No. 3638, 1945 WL 27415, at \*2 (Jan. 3, 1945) (“Speaking generally, it is the purpose of Rule X-14A-7 to place stockholders in a position to bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects for stockholders’ action under the laws of the state under which it is organized.”). The Commission staff interpreted the rule as bounded by state law from the outset. The approach was eventually made explicit in the text of the rule. See Adoption of Amendments to Proxy Rules, Exchange Act Release No. 4979, 1954 WL 5772, at \*1 (Jan. 6, 1954) (“The amended rule thus specifically provides that state law is to be the standard of eligibility of a proposal under the rule.”). See also *Dyer v. SEC*, 266 F.2d 33, 43–44 (8th Cir. 1959) (upholding SEC’s authorization to exclude two proposals about ownership of shares by minors deemed in violation of state law).

<sup>38</sup> See Adoption of Amendments to Proxy Rules, *supra* note 37.

<sup>39</sup> See Proposed Amendments to Rule 14a-8, Exchange Act Release No. 19,135, 1982 WL 600869, at \*16 (Oct. 14, 1982) (noting that the exclusion “is based on the requirements of most state laws that the business affairs of the corporation be conducted ‘by’ or ‘under the direction of’ the board of directors.”); see also Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 39,093, 50,682–83 (Sept. 18, 1997) (“The ‘ordinary business’ exclusion is based in part on state corporate law establishing spheres of authority for the board of directors on one hand, and the company’s shareholders on the other.”).

<sup>40</sup> See 8 Del. C. § 141(a).

<sup>41</sup> See Amendments to Rules on Shareholder Proposals, *supra* note 39, at 50,689 (“The general underlying policy of this exclusion is consistent with the policy of most state corporate laws: to confine the resolution of ORDINARY BUSINESS problems to management and the board of directors since it is impracticable for shareholders to decide how to solve such problems.”); see also Notice of Proposed Amendments to Proxy Rules, Exchange Act Release No. 4950, 1953 WL 5756, at \*2 (Oct. 9, 1953) (“In order to relieve the management of the necessity of including in its proxy material security holder proposals which relate to matters falling within the province of the management, it is proposed to amend this rule so as to permit the omission of any proposal which consists of a recommendation or request that the management take

As a practical matter, however, the dearth of state law on the issue<sup>42</sup> effectively gave to the staff complete discretion to determine the relative division of power between shareholders and managers.<sup>43</sup>

The application of the exclusion was initially a relatively straightforward matter.<sup>44</sup> The staff looked to such factors as the fundamental importance of the task to management,<sup>45</sup> the impracticability of shareholders resolving the issue,<sup>46</sup> and the lack of shareholder expertise on the subject matter of the proposal.<sup>47</sup> Likewise, the SEC sometimes explained that the exclusion was designed to prevent shareholders from micro-managing the business of the corporation.<sup>48</sup>

This early approach did not consider the social impact of the proposal and allowed for the exclusion of “matters of considerable importance to the

action with respect to a matter relating to the conduct of the ordinary business operations of the issuer.”).

<sup>42</sup> Proposed Amendments to Rule 14a-8, *supra* note 39, at 47,420 (“State law precedent, however, is rarely conclusive as to what is or is not ORDINARY BUSINESS, and the staff generally has had to make its own determination as to whether a proposal involves an activity relating to the issuer’s ORDINARY BUSINESS.”); *see also* Amendments to Rules on Shareholder Proposals, *supra* note 39, at 50,689 (“Although the policy is based on state law, it is not completely guided by it, due in part to an absence of state authority on many of the issues we are called upon to address.”).

<sup>43</sup> Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018, 63 Fed. Reg. 29,106, 29,107 (May 21, 1998) (“The term refers to matters that are not necessarily ‘ordinary’ in the common meaning of the word, and is rooted in the corporate law concept providing management with flexibility in directing certain core matters involving the company’s business and operations.”).

<sup>44</sup> *See* Amendments to Rules on Shareholder Proposals, *supra* note 39, at 50,688-89 (describing exclusion in early days as “fairly straightforward” but noting that “proposals relating to such matters but focusing on significant social policy issues generally would not be considered to be excludable, because such issues typically fall outside the scope of management’s prerogative”).

<sup>45</sup> *Id.* at 50,688 (“Certain tasks are so fundamental to management’s ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. Examples include the management of the workforce, such as the hiring, promotion, and termination of employees, decisions on production quality and quantity, and the retention of suppliers.”).

<sup>46</sup> *Id.* at 50,689 (“The general underlying policy of this exclusion is consistent with the policy of most state corporate laws: to confine the resolution of ORDINARY BUSINESS problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems.”).

<sup>47</sup> Hearings on SEC Enforcement Problems Before the Subcommittee of the Senate Committee on Banking & Currency, 85th Cong., 1st Sess. part 1, at 119 (1957) (“The basic reason for this policy is that it is manifestly impracticable in most cases for stockholders to decide management problems at corporate meetings.”).

<sup>48</sup> Amendments to Rules on Shareholder Proposals, *supra* note 39, at 50,689 (“The second consideration relates to the degree to which the proposal seeks to ‘micro-manage’ the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment. This consideration may come into play in a number of circumstances, such as where the proposal involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies.”); *see also* Amendments to Rules on Shareholder Proposals, *supra* note 39. As one court stated, “management cannot exercise its specialized talents effectively if corporate investors assert the power to dictate the minutiae of daily business decisions.” *Med. Comm. for Human Rights v. SEC*, 432 F.2d 659, 679 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972).

issuer and its security holders.”<sup>49</sup> By the 1970s, the status quo became increasingly untenable, with shareholders pressuring to use Rule 14a-8 to promote public debate on corporate behavior.<sup>50</sup> On topics ranging from the manufacture of napalm<sup>51</sup> to the segregation of buses,<sup>52</sup> the proposals submitted by shareholders were intended to facilitate discussion on company practices that implicated matters of important social policy.

The SEC initially resisted efforts to allow these sorts of proposals, viewing the proxy process as an inappropriate forum for promoting public debate.<sup>53</sup> Pressure from investors, along with judicial intervention, eventually forced the agency’s hand. In 1976, the SEC expressly acknowledged that the “ordinary business” exclusion would be modified by consideration of the social importance of the proposal,<sup>54</sup> something that would require the staff to “adjust its [interpretive] approach.”<sup>55</sup>

The change was not motivated by the requirements of state law. Indeed, such an exception to the board’s authority to supervise day-to-day activities arguably did not exist under state law.<sup>56</sup> Instead, the SEC and the courts mostly sought to implement the intent of Congress in using the proxy rules

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<sup>49</sup> Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 12,598, 41 Fed. Reg. 29,982, 29,984 (July 7, 1976).

<sup>50</sup> Amendments to Rules on Shareholder Proposals, *supra* note 39, at 50,688 (“That mission became more complicated with the emergence of proposals focusing on social policy issues beginning in the late 1960’s. As drafted, the rule provided no guidance on how to analyze proposals relating simultaneously to both an ‘ORDINARY BUSINESS’ matter and a significant social policy issue.”).

<sup>51</sup> See Med. Comm. for Human Rights v. SEC, *supra* note 48.

<sup>52</sup> See *Peck v. Greyhound Corp.*, 97 F. Supp. 679, 680 (S.D.N.Y. 1951).

<sup>53</sup> See SEC Today Released an Opinion of Baldwin B. Bane, *supra* note 37, at \*2 (“It was not the intent of Rule X-14A-7 to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature. Other forums exist for the presentation of such views.”); see also Med. Comm. for Human Rights v. SEC, *supra* note 48, at 677 (“The Commission’s release endorsed the Director’s conclusion that ‘proposals which deal with general political, social or economic matters are not, within the meaning of the rule, ‘proper subjects for action by security holders.’”).

<sup>54</sup> See Amendments to Rules on Shareholder Proposals, *supra* note 39, at 14 (“However, proposals relating to such matters but focusing on significant social policy issues generally would not be considered to be excludable, because such issues typically fall outside the scope of management’s prerogative.”).

<sup>55</sup> *Id.* at 12 (“Over the years, for instance, the Division has in several instances reversed its position on the excludability of proposals involving plant closings, the manufacture of tobacco products, executive compensation, and golden parachutes.”) (footnotes omitted). The same release explicitly reversed the staff’s position excluding proposals relating to employment practices a position that had previously been asserted in *Cracker Barrel*. *Id.* at 13 (“Return to a case-by-case approach should redress the concerns of shareholders interested in submitting for a vote by fellow shareholders employment-related proposals raising significant social issues.”).

<sup>56</sup> See *Brooks v. Standard Oil Co.*, 308 F. Supp. 810, 814 (S.D.N.Y. 1969) (“*Laredef* makes it amply clear that plaintiff’s heavily stressed proposition that ‘policy-making matters’ are beyond the directors’ control (an assertion he makes in his letter to the Commission and again in his Memorandum of Law) is not correct.”).

to promote the shareholder franchise.<sup>57</sup> However, without any guiding legal principles from state law, the public policy addendum was left entirely to the staff to define and interpret.<sup>58</sup>

Thereafter, application of the “ordinary business” exclusion ostensibly required a two-step analysis. First, the staff had to assess whether the proposal involved excessive intrusion by shareholders into the affairs of management. Second, assuming that it did, the staff had to assess whether the importance of the subject matter was nonetheless sufficient to warrant inclusion of the proposal in the proxy statement.<sup>59</sup>

In fact, there is little evidence that the two-step analysis routinely occurred. The staff never developed meaningful standards for delineating the relative roles of shareholders and managers. Nor was the concept of public interest ever defined. Disconnected from state law and devoid of any real standards, application of the “ordinary business” exclusion developed in an ad hoc and inconsistent fashion<sup>60</sup> that could result in tenuous determinations.<sup>61</sup>

The result was substantial staff discretion. Yet the discretion did not exist in a vacuum. Rather than employ objective definitions or otherwise

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<sup>57</sup> See *Med. Comm. for Human Rights v. SEC*, *supra* note 48, at 680-81 (“As our earlier discussion indicates, the clear import of the language, legislative history, and record of administration of section 14(a) is that its overriding purpose is to assure to corporate shareholders the ability to exercise their right – some would say their duty – to control the important decisions which affect them in their capacity as stockholders and owners of the corporation.”).

<sup>58</sup> See Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 20091, 28 SEC Docket 798 (Aug. 16, 1983) (“Because this interpretation raises form over substance and renders the provisions of paragraph (c)(7) largely a nullity, the Commission has determined to adopt the interpretative change set forth in the Proposing Release. Henceforth, the staff will consider whether the subject matter of the special report or the committee involves a matter of ORDINARY BUSINESS; where it does, the proposal will be excludable under Rule 14a-8(c)(7).”). For a time, the staff sought to avoid the interpretative difficulties by allowing proposals involving a company’s ordinary business that merely called for reports however the SEC, however, abandoned that approach in 1983. ) The history of the change is described in *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores*, 821 F. Supp. 877, 881-82 (S.D.N.Y. 1993); see also *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 429 (D.C. Cir. 1992) (“Just as the Commission has clarified that requests for special reports or committee studies are not automatically includable in proxy materials, we caution that such requests are not inevitably excludable.”).

<sup>59</sup> See, e.g., *Austin v. Consol. Edison Co. of N.Y., Inc.*, 788 F. Supp. 192, 195 (S.D.N.Y. 1992) (non-binding resolution endorsing the idea that defendant’s employees should be allowed to retire after thirty years of service, regardless of age; proposal related to entire work force, not just senior management, and enhanced pension rights had “not yet captured public attention”).

<sup>60</sup> Early commentary on the exclusion noted the possibility of such a result. See *Hearings*, *supra* note 47, at 118 (“Consistency with this premise requires that the phrase ‘ordinary business operations’ in Rule X-14A-8 have the meaning attributed to it under applicable State law. To hold otherwise would be to introduce into the rule the possibility of endless and narrow interpretations based on no ascertainable standards.”).

<sup>61</sup> See Amendments to Rules on Shareholder Proposals, *supra* note 39, at 4 (“Although a few of the distinctions made in those cases may be somewhat tenuous, we believe that on the whole the benefit to shareholders and companies in providing guidance and informal resolutions will outweigh the problematic aspects of the few decisions in the middle ground.”).

devise the relevant standards, the staff instead took positions with respect to the ordinary business exclusion that were often explained by shifts in the political makeup of the Commission.

### *B. Arbitrating Disputes Between Shareholders and Managers*

Staff interpretations of the “ordinary business” exclusion under Rule 14a-8 change regularly. These shifts often do not reflect a substantive revision in the meaning or breadth of the exclusion; rather, they more likely arise from the need to conform to the views of a majority of those sitting on the Commission. As a result, changes often occur following shifts in the political composition of the body.

The influence of the Commission on the staff can be deceptively hard to see. Commissioners most obviously become aware of staff positions under Rule 14a-8 through an appeal by the party dissatisfied with the position taken in the No-Action letter.<sup>62</sup> The staff typically notifies the Commission of the appeal and recommends that it be denied. As long as staff views comport with those of a majority of the Commission, the recommendation will be accepted and the appeal disallowed. Non-review, therefore, signals acquiescence of the Commissioners to the positions taken by the staff.

In contrast, the Commission will accept an appeal when it disagrees with the staff’s position and will often reverse.<sup>63</sup> To avoid this administrative embarrassment, the staff has an incentive to proactively implement interpretations that will be acceptable to the Commission. In particular, this may require alterations as administrations change and the regulatory position of the Commission shifts.

The staff’s ability to change its interpretation under the “ordinary business” exclusion is facilitated by the lack of substantive impact typically associated with proposals that implicate the exclusion. Although the exclusion is intended to prevent shareholder interference in the prerogative of the board, the proposals have almost no meaningful possibility of doing so.

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<sup>62</sup> See 17 C.F.R. § 202.1(d) (2011). Pursuant to 17 C.F.R. § 202.1(d), the SEC may review proxy issues “which involve matters of substantial importance and where the issues are novel or highly complex.”

<sup>63</sup> See Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1039 (August 1987) (“[A]ppeals are presented to the Commission in the form of a staff recommendation that the Commission determine not to review the adverse response, i.e., that the Commission not review the merits of the matter.”). Where the SEC agrees with the staff position, it will usually accept this advice. Doing so reduces the SEC’s workload and provides some additional protection in any resulting legal challenge. *Id.* at 1039-40 (“It is fairly well settled that if the Commission accepts the staff’s recommendation, i.e., it does not review the merits of the adverse response, that decision is not reviewable by the courts. Moreover, because the staff has no authority to make reviewable orders, the effect of a Commission decision not to hear an appeal is to preclude any judicial review of an adverse response. On the other hand, it appears equally well settled that if the Commission determines to review an adverse response, that action is reviewable by the courts.”).

First, they rarely receive majority support from shareholders.<sup>64</sup> Second, they are mostly precatory and request, rather than require, managerial action. As a result, they can be ignored even when approved. Finally, should shareholders ever succeed in adopting a mandatory proposal, directors would be able to challenge the outcome through litigation in state court.<sup>65</sup>

As a result, the proposals are in reality mostly efforts by shareholders to bring public attention to potentially embarrassing corporate practices. Management, predictably, seeks to omit proposals falling under this exclusion not because they will actually interfere with its authority but because of the public pillorying that will often result and the pressure for change that will be applied by non-shareholder groups.<sup>66</sup> As a result, the staff's role is less about determining the balance of authority between directors and shareholders and more about determining the parameters of the public debate.

Not surprisingly, therefore, the interpretation of the "ordinary business" exclusion tends to differ among those who favor the use of the proxy process to engender broad public debate on corporate practices and those who do not. This is particularly apparent in the application of the public policy exception. During administrations that give greater weight to managerial concerns, the staff is more likely to narrow and sometimes eliminate consideration of the public policy exception. The effect is to allow management to exclude more potentially critical or embarrassing proposals. Under shareholder-centric administrations, the public policy exception is likely to

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<sup>64</sup> See Marleen O'Connor-Felman, *American Corporate Governance and Children: Investing In Our Future Human Capital During Turbulent Times*, 77 S. CAL. L. REV. 1258, 1340 (2004) (the first proposal on an issue of social importance to receive majority support only occurred in 2003 in connection with *Cracker Barrel*); See also Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23 (2004). Moreover, the circumstances in this case were unusual. See *infra* notes 69-75.

<sup>65</sup> See, e.g., J. Robert Brown, *Bring it On: The Delaware Courts Speak on Precatory Proposals under Rule 14a-8*; THE RACETOTHEBOTTOM.ORG, <http://www.theracetothetbottom.org/preemption-of-delaware-law/bring-it-on-the-delaware-courts-speak-on-precatory-proposals-under-rule-14a-8.html> (noting at least one judge in Delaware has called on the SEC to take this approach.).

<sup>66</sup> See Myron P. Curzan & Mark L. Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 677-82 (1979-80) (early examples include proposals involving companies operating in South Africa during the period of apartheid). For a discussion of the impact of public image problems on non-shareholder groups, see Russell B. Stevenson, Jr., *Corporations and Social Responsibility: In Search of the Corporate Soul*, 42 GEO. WASH. L. REV. 709, 724-28 (1973-74). Even advisory votes can place pressure on management to change existing policies. See Marleen O'Connor-Felman, *American Corporate Governance and Children: Investing In Our Future Human Capital During Turbulent Times*, 77 S. CAL. L. REV. 1258, 1341 (2004) (noting that after proposal calling for nondiscriminatory policies relating to sexual orientation "passed with fifty-eight percent of the shareholder vote, the company agreed to amend its written equal opportunity policy to state that the company does not discriminate based on sexual orientation."). Publicity can attach through the process of seeking SEC authority to delete a proposal. Nonetheless, the process is less apparent and does not result in the distribution of materials to thousands, sometimes even hundreds of thousands of investors.

be given a much broader range, allowing shareholders to publicly debate a wider array of corporate practices.

The approach taken with respect to proposals dealing with corporate employment practices illustrates this back-and-forth shift that can occur when administrations change. The staff originally found that employment-related matters affecting non-executive employees fell within the “ordinary business” of the company. To the extent they involved practices of social importance such as affirmative action or anti-discrimination policies, however, the proposals were generally treated as matters of public policy and could not be omitted under the exclusion.

In 1991, however, at the end of a Republican administration, the Commission accepted an appeal of a proposal addressing a company’s affirmative action policies and reversed the staff, concluding that it could be omitted under the “ordinary business” exclusion.<sup>67</sup> The staff rightfully understood that the Commission favored the exclusion of non-executive employment matters even when they implicated public policy concerns and changed its position, something that became clear the following year in *Cracker Barrel Old Country Stores*.

Cracker Barrel had become embroiled in controversy over alleged discrimination against employees on the basis of sexual orientation.<sup>68</sup> A shareholder proposal was dutifully submitted that requested the adoption of policies designed to prohibit the behavior. Cracker Barrel sought exclusion and despite the prominent public profile of the matter, the staff agreed.<sup>69</sup>

The analysis in the No-Action letter illustrated the likely political nature of the decision. Policies concerning non-executive employees were characterized as “uniquely matters relating to the conduct of the company’s ordi-

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<sup>67</sup> See Capital Cities/ABC, Inc., SEC No-Action Letter, 1991 WL 178565 (Mar. 7, 1991) (disallowing exclusion); Capital Cities/ABC, Inc., SEC No-Action Letter, 1991 WL 178633 (Apr. 4, 1991) (“Upon review, the Commission has reversed the Division’s position concerning the proposal. It has been determined that the proposal may be omitted from the Company’s proxy material in reliance upon Rule 14a-8(c)(7) since it appears to deal with matters relating to the conduct of the Company’s ordinary business operations. In this regard, the proposal involves a request for detailed information on the composition of the Company’s work force, employment practices and policies, and selection of program content.”). The decision allowing exclusion was by a 3-2 vote, *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores*, *supra* note 58, at 887 (“[T]hrough March 1991, the SEC’s no-action letters determined that companies could not exclude proposals requesting the information requested in plaintiffs’ Proposal here. On April 4, 1991, however, the full Commission appeared to shift position, and voted 3-2 to reverse the staff position stated in a no-action letter issued to Capital Cities/ABC.”).

<sup>68</sup> Cracker Barrel Old Country Stores, Inc., Preliminary Proxy Statement (Form DEF 14a), available at <http://apps.shareholder.com/sec/viewerContent.aspx?companyid=CBRL&docid=731999> (according to the resolution submitted by New York City Employees’ Retirement System to Cracker Barrel, “[I]n February, 1991 the management of Cracker Barrel Old Country Stores restaurants announced a policy of DISCRIMINATION in employment against gay men and lesbians.”).

<sup>69</sup> CRACKER BARREL Old Country Stores, Inc., SEC No-Action Letter, 1992 WL 289095, at \*2 (Oct. 13, 1992).

nary business operations.”<sup>70</sup> The staff conceded that exceptions had “been made in some cases where a proponent based an employment-related proposal on ‘social policy’ concerns.”<sup>71</sup> The distinction, however, had become “increasingly difficult” to determine.<sup>72</sup> Rather than narrow the definition of public policy, the staff opted to impose a bright-line test.<sup>73</sup> Proposals would be excluded if they concerned “a company’s employment policies and practices for the general workforce” irrespective of their social importance.<sup>74</sup> In an unusual move, the full Commission affirmed the decision.<sup>75</sup>

The position had no real basis in the interpretive lore surrounding the “ordinary business” exclusion. No explanation was provided for the conclusion that employment matters were “uniquely” within the ordinary business of management. The letter did not attempt to square the elimination of social policy considerations with the statement in 1976 that suggested otherwise.<sup>76</sup> Nor was there any discussion of the reasons for applying a bright line test only to employment matters.<sup>77</sup> The staff’s shift in position, therefore, was most likely designed to better reflect the Commission’s view that Rule 14a-8 was an inappropriate vehicle for encouraging debate over corporate employment practices.

The administration changed in early 1993 although it took several more years before President Clinton succeeding in appointing a majority of Commissioners.<sup>78</sup> Once this was accomplished, the Commission set about revers-

<sup>70</sup> *Id.* at \*1.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> See generally CRACKER BARREL Old Country Stores, Inc., SEC No-Action Letter, 1992 WL 289095 (Oct. 13, 1992).

<sup>74</sup> *Id.*

<sup>75</sup> CRACKER BARREL Old Country Store, Inc., SEC No-Action Letter, 1993 WL 11016, at \*1 (Jan. 15, 1993) (“Pursuant to 17 C.F.R. section 202.1(d), the Division presented the matter to the Commission for review. The Commission has affirmed the Division’s position that the proposal was excludable from the Company’s proxy material in reliance upon rule 14a-8(c)(7).”). Approval by the SEC had consequences. It meant that the staff could not unilaterally change the position in the next administration but had to obtain explicit Commission approval to do so. See *AFSCME v. AIG*, 462 F.3d 121, 129 (DC Cir. 2006) (concluding that staff interpretation conflicted with position taken by SEC in 1975 and requiring that, before the position could be altered, the SEC had a duty to explain the changed position).

<sup>76</sup> See *supra* note 55.

<sup>77</sup> See, e.g., Marleen A. O’Connor, *Organized Labor As Shareholder Activist: Building Coalitions to Promote Worker Capitalism*, 31 U. RICH. L. REV. 1345, 1364-65 (1997) (noting a more political explanation for the position. “Some of the Commissioners had been “very troubled” by complaints from corporate secretaries. According to some sources, Chairman Richard Breedon [sic] held a particularly strong view on this issue. Breedon [sic] and others may have been bothered in part because labor unions were beginning to raise the equal employment issue.”) (quoting *The Controversy Over Employment-Related Shareholder Resolutions: A Recap*, CORP. SOC. ISSUES REP., Investor Resp. Res. Center Soc. Issues Service, Wash., D.C. (Feb. 1996) at 5).

<sup>78</sup> See <http://www.sec.gov/about/sechistoricalsummary.htm>. It took President Clinton several years before he had appointed a majority of commissioners to the SEC. Richard Breedon, the Chairman under President Bush stepped down in May 1993. Arthur Levitt, the chairman appointed by President Clinton, assumed office in July 1993. Steven Wallman took office in July 1994. At that point, the Commission consisted of two appointees of President Clinton and

ing *Cracker Barrel*. In the comment process, shareholders almost unanimously favored repeal; managers almost unanimously opposed.<sup>79</sup> In ultimately overturning the decision, the Commission pointed to factors that came to light in the aftermath of the *Cracker Barrel* decision.<sup>80</sup> Yet in fact the reversal was better explained by a Commission more favorably disposed toward greater debate over corporate employment practices.

The same thing happened with respect to proposals involving public health and the environment. In 2005, the Commission consisted of three Republicans and two Democrats.<sup>81</sup> The staff issued a bulletin narrowing the “ordinary business” exclusion by imposing a “bright line” test that allowed companies to omit proposals involving “an internal assessment of the risks or liabilities that the company faces as a result of its operations that may adversely affect the environment or the public’s health.”<sup>82</sup> This was true, apparently, irrespective of the social importance of the issue within the proposal.

In *Cracker Barrel* fashion, the staff bulletin never explained why risk assessment was invariably a matter of “ordinary business,” nor did it discuss why the staff chose to dispatch with public policy implications only in cases of risk analysis and only those involving the environment and public health. Finally, the bulletin did not explain the distinction between those proposals

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three of President Bush (Roberts, Beese and Schapiro). Only in 1996 did President Clinton succeed in appointing a majority of the Commission and in ensuring the presence of three commissioners from his political party.

<sup>79</sup> Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29106, 29108 (May 28, 1998) (to be codified at 17 C.F.R. pt. 240) (“Nearly all commenters from the shareholder community who addressed the matter supported the reversal of this position. Most commenters from the corporate community did not favor the proposal to reverse CRACKER BARREL, though many indicated that the change would be acceptable as part of a broader set of reforms.”). Much of the impetus for the shift apparently came from a single commissioner. See <http://sec.gov/rules/proposed/s72597cn.htm> (statement by Commissioner Wallman that he had “repeatedly called for the reversal of *Cracker Barrel*—independent of any other or more comprehensive reform.”). One commentator described the reaction as an “acute dissonance between the views of corporate America and its shareholders regarding” the result. Aaron A. Dhir, *Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability*, 43 AM. BUS. L.J. 365, 381-82 (2006).

<sup>80</sup> Amendments to Rules on Shareholder Proposals, *supra* note 43 at 29,108 (“Since 1992, the relative importance of certain social issues relating to employment matters has reemerged as a consistent topic of widespread public debate. In addition, as a result of the extensive policy discussion that the *Cracker Barrel* position engendered, and through the rulemaking notice and comment process, we have gained a better understanding of the depth of interest among shareholders in having an opportunity to express their views to company management on employment-related proposals that raise sufficiently significant social policy issues.”).

<sup>81</sup> See <http://www.sec.gov/about/sechistoricalsummary.htm>. The Republicans consisted of Chairman Donaldson and commissioners Glassman and Atkins. The Democrats consisted of commissioners Goldschmid and Campos.

<sup>82</sup> SEC Staff Legal Bulletin No. 14C (CF) (June 28, 2005), *available at* <http://www.sec.gov/interp/legals/cfslb14c.htm> (“To the extent that a proposal and supporting statement focus on the company engaging in an internal assessment of the risks or liabilities that the company faces as a result of its operations that may adversely affect the environment or the public’s health, we concur with the company’s view that there is a basis for it to exclude the proposal under rule 14a-8(i)(7) as relating to an evaluation of risk.”).

that required risk analysis and those that did not.<sup>83</sup> Given that “most corporate decisions involve some evaluation of risk,”<sup>84</sup> companies used the staff position to challenge other types of proposals, even those that did not actually reference risk analysis.<sup>85</sup>

The interpretation did not last long. Following the election of a Democratic President in 2008, the political tilt of the Commission changed.<sup>86</sup> The staff almost immediately jettisoned the position, acknowledging that the analytical framework “may have resulted in the unwarranted exclusion of proposals that relate to the evaluation of risk but that focus on significant policy issues.”<sup>87</sup> The staff also questioned the premise that risk analysis never implicated public policy.<sup>88</sup> Proposals would thereafter be analyzed based upon the subject matter, with the need for risk analysis “not dispositive.”<sup>89</sup> Consistent with the reversal in *Cracker Barrel*, the staff reinstated the case-by-case approach.<sup>90</sup>

There are numerous other examples of similar positions taken in one administration and reversed in another. In 2006, the staff upheld the exclusion of a proposal submitted by the International Brotherhood of Electrical Workers Pension Benefit Fund to Comcast calling for limits in a severance agreement of no more than 2.99 times salary.<sup>91</sup> Four years later with a change in administration,<sup>92</sup> the staff took a different position in an almost

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<sup>83</sup> The release merely provided that if the proposal did not involve risk assessment, it could not be excluded. *See id.* (“To the extent that a proposal and supporting statement focus on the company minimizing or eliminating operations that may adversely affect the environment or the public’s health, we do not concur with the company’s view that there is a basis for it to exclude the proposal under rule 14a-8(i)(7).”).

<sup>84</sup> SEC Staff Legal Bulletin No. 14E (CF) (Oct. 27, 2009), available at <http://www.sec.gov/interp/legals/cfslb14e.htm>.

<sup>85</sup> *Id.* (“We have recently witnessed a marked increase in the number of no-action requests in which companies seek to exclude proposals as relating to an evaluation of risk. In these requests, companies have frequently argued that proposals that do not explicitly request an evaluation of risk are nonetheless excludable under Rule 14a-8(i)(7) because they would require the company to engage in risk assessment.”).

<sup>86</sup> *See infra* note 132. At the end of 2008, the Commission consisted of three Republicans (commissioners Paredes and Casey and Chairman Cox) and two Democrats (commissioners Walter and Aguilar). Commissioner Cox resigned and was replaced by Chairman Schapiro, an independent but one appointed by the Democratic President. *See* <http://www.sec.gov/about/sechistoricalsummary.htm>

<sup>87</sup> SEC Staff Legal Bulletin No. 14E (CF), *supra* note 84.

<sup>88</sup> *Id.* (“[W]e have become increasingly cognizant that the adequacy of risk management and oversight can have major consequences for a company and its shareholders.”).

<sup>89</sup> *Id.*

<sup>90</sup> *Id.* (“In determining whether the subject matter raises significant policy issues and has a sufficient nexus to the company, as described above, we will apply the same standards that we apply to other types of proposals under Rule 14a-8(i)(7).”).

<sup>91</sup> Comcast Corp., SEC No-Action Letter, 2006 WL 851299, at \*5 (Mar. 27, 2006).

<sup>92</sup> *See supra* note 86.

identical proposal.<sup>93</sup> In 2009, the staff effectively reinstated the social policy analysis for proposals addressing the use of antibiotics in animal food.<sup>94</sup>

### III. SHAREHOLDER APPROVAL OF THE OUTSIDE AUDITOR

Since the 1930s, shareholders have routinely been given the right to ratify a company's auditors. Likewise, the SEC has a long history of encouraging the practice, including successful efforts to lobby Congress to include the authority in the Investment Company Act of 1940.<sup>95</sup> The position was reflected in the staff's interpretation of Rule 14a-8. Proposals calling for shareholder approval of auditors were regularly submitted and routinely included in proxy statements.<sup>96</sup> Indeed, some of the earliest litigation involving the rule arose when the SEC sought to enjoin a company from omitting a proposal calling for shareholder ratification from its proxy materials.<sup>97</sup>

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<sup>93</sup> Navistar Int'l Corp., SEC No-Action Letter, 2010 WL 4254849, at \*10 (Jan. 4, 2011) (the staff initially agreed that the proposal could be omitted because it "has been substantially implemented by the Company's decision to include its existing severance agreements among the disclosures that will be subject to the Company's say-on-pay vote pursuant to Section 14A(a) of the Securities Exchange Act of 1934."). Following an appeal, however, the staff quickly reconsidered and agreed that the proposal could not be excluded. *Id.*, at \*1-2. ("Upon reconsideration, we are unable to concur in Navistar's view that it may exclude the proposal under rule 14a-8(i)(10). The proposal urges the board to adopt a policy of obtaining shareholder approval for future severance agreements in which the company contemplates paying out more than two times the sum of an executive's base salary plus bonus. The proposal does not request a shareholder vote on severance agreements already entered into and disclosed pursuant to Item 402 of Regulation S-K. We note that Navistar does not appear to have a policy of having to obtain shareholder approval for future severance agreements. Accordingly, we do not believe that Navistar may omit the proposal from its proxy materials in reliance on rule 14a-8(i)(10).").

<sup>94</sup> Tyson Foods, Inc., SEC No-Action Letter, 2009 WL 5149212, at \*1 (Dec. 15, 2009) ("After reviewing the information contained in your letter, the Division grants the reconsideration request. Upon reconsideration, we are unable to concur in Tyson's view that it may exclude the proposals under Rule 14a-8(i)(7). That provision allows the omission of a proposal that 'deals with a matter relating to the company's ordinary business operations.' While two prior no-action responses from 2002 and 2003 permitted companies to rely on that rule to exclude comparable proposals relating to the use of antibiotics in livestock production, we believe that those positions should now be reversed."). Although noting the existence of two prior letters allowing for exclusion of the proposal, the staff in Tyson Foods, Inc. noted that antimicrobial resistance through the use of antibiotics in livestock had generated "widespread public debate." The staff justified the decision based upon developments that had occurred after the earlier letters. *Id.* at \*5 ("In arriving at this position, we note that since 2006, the European Union has banned the use of most antibiotics as feed additives and that legislation to prohibit the non-therapeutic use of antibiotics in animals absent certain safety findings relating to antimicrobial resistance has recently been introduced in Congress.").

<sup>95</sup> 15 U.S.C. § 80a-31(a) (2011).

<sup>96</sup> See *infra* notes 109, 121; see also 15 U.S.C. § 80a-32(a) (2011). The requirement only applied where funds held an annual meeting. See also Protecting Investors: A Half Century of Investment Company Regulation, 1992 SEC LEXIS 3489, at \*604 (May 1992) ("Shareholders also are required to ratify the selection of public accountants previously made by the independent directors, but only if an annual meeting of shareholders is held. If no annual meeting is held, the selection of auditors is left to the discretion of the independent directors.") (footnote omitted).

<sup>97</sup> *Infra* notes 112-114.

In 2005, however, the staff quietly issued a series of No-Action letters allowing companies to exclude auditor ratification proposals under the “ordinary business” exclusion. The letters contained no explanation for the sudden departure from the half century-old position nor did they make any attempt to reconcile the view with the public importance of the issue. The interpretation also conflicted with actual practice; most large public companies extended ratification rights to their shareholders.<sup>98</sup>

A. *The SEC and Shareholder Approval of Auditors*

Companies routinely ask shareholders to ratify the choice of outside auditors,<sup>99</sup> a practice that apparently began in the 1930s.<sup>100</sup> Unlike the laws in other common law countries,<sup>101</sup> however, states do not mandate the prac-

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<sup>98</sup> See the discussion in Section III.A. .

<sup>99</sup> See Douglas W. Hawes, *Stockholder Appointment of Independent Auditors: A Proposal*, 74 COLUM. L. REV. 1 (1974) (noting that the practice has apparently grown in popularity.). In 1973, fewer than half of all public companies and only 57 of the top 100 companies gave shareholders the right to vote on auditors. The numbers have since increased. See *infra* note 153.

<sup>100</sup> See Klaus Eppler & R. Bruce Steinert, Jr., *Drafting the Proxy Statement, in Preparation of Annual Disclosure Documents 2002*, B0-018D PLI CORP. LAW & PRACTICE COURSE HANDBOOK SERIES 737, 767, (2002) (“Since the 1930s it has been customary to have shareholders vote to approve the selection of the auditors although in most cases there is no legal requirement for such approval.”).

<sup>101</sup> See, e.g., INDUSTRY CANADA, GENERAL OVERVIEW OF *THE CANADA CORPORATIONS ACT* PART II, available at [http://www.ic.gc.ca/eic/site/cd-dgc.nsf/vwapj/13-1E\\_23-04-07.pdf/\\$file/13-1E\\_23-04-07.pdf](http://www.ic.gc.ca/eic/site/cd-dgc.nsf/vwapj/13-1E_23-04-07.pdf/$file/13-1E_23-04-07.pdf). (“Each corporation is required to prepare annual financial statements for examination by the auditor. These statements will be presented to the members at the annual meeting along with the report of the auditor.”). Canada has had the requirement in place since 1927. See Hawes, *supra* note 99, at 4. The requirement also exists in the United Kingdom, see Companies Act (c. 46), 2006 § 489, and has been in place since 1844. Hawes, *supra* note 99, at 4.

tice,<sup>102</sup> despite occasional calls that they do so.<sup>103</sup> The one state that required shareholder ratification repealed the provision in the 1970s.<sup>104</sup>

Following the adoption of the Exchange Act, the SEC emphasized the importance of shareholder ratification. In *McKesson & Robbins, Inc.*, the SEC issued a Section 21(a) Report addressing the fraud committed by McKesson & Robbins.<sup>105</sup> The Company had reported fictitious sales and assets.<sup>106</sup> The SEC viewed the audit as deficient and blamed the results at least in part on the selection process for the outside auditor. With the process dominated by management, the SEC recommended the “[e]lection of auditors for the current year by vote of the stockholders at the annual meeting.”<sup>107</sup>

The Report stopped short of an imposition. Nonetheless, the view did find its way into the law. At the same time the SEC was investigating McKesson & Robbins, Congress had under consideration the Investment Company Act of 1940. The investigation made a cameo appearance in the legislative history and the SEC insisted that the Act include mandatory shareholder approval of auditors.<sup>108</sup>

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<sup>102</sup> William K. Sojstrom, *The Case Against Mandatory Annual Director Elections and Shareholder Meetings*, 74 TENN. L. REV. 199, 231 (2007) (“Auditor ratification by shareholders is not required by state or federal law or exchange listing standards.”). States are uniform in the matters that must be submitted to shareholders for approval. They include amendments to the articles, dissolution, and sale of all or substantially all of the assets, or merger. In addition, shareholders elect directors. For public companies, shareholders also have the right to an advisory vote on executive compensation. For stock exchange companies, certain benefit plans and stock sales must also be approved. See Model Bus. Corp. Act § 7.28 (directors); Model Bus. Corp. Act § 10.03 (amendments to the articles); Model Bus. Corp. Act § 11.04(b) (mergers); Model Bus. Corp. Act § 12.02 (sale of assets); Model Bus. Corp. Act § 14.02 (dissolution).

<sup>103</sup> Standing Audit Committees Composed of Outside Directors, Exchange Act Release No. 9548, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,670, at 81,424 (Mar. 23, 1972) (“As far back as 1917 it was urged that auditors in the United States should be appointed or selected by the stockholders in accordance with the practice in Great Britain and in Canada, and that State laws or company by-laws ‘should contain a provision for an independent report on the affairs of the company by an auditor appointed by the stockholders.’”) (citing JOHN T. MADDEN, ACCOUNTING PRACTICE AND AUDITING: MODERN BUSINESS TEXTS, 248-49 (1917)).

<sup>104</sup> Hawes, *supra* note 99, at 12 (1974) (citing MASS. ANN. LAWS 156B § 111 (1970), a shareholder approval requirement that had been in place since 1897. The provision, however, was repealed in 1977.).

<sup>105</sup> See *McKesson & Robbins, Inc.*, Exchange Act Release No. 2707, 1940 WL 977 (Dec. 5, 1940).

<sup>106</sup> See *id.* at 2.

<sup>107</sup> *Id.* at 3. In addition, the SEC recommended that the “auditors . . . be required to attend meetings of the stockholders at which their report is presented to answer questions thereon, to state whether or not they have been given all the information and access to all the books and records which they have required, and to have the right to make any statement or explanation they desire with respect to the accounts.”

<sup>108</sup> See *Investment Trusts and Investment Companies: Hearing on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency, Part 2*, 76th Cong. 306, 690-91 (1940) (from the third session of congress); see also Hawes, *supra* note 99, at 14 (investigation “most likely led to the inclusion [in the 1940 Act] of Section 32(a)”).

Section 32 of the Investment Company Act ultimately required that the outside accountant be submitted for “ratification or rejection” at the annual meeting,<sup>109</sup> although disinterested directors could fill vacancies that occurred between meetings.<sup>110</sup> The benefit was described as “psychological,” but one that would “bring home to the independent public accountant that . . . under the existing statutes and existing practice [the] independent public accountant is really acting for the security holders rather than for the management.”<sup>111</sup>

Likewise, the SEC took a dim view toward attempts to exclude proposals calling for auditor approval by shareholders and, in at least one case, sought to enjoin a company from doing so.<sup>112</sup> In *SEC v. Transamerica Corp.*, Transamerica opted, over the objection of the SEC, to exclude a number of shareholder proposals, including one calling for shareholder ratification of the firm’s auditor.<sup>113</sup> The proxy statement did reveal that a stockholder would “present for action” a proposal at the meeting “to require that independent public auditors should be elected by the stockholders,” but did not otherwise include the text of the proposal or provide space to vote on the proxy card.

The SEC brought an injunctive proceeding challenging Transamerica’s actions.<sup>114</sup> In determining whether the proposal amounted to a “proper sub-

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<sup>109</sup> Role of Indep. Directors of Inv. Companies, Exchange Act Release No. 42007, 70 SEC Docket 1867, 1883 (Oct. 14, 1999) (“The Investment Company Act requires that a fund’s independent directors select the fund’s independent public accountant. The Act further requires that the selection of the fund’s independent public accountant be submitted to shareholders for ratification or rejection at their next annual meeting.”).

<sup>110</sup> See *id.* (noting that shareholders rarely contest votes over the ratification of the selection of a fund’s independent accountant causing many people to believe that shareholder ratification has become perfunctory),

<sup>111</sup> *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency, Part 1*, 76th Cong. 305 (1940) (statement of Robert E. Healey, Commissioner, Securities and Exchange Commission). Amendments adopted in 1970 at the request of the Commission further strengthened the approval requirement for auditors. See Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413, 1427?28 (1970) ; Overseas Securities Co., Inc., 1981 WL 26291 at \*000060 (Mar. 12, 1981) (“The requirement that the vote be cast in person was adopted in 1970, at the recommendation of the Commission which had deplored the practice allowed by some states of absentee approval by board members of some investment companies.”). The Act required that directors approving the auditor do so in person. See, e.g., Approval of Inv. Advisory Contracts and Other Matters, Investment Company Act Release No. 6336, 1971 WL 126146 (Feb. 2, 1971) (noting that the requirement “cannot be complied with by voting over the telephone, through the use of a closed-circuit television conference, by proxy or otherwise than by personal appearance.”).

<sup>112</sup> See *SEC v. Transamerica Corp.*, 163 F.2d 511, 513 (3d Cir. 1947). In the early days of Rule 14a-8, proposals asking for shareholder approval of auditors were common. See Robert H. O’Brien, Comm’r, Sec. & Exch. Comm’n, Stockholders and Corporate Management, Address before the Conference Board (Jan. 21, 1943), available at <http://www.sec.gov/news/speech/1943/012143obrien.pdf> (“For stockholders, once given a right to make their own proposals for action at annual meetings, chose as one of the early subjects of their concern the relationship of accountants to management and stockholders.”).

<sup>113</sup> *Id.* at 513.

<sup>114</sup> *Id.*

ject for action” by shareholders,<sup>115</sup> the Court described the right of shareholders to ratify the independent auditor as “proper and common” and could find no basis for excluding the proposal. The Court stated that:

No cogent reason has been advanced why the proposal to have independent public auditors of the books of the corporation elected by stockholders (beginning with the annual meeting of 1947, and a representative of the auditing firm so chosen attend the annual meeting each year) is not a proper subject matter to come before the annual meeting . . . . With respect to the annual meeting of defendant Transamerica, management by the exercise of procedural limitations had no right to omit this particular Gilbert proposal from the notice of the annual meeting to be sent to all stockholders.<sup>116</sup>

Characterizing the auditors as holding a position of trust, the Court mused that “it would be an odd legal relationship whereby trustee has conclusive discretion over the method and person who shall review the trustee’s accounts.”<sup>117</sup>

The Third Circuit affirmed in a somewhat exasperated tone.<sup>118</sup> “Surely the audit of a corporation’s books may not be considered to be peculiarly within the discretion of the directors. A corporation is run for the benefit of its stockholders and not for that of its managers.”<sup>119</sup> Appointment of an auditor by shareholders was “beyond any question” a “proper subject for action by the stockholders.”<sup>120</sup>

Although not addressing the “ordinary business” exclusion in Rule 14a-8 (it had not yet been adopted), the reasoning of both courts effectively precluded its application. The analysis reflected the view that ratification of auditors was not an “ordinary” matter within the purview of the board but, given the gatekeeper role of accounting firms, was an appropriate subject for shareholders.

In the aftermath of the decision, shareholder proposals seeking approval of auditors were common and routinely included in the proxy materials,<sup>121</sup>

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<sup>115</sup> SEC v. Transamerica Corp., 67 F. Supp. 326, 329 (D. Del. 1946).

<sup>116</sup> *Id.* at 333. *See also id.* at 333-34 (“Furthermore, there is no provision in the Delaware Corporation Law from which the conclusion is inescapable that such a right must be exclusively exercised by the directors on the theory that the stockholders have delegated every conceivable piece of business, with respect to the affairs of the corporation, to the directors. Here, the stockholders, as beneficial owners of the enterprise, may prefer to consider the selection of independent auditors to review what is no more than the trust relationship which exists between the directors and stockholders.”).

<sup>117</sup> *Id.* at 334.

<sup>118</sup> *See* SEC v. Transamerica Corp., 163 F.2d 511, 516 (3d Cir. 1947) (“The court below took the view, in our opinion, fully supportable, that the stockholders as the beneficial owners of the enterprise may prefer to consider the selection of independent auditors to review ‘what is no more than the trust relationship which exists between the directors and stockholders.’”).

<sup>119</sup> *Id.* at 517.

<sup>120</sup> *Id.*

<sup>121</sup> *See, e.g.*, Firestone Tire & Rubber Co., 1979 SEC No-Act. LEXIS 3848, at \*6 (Dec. 12, 1979) (“The First Letter contains two proposals: (i) a request that the selection of Firestone’s independent public accountants be submitted for stockholder ratification and (ii) a request that the names and addresses of all stockholders who sponsor resolutions be printed in

with some receiving majority support.<sup>122</sup> In 1960, the Chairman of the SEC described them as “popular proposals.”<sup>123</sup> Likewise, the SEC occasionally reiterated the inapplicability of exclusions in Rule 14a-8 to auditor ratification proposals.<sup>124</sup>

Proposals calling for ratification of auditors were occasionally excluded but only on grounds that were narrow or procedural.<sup>125</sup> The only common basis was mootness,<sup>126</sup> and then only when the board effectively agreed to

management’s proxy statement along with the resolutions they present. Firestone currently intends to include these two proposals in management’s proxy statement.”); *see also* Northrop Corporation, 1974 SEC No-Act. LEXIS 341, at \*16 (Sept. 23, 1974) (while challenging one shareholder proposal, the company noted that it would include proposal calling for ratification of auditors by shareholders); Table 2, <http://archive.nyu.edu/bitstream/2451/27000/2/wpa98046.pdf> (noting inclusion in proxy statement of proposal calling for shareholder approval of auditors); Report from the Securities and Exchange Commission on Its Problems in Enforcing the Securities Laws, Hearing Before a Subcommittee of the Committee on Banking and Currency, US Senate, 85th Cong., 1st Sess., at 78-84 (March 5, 1957) (list of shareholder proposals included in proxy statements for calendar year 1955 included five calling for shareholder ratification of auditor, see proposals submitted to Thermoid Co., Webb & Knapp, Inc., Burlington Mills Corp., Paramount Pictures Corp., United Board and Carton Corp.; in fiscal year 1956, four proposals were included, see proposals submitted to RKO Theaters Corp., Thermoid Co., United Board and Carton Corp., Webb & Knapp, Inc.).

<sup>122</sup> Frank D. Emerson & Franklin C. Latcham, *The SEC Proxy Proposal Rule: The SEC Proxy Proposal Rule: The Corporate Gadget*, 19 U. CHI. L. REV. 807, 814 n.32 (1951-52). Of the nine proposals submitted to shareholders in the immediate aftermath of the *Transamerica* decision, two received more than 50% of the vote. Neither was opposed by management and both received over 90% support from shareholders. *Id.* at 815. Of the 286 proposals submitted during the period, only seven received majority support. *Id.* at 828. Of the total, 137 were submitted by two individuals, Lewis D. and John J. Gilbert. *Id.* at 830.

<sup>123</sup> Edward N. Gadsby, Address before the American Society of Corporate Secretaries (June 7, 1960), <http://www.sec.gov/news/speech/1960/060760gadsby.pdf> at 1 (“Other popular proposals related to changing or rotating the place of the annual meeting, furnishing post-meeting reports, approval of independent accountants by stockholders, restrictions on bonus plans and reduction of management compensation.”).

<sup>124</sup> *See, e.g.*, Solicitations of Proxies, Exchange Act Release No. 9784, 1972 WL 125400, at \*2 (Sept. 22, 1972) (amendments designed to allow for omission of proposals “not significantly related to the business of the issuer or not within its control” were not intended to “serve as a basis for the omission of traditional shareholder proposals dealing with stockholder relationships with the management, such as cumulative voting, annual meetings and *ratification of auditors*, since all these matters can be considered significantly related to the issuer’s business or within its control[.]”) (emphasis added).

<sup>125</sup> *See, e.g.*, The Washington Post Company, 1973 SEC No-Act. LEXIS 1447, at \*3 (Feb. 22, 1973) (proposal excluded because proposing shareholders lacked the authority to vote on the matter; if proposal made at meeting, shareholder would be “ruled out of order”). A single letter did allow for the exclusion of a proposal calling for shareholder ratification but only on a temporary basis. Excalibur Technologies Corporation, 1998 SEC No-Act. LEXIS 570, at \*7 (May 4, 1998) (allowing exclusion of shareholder approval proposal where company asserted that during seven month period it would “not necessarily . . . be in a position to definitively select the accounting firm to perform the audit in the following January.”). *See, e.g.*, Safeguard Scientific, Inc., SEC No-Action Letter, 1990 WL 286394, at \*1 (Mar. 2, 1990) (shareholder allegedly did not meet the ownership requirements for submitting a proposal).

<sup>126</sup> *See, e.g.*, Corning Natural Gas. Corp., SEC No-Action Letter, 1983 WL30779 at \*1 (Feb. 16, 1983) (allowing for exclusion on the grounds of mootness of a provision calling for auditors to be present at annual meeting where “the Company’s independent auditors have agreed to attend the annual meeting, and that the Company will include a statement to that effect in its proxy materials.”).

implement the practice.<sup>127</sup> Indeed, shareholder ratification emerged as a basis for excluding other proposals, particularly those seeking to impose qualitative standards on the selection of the auditor.<sup>128</sup>

The consistency of the approach could be contrasted with other proposals that sought to constrain the selection of auditors by the board. Proposals seeking to require guidelines,<sup>129</sup> impose mandatory rotation,<sup>130</sup> or increase the

<sup>127</sup> See, e.g., *The Arundel Corp.*, SEC No-Action Letter, 1987 WL 10770, at \*1 (Mar. 10, 1987) (staff reversed position and “apologize[d] for creating any ambiguity” and stated that the board would reconfirm “policy of submitting at all future annual stockholder meetings its selection of independent auditors to the stockholders for ratification.”); see also *Stevens & Lee Corp.*, SEC No-Action Letter, 1987 WL 107700, at \*1 (Feb. 17, 1989) (proposal rendered moot by decision of the board to allow shareholders to vote on appointment of auditor at upcoming meeting); *MERCANTILE BANKSHARES Corp.*, SEC No-Action Letter, 1979 SEC No-Act. LEXIS 2193, at \*1-2 (Feb. 1, 1979) (allowing for exclusion on the grounds of mootness a proposal that requested the “Board of Directors to take the steps necessary for annual ratification by vote of the Audit Committee selection of independent accountants” but only when the board “adopts the recommendations of management” concerning shareholder ratification of auditors); *Northrop Corp.*, SEC No-Action Letter, 1975 SEC No-Act. LEXIS 889, at \*2 (Apr. 25, 1975) (allowing for exclusion on the grounds of mootness a proposal that requested the board “to take such steps as may be necessary to provide that, in the future, the selection of independent public accountants to audit the books of the Corporation shall be submitted by management for ratification by the stockholders each year at the annual meeting.”). The approach continued through the 1990s. See, e.g., *Albertson’s, Inc.*, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 388, at \*2-3 (Mar. 3, 1997) (applying mootness analysis but concluding that proposal calling for adoption of policy to allow shareholder approval of auditor not subject to exclusion as moot).

<sup>128</sup> See, e.g., *Wilson Bros.*, SEC No-Action Letter 1973 SEC No-Act. LEXIS 2239, at \*12 (Apr. 17, 1973) (permitting exclusion of proposal that auditor be “truly independent” of certain individuals and companies on grounds that it functions as a “counter proposal” to management’s proposal that shareholders ratify the selection of auditors); see also *B.F. Saul Read Estate Inv. Trust*, SEC No-Action Letter 1981 SEC No-Act. LEXIS 4349, at \*1-3 (Nov. 24, 1981) (permitting exclusion of similar proposal on same grounds).

<sup>129</sup> See, e.g., *Pennsylvania Power & Light Co.*, SEC No-Action Letter 1985 SEC No-Act. LEXIS 2913, at \*4-5 (Dec. 30, 1985) (allowing exclusion of proposal requiring mandatory rotation of accounting firm every six years, that Audit Committee consider at least three qualified accounting firms “utilizing a system of competitive bidding,” and that the board give primary consideration to the competitive bid submissions); see also *S. California Edison Co.* 1985 SEC No-Act. LEXIS 2887, \*2 (Dec. 19, 1985) (approving exclusion of nearly identical proposal) *Transamerica Co.*, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 310, at \*1 (Mar. 8, 1996) (concluding that proposal calling for mandatory rotation of auditing firm every four years may be omitted); *Texaco, Inc.*, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 931, at \*2 (Aug. 23, 1993) (permitting exclusion of proposal that auditors be rotated every five years); *Monsanto Co.*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 41, at \*2 (Jan. 17, 1989) (allowing exclusion of proposal requiring that company’s independent auditors be rotated at least every five years); *Mobil Corp.*, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1590, at \*2 (Jan. 3, 1986) (concurring in company’s decision to omit a proposal requiring the rotation of independent auditors at least every five years).

<sup>130</sup> *Cnty., Bancshares, Inc.*, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 426, at \*42 (Mar. 15, 1999) (permitting exclusion of proposal requesting that the company’s bylaws be amended to require that its independent auditors be a regional or national certified accounting firm and be selected by an independent audit committee); see also *Public Service of New Hampshire*, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1689, at \*1-2 (Jan. 22, 1986) (concluding that company could properly exclude a proposal providing for the institution of guidelines for the selection of auditors by the company); *Consumers Power Co.*, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 1599, at \*4-5 (Jan. 3, 1986) (sanctioning exclusion of proposal that the “Board of Directors revise as follows the By-laws, etc., relative to share-

amount of disclosure available to shareholders about the auditor were routinely excluded.<sup>131</sup>

### B. A Shift in Time

The administration changed in 2001 and so did the make-up of the Commission. Chairman Levitt, who served in that position during the entire Clinton administration, resigned and made room for a new Republican chairman, Harvey Pitt. By 2002, President Bush had appointed all five persons serving on the Commission.<sup>132</sup>

This Commission confronted growing concern among shareholders about auditor independence. In the aftermath of the collapse of Enron, Congress included in Sarbanes-Oxley a provision designed to reduce managerial control over auditors in exchange traded companies by transferring to the audit committee of the board the authority to hire and fire accounting firms.<sup>133</sup> As the SEC noted in implementing the requirement:

The auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review.<sup>134</sup>

Shareholders sought to augment this authority by encouraging companies to submit auditors for ratification. In 2004, shareholders submitted proposals to a series of companies requesting adoption of a policy providing for shareholder ratification of the company's independent auditors.<sup>135</sup> The proposals seemed uncontroversial. Most companies already allowed for share-

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holder ratification, selection process, and the maximum retention period of the independent accounting firm which is to perform the annual external audit of the Company").

<sup>131</sup> LTV Corp., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1078, at \*1 (Dec. 22, 1997) (permitting exclusion of proposal requesting that the board disclose certain financial information regarding the company's auditors in the proxy, statement); Occidental Petroleum Corp., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1120, at \*6 (Dec. 11, 1997) (agreeing that a company's management may exclude a proposal requesting that the board provide information regarding the financial capacity of the company's independent auditors to pay claims for malpractice, negligence and fraud).

<sup>132</sup> See SEC, *SEC Historical Summary of Chairmen and Commissioners*, U.S. SECURITIES AND EXCHANGE COMMISSION (Aug. 5, 2011), <http://www.sec.gov/about/sechistoricalsummary.htm> (last visited Oct. 30, 2011). Arthur Levitt left the SEC in February 2001. President Bush filled the vacancy with the new chairman, Harvey Pitt. See *id.* President Bush did not appoint another member to the Commission until 2002. See *id.* By August 2002, he had appointed all five of the Commissioners. See *id.* Chairman Cox, the last chairman appointed by President Bush, departed from the Commission on Jan. 20, 2009. See *id.* President Obama used the vacancy to appoint Mary Schapiro as chair. See *id.*

<sup>133</sup> The requirement applied only to listed companies. See Rule 10A-3(b)(2), 17 C.F.R. § 240.10A-3(b)(2).

<sup>134</sup> Exchange Act Release No. 47654 (April 9, 2003).

<sup>135</sup> See *infra* note 138.

holder ratification.<sup>136</sup> Moreover, they were precatory and merely “requested” the authority. Finally, the SEC had historically encouraged shareholder ratification.

Nonetheless, a number of companies petitioned the SEC for the right to omit the proposals, relying in part on Sarbanes-Oxley. Car company PACCAR, for example, argued that shareholder ratification interfered with the role of the audit committee and that selection of an auditor should more appropriately be left to the expertise of directors.<sup>137</sup> Despite the longstanding and consistent position of the SEC,<sup>138</sup> the staff unexpectedly concluded, without analysis or explanation, that the proposal could be omitted under the “ordinary business” exclusion.<sup>139</sup> The public importance of the debate over auditor independence received no mention. In quick order, the position was repeated in other No-Action letters.<sup>140</sup> By 2005, companies routinely received relief authorizing the exclusion of these sorts of proposals.<sup>141</sup>

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<sup>136</sup> See *infra* note 153 at 23.

<sup>137</sup> PACCAR, SEC No-Action Letter, 2004 SEC No-Act. LEXIS 73, \*7 (Jan. 14, 2004) (“Given the need to evaluate the many factors used to choose an independent auditor, as illustrated by the recently adopted amendments to the Nasdaq National Market Rules, and the time and resources required to acquaint new auditors with PACCAR and its procedures, it is reasonable and appropriate that the selection of PACCAR’s independent auditors fall within the purview of the Board and the Audit Committee as part of PACCAR’s ordinary business operations and not be subject to approval or ratification by the shareholders.”).

<sup>138</sup> PACCAR did argue that precedent existed for the decision to exclude the ratification proposal. *Id.* at \*5 (“PACCAR respectfully submits that the Proposal has substantially the same effect as the shareholder proposal submitted in *Excalibur Technologies*.”). The Excalibur letter, however, involved unusual facts. The company noted that there was a seven month period between the annual meeting and the close of the fiscal year. It argued to the SEC staff that the company needed the “flexibility” to determine the accounting firm closer to the close of the fiscal year and the time when the audit would be conducted; see also Excalibur Tech. Corp., SEC No-Action Letter, 1998 WL 234151, at \*1 (May 4, 1998). The letter did not reflect the staff view that ratification proposals could always be excluded under the “ordinary business” exclusion.

<sup>139</sup> PACCAR, *supra* note 137, at \*1.

<sup>140</sup> See Wendy’s Int’l, Inc., SEC No-Action Letter, 2004 WL 224543, at \*1 (Jan. 25, 2004); see also Cousins Properties Inc., SEC No-Action Letter, 2004 WL 334466, at \*1 (Feb. 17, 2004); Xcel Energy Inc., SEC No-Action Letter, 2004 WL 224479, at \*1 (Jan. 28, 2004) (Central Laborers’ Pension Fund); Apache Corp., SEC No-Action Letter, 2004 WL 224450, at \*1 (Jan. 25, 2004) (Central Laborers’ Pension, Welfare, and Annuity Funds); Dover Corp., SEC No-Action Letter, 2004 WL 224450, 15 \*1 (Jan. 27, 2004).

<sup>141</sup> See Charles Schwab Corp., SEC No-Action Letter, 2005 WL 484410, at \*2 (Feb. 23, 2005) (permitting exclusion of proposal calling on the board to “adopt a policy that the selection of the Company’s independent AUDITOR be submitted to the Company’s SHAREHOLDERS for their RATIFICATION at the Company’s annual meeting.”); see also Qwest Commc’ns Int’l Inc., SEC No-Action Letter, 2005 WL 484382 at \*1 (Feb. 23, 2005) (permitting exclusion of a similar proposal); Xcel Energy Inc., SEC No-Action Letter, WL 484394, at \*1 (Feb. 23, 2005) (permitting exclusion of a similar proposal); Toys “R” Us, Inc., SEC No-Action Letter, 2005 WL 448213, at \*1 (Feb. 22, 2005) (permitting exclusion of a similar proposal); Cousins Properties Inc., SEC No-Action Letter, 2004 WL 334466, at \*1 (Feb. 17, 2004) (permitting exclusion of a similar proposal); Xcel Energy Inc. (Jan. 28, 2004) (permitting exclusion of a similar proposal); Dover Corp., SEC No-Action Letter, 224479, at \*1 (Jan. 27, 2004) (permitting exclusion of a similar proposal); Apache Corporation (Jan. 25, 2004) (permitting exclusion of a similar proposal); Wendy’s Int’l, Inc., SEC No-Action Letter, WL 224543 at \*1 (Jan. 25, 2004) (permitting exclusion of a similar proposal). The staff also allowed for the exclusion

A year later, shareholders tried to bring the matter to the Commission. The New York City Pension Fund submitted a proposal to Rite Aid Corporation asking that the auditor be submitted to shareholders for ratification.<sup>142</sup> Rite Aid arguably represented an appealing candidate. The company had suffered through serious financial scandals<sup>143</sup> and its auditor settled shareholder lawsuits for a substantial sum.<sup>144</sup> Consistent with the position taken two years earlier, the staff summarily affirmed the company's right to exclude the proposal.<sup>145</sup>

The Fund appealed, tactfully noting that the earlier letters had allowed for the exclusion of auditor ratification proposals "without the benefit of any proponent opposition."<sup>146</sup> The Fund also stressed the public importance of shareholder approval and pointed to the adoption of Sarbanes-Oxley as evidence.<sup>147</sup> Rite Aid, however, read the statute differently and argued that Congress had intended to give selection authority not to shareholders but to the independent directors on the audit committee. Again without explanation, the staff denied the appeal and reaffirmed that auditor selection fell within the "ordinary business" exclusion.<sup>148</sup> The action suggested acquiescence by the Commission in the staff's revised interpretation.<sup>149</sup>

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of a proposal that called for shareholder ratification of the transfer agent. *See* General Electric Co., SEC No-Action Letter, 2004 WL 3076274, at \*5 (Jan. 5, 2005) ("Resolved: The shareholders of General Electric (the 'Company') request the Board of Directors and its Executive Committee, adopt a policy whereby the selection of the Company's Stock Transfer Agent / Registrar (the 'Registrar') is submitted to the Company's shareholders for their ratification at the Company's annual meeting.").

<sup>142</sup> *See* Rite Aid Corp., SEC No-Action Letter, 2006 WL 871029, at \*1 (Mar. 31, 2006). The proposal requested that the board "initiate the appropriate process to amend the Company's governance documents (certificate of incorporation or bylaws) to require that the Board present the appointment of the independent AUDITORS for SHAREHOLDER RATIFICATION or rejection at the annual meeting; and that RATIFICATION would require a majority vote of votes actually cast 'for' or 'against', excluding abstentions and broker-non votes."

<sup>143</sup> *See, Ex-Rite Aid Chief to Serve Up to 10 Years in Prison*, N. Y. TIMES, May 14, 2004, <http://www.nytimes.com/2004/05/14/business/ex-rite-aid-chief-to-serve-up-to-10-years-in-prison.html>.

<sup>144</sup> *See KPMG to Pay \$200M in Audit-Related Suits*, ASSOCIATED PRESS (Mar. 12, 2003).

<sup>145</sup> *See* Rite Aid Corp., *supra* note 142 at \*1 ("There appears to be some basis for your view that Rite Aid may exclude the proposal under rule 14a-8(i)(7), as relating to its ordinary business operations (i.e., the method of selecting independent auditors). Accordingly, we will not recommend enforcement action to the Commission if Rite Aid omits the proposal from its proxy materials in reliance on rule 14a-8(i)(7).").

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *See* Rite Aid Corp., SEC No-Action Letter, 2006 WL 1084052, at \*1 (Apr. 21, 2006) ("Under Part 202.1(d) of Section 17 of the Code of Federal Regulations, the Division may present a request for Commission review of a Division no-action response relating to rule 14a-8 if it concludes that the request involves 'matters of substantial importance and where the issues are novel or highly complex.' We have applied this standard to your request and determined not to present your request to the Commission. We also have viewed your letter as a request that the Division of Corporation Finance reconsider its position. After reviewing the information contained in your letter, we find no basis to reconsider our position.").

<sup>149</sup> *See supra* note 62-63.

The political nature of the position could be seen from the lack of a compelling legal justification.<sup>150</sup> The interpretation conflicted with the analysis in *Transamerica*. *Transamerica* stood for the proposition that there was nothing “ordinary” about a firm’s selection of an auditor.<sup>151</sup> Unlike other consultants and contractors, the Court had reasoned, auditors play a unique role in protecting the interests of shareholders and investors.<sup>152</sup> Moreover, the “ordinary” practice by larger public companies was to allow for shareholder ratification.<sup>153</sup> Reminiscent of *Cracker Barrel*, *Rite Aid* addressed the social policy issues not by narrowing or refining the analysis but by ignoring it. The letter and appeal denial made no mention of the ongoing debate over auditor independence.<sup>154</sup>

As for the decision by Congress in Sarbanes-Oxley to transfer auditor selection to independent directors on the board, ratification did not interfere with the authority.<sup>155</sup> Shareholder approval neither involved the selection of the auditor in the first instance nor a subsequent veto of the appointment.<sup>156</sup>

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<sup>150</sup> In April 2006, the Commission consisted of three Republicans (Chairman Cox, commissioners Glassman and Atkins) and two Democrats (commissioners Campos and Nazareth). See <http://www.sec.gov/about/sechistoricalsummary.htm>.

<sup>151</sup> See *SEC v. Transamerica Corp.*, *supra* note 112, at 517 (“Surely the audit of a corporation’s books may not be considered to be peculiarly within the discretion of the directors. A corporation is run for the benefit of its stockholders and not for that of its managers.”). Said another way, extraordinary matters do not fall within the exclusion. See *RJR NABISCO Holdings Corp.*, SEC No-Action Letter, 1995 WL 749658, at \*2-3 (Dec. 15, 1995) (“The Division is unable to concur in your view that the proposal may be omitted from the Company’s proxy materials in reliance on rule 14a-8(c)(7), as a matter relating to the conduct of the Company’s ordinary business operations. . . . It appears . . . that the object of the proposal relates to a decision concerning extraordinary corporate transactions rather than to matters involving the operation of the Company’s ordinary business.”).

<sup>152</sup> See Revision of the Comm’n’s Auditor Independence Requirements, Exchange Act Release No. 42994, 72 SEC Docket 1901 (June 30, 2000) (“The federal securities laws, to a significant extent, make independent auditors ‘gatekeepers’ to the public securities markets.”).

<sup>153</sup> In 2010, 88% of the companies in the Russell 3000 and 92% of those in the S&P 500 provided for shareholder ratification. Data Provided by ISS (on file with the Harvard Business Law Review).

<sup>154</sup> A few years after the ruling, a blue ribbon panel would propose that shareholder ratification be made mandatory, at least for exchange traded companies. See Final Report, Advisory Committee on the Auditing Profession, Department of Treasury, (Oct. 6, 2008), <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>. A study of the audit profession by a committee assembled by the Department of the Treasury recommended approval rights for shareholders of listed companies. Similarly, a substantial shareholder petitioned the Commission to mandate shareholder approval of auditors. See CALSTRS PETITION, available at <http://www.sec.gov/rules/petitions/2008/petn4-570.pdf>. The Commission never acted on the petition.

<sup>155</sup> Final Report, *supra* note 154 (“Even though ratification of a company’s auditor is non-binding, the Committee learned that corporate governance experts consider this a best practice serving as a ‘check’ on the audit committee.”).

<sup>156</sup> Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L. J. 269, 292 (2003) (“Although shareholders are often given the nominal power to ratify management’s selection of auditors the voting mechanism typically does not give shareholders the power to veto management’s choice or to select an alternative auditor.”). See also Selected Funds, SEC No-Action Letter, 1983 WL 31018, at \*1 (Feb. 22, 1983) (“Ratification is a common law agency concept which connotes the affirmation by a person of an act performed on his behalf by another. See *e.g.*, Black’s Law Diction-

Ratification did not interfere with the right to change auditors or alter the terms of engagement.<sup>157</sup> The vote, therefore, was advisory and complemented rather than conflicted with the authority of the audit committee included in Sarbanes-Oxley.<sup>158</sup>

More strikingly, *Rite Aid* ignored the Commission's own views on the symbiotic relationship between Sarbanes-Oxley and auditor ratification. In adopting Rule 10A-3, the Commission clarified that audit committee approval did not restrict or interfere with "any requirement or ability under a listed issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify" the independent auditor.<sup>159</sup> The language was not in the original proposal and appeared after commentators sought clarification that the rule did not restrict or interfere with shareholder ratification.<sup>160</sup>

The staff's position cannot, therefore, be justified by the changes adopted in Sarbanes-Oxley with respect to audit committees. Under longstanding SEC views, auditor approval is neither "ordinary business" nor exempt from consideration through the social policy analysis. The position is consistent with a Commission that favored limitations on public debate over the auditor selection process. The better explanation is, therefore, that the change arose out of a change in administrations and the resulting shift in the political makeup of the Commission. This approach suggests that the position will be vulnerable to reversal by a Commission that favors greater public discourse over the auditor selection process.<sup>161</sup>

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ary 5th ed. (1979)."); *Gantler v. Stephens*, 965 A.2d 695, n.54 (Del. 2009) ("The only species of claim that shareholder ratification can validly extinguish is a claim that the directors lacked the authority to take action that was later ratified.").

<sup>157</sup> See *In re Verisign, Inc. Derivative Litig.*, 531 F. Supp. 2d 1173, 1224 (N.D. Cal. 2007) (shareholder approval of auditor did not prevent company from changing terms of engagement after approval occurred).

<sup>158</sup> Under state law, ratification is not a necessary condition for an action to occur. It does, however, further insulate the ratified decision from legal challenge. See *Gantler*, 925 A.2d at 713 ("[T]he 'cleansing' effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether (i.e., obviating all judicial review of the challenged action)").

<sup>159</sup> 17 C.F.R. § 240.10A-3 (2011).

<sup>160</sup> Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 47654, 2003 WL 1833875, at \*16 (Apr. 9, 2003) ("We proposed adding an instruction to the rule to clarify that the requirements regarding auditor responsibility do not conflict with, and are not affected by, any requirement under an issuer's governing law or documents or other home country requirements that requires shareholders to elect, approve or ratify the selection of the issuer's auditor. . . . We also agree with those commenters that noted that the clarification should apply even if shareholders are not required to vote on the responsibilities, but voluntarily elect to do so.").

<sup>161</sup> The position would also likely be vulnerable in the courts. Courts have tended to invalidate staff positions that conflict with the interpretations adopted by the entire Commission. See, e.g., *Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc.*, 821 F. Supp. 877, 890 ("This interpretation contravenes the 1976 Interpretive Release's explicit recognition that all proposals could be seen as involving some aspect of day-to-day business operations."); *Am. Fed'n State, Cnty. & Mun. Emp. v. Am. Int'l. Grp.*, 462 F.3d 121, 129 (2d. Cir. 2006) ("The SEC has not provided, nor to our knowledge has it or the Division ever

## IV. THE SEC AND A REDUCTION IN GOVERNANCE VOLATILITY

Authority over the substantive requirements of corporate governance has been shifting from the states to the SEC.<sup>162</sup> Sarbanes-Oxley, the statute adopted in the aftermath of the Enron scandal, made significant but tentative steps in that direction. Congress preempted a variety of governance practices traditionally left to state law but often did so without augmenting the authority of the SEC.<sup>163</sup>

Dodd-Frank continued the process of preemption. Congress, however, was more comfortable transferring the authority directly from the states to the SEC. The SEC was given regulatory discretion with respect to “say on pay,” ratio disclosure, and “excessive” compensation practices.<sup>164</sup> Rulemaking authority to implement shareholder access was clarified.<sup>165</sup> Moreover, while Congress used listing standards to implement some of the requirements in Dodd-Frank, the SEC obtained greater administrative control over the process.<sup>166</sup>

The SEC’s role in corporate governance has, therefore, grown in importance, a phenomenon that is likely to continue. The agency will increasingly be asked to resolve disputes between managers and owners. The investor protection mandate of the SEC compared with the management friendly approach of Delaware will almost always result in different outcomes.<sup>167</sup> At the same time, the shift in authority provides greater opportunity for increased politicization of the governance process. Decisions will often depend on the

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provided, reasons for its changed position regarding the excludability of proxy access bylaw proposals.”).

<sup>162</sup> See Mark Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003) (asserting that federal government rather than other states was the most likely source of regulation that would overturn corporate law approach taken by Delaware).

<sup>163</sup> Thus, for example, Sarbanes-Oxley regulated loans to corporate executives. Rather than provide the SEC with rulemaking authority, the Act simply prohibited the loans. Similarly, with respect to audit committees, Congress prescribed the requirements and ordered the SEC to implement them through the mechanism of listing standards. These provisions are discussed in J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQ. L. REV. 309 (2006). While these actions preempted state law, they did not significantly increase the SEC’s regulatory authority.

<sup>164</sup> See *supra* note 7. See also J. Robert Brown, Jr., *Dodd-Frank, Compensation Ratios, and the Expanding Role of Shareholders in the Governance Process*, 2 HARV. BUS. L. REV. ONLINE 91 (2011).

<sup>165</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Sec. 971, § 14(a), 124 Stat. 1376, 1915 (2010).

<sup>166</sup> For example Dodd-Frank used listing standards to implement reforms for the compensation committee of the board of directors. See Dodd-Frank Act § 952. The provision required the compensation committee to have independent directors. While Sarbanes-Oxley had imposed a definition of independent directors on the audit committee, *see*, 17 C.F.R. § 240.10A-3, Dodd-Frank gave the SEC the authority to require consideration of factors it deemed “relevant.” In effect, therefore, the SEC had the authority to compel the exchanges to adopt a particular definition of independent director.

<sup>167</sup> See Brown, *supra* note 9 at 2.

political make-up of the Commission,<sup>168</sup> with existing decisions subject to reversal following changes in administration.<sup>169</sup>

Politicization will be less likely for practices adopted pursuant to rulemaking under the APA. The shareholder access rule illustrates the difficulties of altering governance practices through changes to rules. In the new millennium,<sup>170</sup> the SEC first proposed a shareholder access rule in 2003.<sup>171</sup> Four years later, competing proposals were issued, including one that would provide a limited right to access<sup>172</sup> and another that would ensure that access bylaws were subject to exclusion.<sup>173</sup>

The SEC adopted the restrictive proposal but when administrations changed in early 2009,<sup>174</sup> yet another shareholder access rule surfaced.<sup>175</sup> This rule was adopted a year later but never actually implemented.<sup>176</sup> As a result of a legal challenge,<sup>177</sup> the SEC stayed the effective date.<sup>178</sup> Legal arguments occurred in April 2011, nearly two years after the process began,<sup>179</sup> and the D.C. Circuit ultimately struck down the rule a few months later,

<sup>168</sup> See Brown, *supra* note 10 at 2; see also *supra* note 9 at 2.

<sup>169</sup> Political divisions in corporate governance matters have become increasingly apparent at the Commission. The Commission divided along party lines in approving the rules implementing “say on pay” (Commissioner Paredes: <http://www.sec.gov/news/speech/2011/spch012511tap-3.htm>; Commissioner Casey: <http://www.sec.gov/news/speech/2011/spch012511klc-2-3.htm>). Similarly, the two Republican commissioners dissented from a report issued by the staff that essentially called for the imposition of common fiduciary standards on brokers and investment advisors. See <http://www.sec.gov/news/speech/2011/spch012211klctap.htm>. Two Republicans (but not the Republican chair) dissented over SEC rulemaking designed to toughen governance requirements for investment companies. See Investment Company Governance, Investment Company Act Release No. 26520 (July 27, 2004) (dissents by Commissioners Atkins and Glassman). Likewise, the commissioners divided 3-2 on proposals concerning executive compensation practices for brokers and investment advisors. See Exchange Act Release No. 64140 (March 10, 2011).

<sup>170</sup> See Brown, *supra* note 9s, at 1358. There have been prior access proposals, including one in 1942.

<sup>171</sup> In re Sec. Holder Director Nominations, Exchange Act Release No. 48626, 2003 WL 22350515, at \*10 (Oct. 14, 2003) (right to access applicable only if 35% or more of vote withheld from director or shareholders adopted a bylaw that would permit access).

<sup>172</sup> See Shareholder Proposals, Exchange Act Release No. 56160, 2007 WL 2175940, at \*7-8 (July 27, 2007).

<sup>173</sup> See Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56161, 2007 WL 2175941, at \*4-5 (July 27, 2007).

<sup>174</sup> See Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56914, 2007 WL 4442610, at \*1 (Dec. 6, 2007).

<sup>175</sup> See Facilitating Shareholder Director Nominations, Exchange Release No. 33-9046, 2009 WL 1953653, at \*10 (June 10, 2009).

<sup>176</sup> See Facilitating Shareholder Director Nominations, Exchange Act Release No. 62764, 2010 WL 3343532, at \*2 (Aug. 25, 2010).

<sup>177</sup> See In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America, For Stay of Effect of Commission’s Facilitating Shareholder Director Nominations Rules, Exchange Act Release No. 63031, 2010 WL 3862548, at \*1-2 (Oct. 4, 2010).

<sup>178</sup> Facilitating Shareholder Director Nominations, Exchange Act Release No. 63109, 2010 WL 4038576, at \*1 (Oct. 14, 2010).

<sup>179</sup> Order Setting Oral Argument Before Chief Judge Sentelle, Judges Ginsburg and Brown, *Bus. Roundtable v. Sec. & Exch. Comm’n*, No. 10-1305 (D.C. Cir., Jan. 19, 2011), available at <http://law.du.edu/documents/corporate-governance/sec-and-governance/business->

concluding that the cost-benefit analysis conducted by the SEC was erroneous.<sup>180</sup>

Rulemaking with respect to access, therefore, entailed an eight-year process involving two different administrations. Admittedly, shareholder access involved several unusual circumstances. There was a Second Circuit case that invalidated the SEC's interpretation in 2006<sup>181</sup> and Congress further intervened through the adoption of Dodd-Frank Act § 971.<sup>182</sup> Moreover, the divisiveness among Commissioners was unusually apparent, and the process took a number of unexpected turns.<sup>183</sup> Nonetheless, it shows some of the difficulties in using rulemaking to change SEC policies.

By contrast, shifts in staff interpretations are much easier and quicker to implement and, as this Article illustrates, commonly occur with changes in the political make-up of the Commission. It is no revelation to point out that policies vary with administrations. With the rubric of investor protection and

roundtable/Order-Setting-Oral-Argument-Before-Chief-Judge-Sentelle-Judges-Ginsburg-and-Brown-Business-Roundtable-v-SEC-No-10-1305-DC-Cir-Jan-19-2011.pdf.

<sup>180</sup> *Bus. Roundtable v. Sec. & Exch. Comm'n*, 647 F.3d 1144, 1155 (DC Cir. 2011). For a critique of the decision, see J. Robert Brown, Jr., *Shareholder Access and Uneconomic Economic Analysis: Business Roundtable v. SEC*, at <http://www.denverlawreview.org/practitioners-pieces/2011/9/30/shareholder-access-and-uneconomic-economic-analysis-business.html>.

<sup>181</sup> *Am. Fed'n of State, Cnty. & Mun. Employees v. Am. Int'l Grp., Inc.*, 462 F.3d 121 (2d Cir. 2006).

<sup>182</sup> The relevant provision added Section 14(a)(2) to the Exchange Act, clarifying that the Commission had the rulemaking authority to provide for shareholder access. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Sec. 971, § 14(a)(2), 124 Stat. 1367, 1915 (2010).

<sup>183</sup> See Paul S. Atkins, *Statement by SEC Commissioner: Statement before the Open Meeting regarding Shareholder Proposals*, U.S. SECURITIES AND EXCHANGE COMMISSION (Jul. 25, 2007), <http://www.sec.gov/news/speech/2007/spch072507psa.htm>. The proposal made in the summer of 2007 to expand access was opposed by two of the three Republican Commissioners, while the two Democratic Commissioners opposed the proposal that would restrict access. The deciding vote for both proposals was Chairman Cox. The restrictive proposal was adopted by a 3-1 vote, with the three Republican Commissioners favoring the requirement and the lone Democratic Commissioner opposing. The rules proposed in 2009 and adopted in 2010 were opposed by the two Republican Commissioners. See e.g., Kathleen L. Casey, *Speech by SEC Commissioner: Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations*, U.S. SECURITIES AND EXCHANGE COMMISSION (May 20, 2009), <http://www.sec.gov/news/speech/2009/spch052009klc.htm>; Kathleen L. Casey, *Speech by SEC Commissioner: Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations*, U.S. SECURITIES AND EXCHANGE COMMISSION (Aug. 25, 2010), <http://www.sec.gov/news/speech/2010/spch082510klc.htm>; Troy A. Paredes, *Speech by SEC Commissioner: Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations*, U.S. SECURITIES AND EXCHANGE COMMISSION (May 20, 2009), <http://www.sec.gov/news/speech/2009/spch052009tap.htm>; Troy A. Paredes, *Speech by SEC Commissioner: Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations ("Proxy Access")*, U.S. SECURITIES AND EXCHANGE COMMISSION (Aug. 25, 2010), <http://www.sec.gov/news/speech/2010/spch082510tap.htm>. The stay issued by the Commission was unusual because it was the first non-automatic stay since 1994. See *In re Christian Klein & Cogburn, Inc.*, Exchange Act Release No. 33424, 55 SEC Docket 2191 (Jan. 5, 1994). Only four other stays were issued since the 1980s. See *In re William J. Higgins*, Exchange Act Release No. 26148, 41 SEC Docket 1313 (Oct. 3, 1988); *In re Chicago Mercantile Exchange*, Exchange Act Release No. 26728, 43 SEC Docket 1092 (Apr. 14, 1989); *In re the application of William Timpinaro*, Exchange Act Release No. 29820, 49 SEC Docket 1613 (Oct. 15, 1991).

enhancement of the markets, each Commission has its own philosophy with respect to regulatory reforms and enforcement priorities. But in the area of governance, as matters become increasingly polarized,<sup>184</sup> the temptation will increase for each Commission to undo the policies of its predecessors. The risk is particularly acute with respect to positions developed and enforced by the staff. Those positions can be changed quickly and without explanation. The result will be constant shifts in governance practices.

The approach will impose significant costs. With respect to interpretations under Rule 14a-8, issuers have an incentive to challenge shareholder proposals, a not inexpensive process.<sup>185</sup> Moreover, given the changes that occur from administration to administration, issuers rationally may seek the omission of proposals that address issues “definitively” resolved by the staff.

Shareholders must bear the costs associated with defending the proposals throughout the no-action process, something which can be expensive.<sup>186</sup> Moreover, they will likely need to expend more resources at the proposal drafting stage in anticipation of possible challenges. While institutional investors probably have the necessary resources, individual shareholders often do not,<sup>187</sup> potentially discouraging the submission of some proposals.

Likewise, the volatility puts pressure on the resources of the SEC.<sup>188</sup> The uncertainty and lack of standards encourages challenges to shareholder proposals. As a result, the staff must devote extraordinary resources to these requests. The deluge of exclusion requests effectively prevents the staff from giving more concerted treatment to other proposals. As a result, administrative analysis likely suffers.

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<sup>184</sup> See note 79. This also can be seen with the polarized debate over shareholder access. See Facilitating Shareholder Director Nominations, Exchange Act Release No. 62764, *supra* note 176.

<sup>185</sup> See Alan R. Palmiter, *Securities Regulation: The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 883 (1994) (providing estimates of the cost associated with challenging shareholder proposals in the 1990s); see also Facilitating S'holder Dir. Nominations, Exchange Act Release No. 62764, 2010 SEC LEXIS 3046, n. 817 (Aug. 25, 2010) (survey data from Business Roundtable indicating that “the average burden associated with preparing and submitting a single no-action request to the Commission staff in connection with a shareholder proposal is approximately 47 hours and associated costs of \$47,784.”).

<sup>186</sup> See Facilitating S'holder Dir. Nominations, Exchange Act Release No. 62764, 2010 SEC LEXIS 3046, n. 833 (Aug. 25, 2010) (“One commenter estimated that the average approximate total cost for shareholders to include a Rule 14a-8 proposal was \$30,000. . . . Assuming these costs correspond to legal fees, which we estimate at an hourly cost of \$400, we estimate that this cost will be equivalent to approximately 75 hours.”).

<sup>187</sup> See Ted Allen, *Apache Sues Activist John Chevedden*, ISS GOVERNANCE BLOG (Jan. 19, 2010, 1:24 PM), <http://blog.riskmetrics.com/gov/2010/01/apache-sues-activist-john-cheveddensubmitted-by-ted-allen-publications.html>. John Chevedden, an individual who frequently submits shareholder proposals, has been forced by issuers to litigate if he wants to ensure that his proposals are included in the proxy statement. As a result of the resource constraints associated with these proposals, Chevedden has acted as his own counsel.

<sup>188</sup> See Palmiter, *supra* note 185, at 883 (noting that the costs of the of regulating shareholder proposals related to Rule 14a-8 was the equivalent of one staff-year).

One way to mitigate these costs is to reduce staff discretion. Most immediately, this could occur by developing objective standards defining “ordinary business” and “social policy” and by requiring the staff to explain significant deviations in approaches. The Commission could adopt such standards after an opportunity for notice and comment. The staff would be bound by those positions until the Commission publicly agreed to change them. This approach would increase transparency and reduce the possibility of arbitrary shifts in interpretations.

But the reforms in this area ought to be even more radical. In truth, the staff has no meaningful expertise in determining the appropriate division of authority between owners and managers. State courts, particularly in Delaware, do have the requisite expertise. Moreover, the appropriate division will change over time. Resolution of these issues is therefore better left to the state courts.<sup>189</sup> Likewise, the staff has no particular expertise in assessing the social importance of a particular proposal.<sup>190</sup>

As a result, the “ordinary business” exclusion should be repealed. This would not prevent companies from blocking proposals that would truly interfere with management’s prerogative. To the extent companies could show that, under state law, a proposal improperly intruded into the authority of the board, it would be subject to exclusion as an improper subject for shareholders.<sup>191</sup> The burden of establishing this effect, however, would rest with the company,<sup>192</sup> allowing the legal uncertainty under state law to benefit shareholders.<sup>193</sup> A company would retain the ability to challenge the proposal in state court if it was ever adopted by shareholders.<sup>194</sup>

Of course, some proposals are sufficiently unimportant that they would clutter an already full proxy statement with immaterial information.<sup>195</sup> Rule 14a-8 could, therefore, be amended to permit exclusion of immaterial pro-

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<sup>189</sup> See Robert J. Brown, *Bring it On: The Delaware Courts Speak on Precatory Proposals under Rule 14a-8*, *THE RACETOTHEBOTTOM* (May 24, 2007, 6:15 AM), <http://www.theracetothetbottom.org/preemption-of-delaware-law/bring-it-on-the-delaware-courts-speak-on-precatory-proposals-under-rule-14a-8.html>. One Vice Chancellor of the Delaware Chancery Court (now Chancellor) has agreed with this view, at least with respect to the use of precatory proposals.

<sup>190</sup> See generally Brown, *supra* note 1.

<sup>191</sup> 17 C.F.R. § 240.14a-8(i)(1) (2011).

<sup>192</sup> *Supra* note 36. See also Rule 14a-8(g), 17 C.F.R. § 240.14a-8(g) (2011) (noting that company generally has the burden of establishing the availability of an exclusion).

<sup>193</sup> See *supra* note 42.

<sup>194</sup> See *supra* note 42. Under the existing state of the law, a challenge relying on state law would be “rarely satisfied.” Nonetheless, this approach would force companies to use state courts to challenge the subject matter of a proposal, something that would, over time, result in a clearer delineation between the roles of managers and shareholders. See *CA v. AFSCME*, 953 A.2d 227 (Del. 2008) (SEC certified issue to Delaware Supreme Court on whether subject of shareholder proposal violated state law).

<sup>195</sup> See generally Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 *WASH. U. L.Q.* 417 (2003); see also *Amalgamated Clothing and Textile Workers Union*, *supra* note 49, at 883 (“The SEC adopted [the ordinary business] exception to save management the cost and burden of including a proposal in proxy material that would be improper if raised by a shareholder at the annual meeting.”).

posals. Unlike “ordinary business” and “social policy,” the staff has considerable expertise in analyzing the materiality of information under both qualitative and quantitative standards.<sup>196</sup> Alternatively, such proposals could be omitted under the existing exclusion for those irrelevant to the business of the company.<sup>197</sup> Again, however, the staff’s approach would need to be transparent, objective, and entail a minimal role in determining the proposals that could be deleted from the proxy statement.

The consequence of this approach would be a significant narrowing of the basis for excluding proposals. The practice might impose additional costs on issuers by potentially increasing the number of proposals and, therefore, the size of the proxy statement. At the same time it would minimize the number of challenges, something which reduce staff, corporate, and shareholder costs. Mostly it would reduce the volatility in corporate governance standards by reducing staff discretion.

This Article in the end is both broad and narrow. It is narrow in the sense that it deals with staff interpretations under the “ordinary business” exclusion in Rule 14a-8. More broadly, however, the Article identifies a regulatory phenomenon that will only grow in importance. In the era when the SEC had a very limited role in the corporate governance process, the need to reduce staff discretion to avoid volatility was less important. As the SEC increasingly becomes the epicenter of governance reform, however, this is no longer true. Politicization will increasingly be an inevitable presence in the governance process and will need to be considered when addressing regulatory reform.

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<sup>196</sup> See SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45151 (Aug. 19, 1999) (interpreting the concept of materiality under the federal securities laws).

<sup>197</sup> See 17 C.F.R. § 240.14a-8(i)(5) (2011).