THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE

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THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE

Third Edition

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To my parents

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Preface

This book is born out of concern and conviction. As a professor specializing in corporate and financial law, I have long nurtured an interest in governance, risk management, and compliance—topics that seemed to be incompletely conceptualized and imperfectly understood either individually or in relationship to each other. As an observer of business practices and financial markets, I am convinced that governance, risk management, and compliance are important today and will only increase in significance over the coming decades. As an independent director of a financial institution, I am impressed by the subtlety and breadth of the governance issues facing business organizations in a rapidly changing world. Added together, these considerations—coupled with the dearth of materials covering these topics on a systematic basis from a legal point of view—led me to write this book.

A word is in order about terminology. The world of governance, risk management, and compliance is populated by an exotic zoo of acronyms, technical terms, and metaphors, often used without much attempt to offer a precise definition or to explain the background of their use. I have attempted to avoid most of these terms, preferring instead to write in a simple and nontechnical way. However, the reader will observe that technical language does find its way into the pages that follow. Where arcane terminology is used, it is usually for one of two purposes. Sometimes the words usefully capture ideas or nuances of meaning that would not be embodied in more familiar language (for example, the notion of a "risk appetite"). At other times, I use unusual language because the terms are ubiquitous among people working in the field of governance, risk management, and compliance (e.g., the "three lines of defense" or "enterprise risk management"). Anyone who wants to become active in this field needs to know how to use these terms; you may as well start now. To aid the reader in this journey, I include text boxes containing definitions of many of the key concepts.

I have used the following conventions in excerpting materials. From time to time I have presented documents or problem sets involving fictional organizations. No connection with any actual organization is intended or should be assumed. In the interest of brevity, I have limited the excerpted material to text that is most pertinent to the question at hand; although I provide background needed for a full understanding, some context is necessarily lost. I have included ellipses when substantive text is omitted, but have not indicated the omission of citations, paragraph numbers, or other non-substantive material. In order to increase readability, I have occasionally, and without alerting the reader, made stylistic alterations: breaking longish sections of text into separate paragraphs or joining shorter sections together, revising or eliminating headings, or changing the case of text. Readers should refer to the original texts for more information.

One cannot spend many years in the world of law and law practice without coming into contact with the leading problems of the day. I am grateful for having been a witness to some of the events recounted in this book. Those experiences have stimulated my interest in the topic of governance, risk management, and compliance, and enriched my understanding of the events and underlying social policies. Although I don't believe these experiences have biased the ideas presented in this book, in the interest of full disclosure I note that I have been involved in numerous class actions and shareholders derivative suits as a lawyer, adviser, or expert witness. I served as an expert in cases arising out of the failure of Bank of Credit and Commerce International, the Enron scandal, and the Deepwater Horizon oil spill. I am a member of the board of directors and the risk and compensation committees and serve as chair of the audit committee of State Farm Bank, a thrift institution that is a wholly-owned subsidiary of State Farm Mutual Automobile Insurance Company.

Many people assisted in the preparation of this volume. Lauren Citrome, Colin S. Huston-Liter, and Adam Karman provided excellent research assistance. My extraordinarily capable assistant, Jerome Miller, helped keep me organized and facilitated the process in innumerable ways. Many colleagues and friends provided advice, counsel, and feedback: Jennifer Arlen, Colleen Baker, Stephen Bainbridge, Carole Basri, Karen Brenner, Theodore Eisenberg, Joanna Flanagan, Howell Jackson, Bruce McClure, Gerald Rosenfeld, Roberta Romano, and Helen Scott among many others. I have been fortunate to learn about governance from some exceptionally able business leaders. I am grateful to my publisher, Wolters Kluwer, for their professional production operation and for their confidence in producing a course book for a topic with no established market. My wife, Allison Brown, tolerated prolonged periods of research and distraction; she also provided generous input into many questions both of structure and detail. She taught me some useful lessons about governance, risk management, and compliance! While each of these people or institutions provided invaluable input, none is responsible for errors or shortcomings.

The field of governance, risk management, and compliance is developing with dizzying speed. Regulators, prosecutors, courts, and the regulated firms themselves generate new rules, new cases, new initiatives, and new ideas nearly every week. In the few years since the first edition of this book appeared, many law schools have instituted courses in Compliance, and several have started full-scale graduate programs in the field. Compliance is also becoming a recognizable topic of legal scholarship—still in its infancy but showing potential for enlightening and imaginative thought and analysis. This new edition both fleshes out topics in greater detail and also incorporates treatments of many new and exciting developments. I hope that everyone who reads this book can experience some of the fascination and excitement that I have felt when writing the volume. It is truly a privilege to observe, comment, and teach about this important and growing area of law and policy.

Geoffrey Parsons Miller
July 2019

THE LAW OF GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE

Introduction

A. WHAT ARE GOVERNANCE, RISK MANAGEMENT, AND COMPLIANCE?

Governance, risk management, and compliance are in vogue. Activist shareholders, institutional investors, and policymakers look to these activities as crucial means for improving business ethics, enhancing compliance with legal norms, and deterring firms from engaging in unsafe or unsound practices. Regulators encourage companies to upgrade their activities in these areas; if companies do not comply, the regulators find ways to force them to do so. Companies large and small seem to have "got it"; during the first and second decades of the twenty-first century they have greatly upgraded the role of governance, risk management, and compliance in their decision processes—and massively increased spending on these functions as well. These developments, moreover, are hardly limited to the United States; similar expansions in governance, risk management, and compliance can be observed throughout the world.

What are governance, risk management, and compliance, and why are they important? Why has their significance grown so rapidly in recent years? Will GRC achieve the goals that its proponents have set for it? What is the future of GRC: Is it a fad, with only passing significance, or is it a sea-change in how businesses and other organizations are managed? What is the role of attorneys in the area, and what should it be?

This book explores these and other issues raised by the explosion of GRC. Our focus will principally be on the business corporation, but we will attend also to other organizations where GRC plays a role: nonprofit firms, charities, religious organizations, and governments (among others). In these respects the coverage of the book is broad. But we will also examine GRC from a specific perspective: that of law, the legal system, and the legal profession. We will not be considering the topic from the standpoint of accountants, auditors, information technology experts, or people involved in specific lines of business. We will not examine GRC as an aspect of business strategy. These limitations on scope are needed, not only to make

the book manageable, but also because of the intended audience. This book is designed for two purposes: first for use as a textbook or resource in law school classes; and second as an introduction to the topic that can be useful for attorneys in governments, organizations, and private law firms who find themselves swept up in the GRC phenomenon.

Before launching into the substance of our topic, it is useful to define terms. At the outset, we can see that the term "governance, risk management, and compliance" suggests two things. The combination of words in a single phrase, and especially the use of an acronym ("GRC"), indicate that the topic has an internal unity: Governance, risk management, and compliance are not simply three things that companies do that are grouped together in arbitrary fashion; rather they have something fundamental in common. But the use of separate words, each with its own history and connotations, indicates that despite the overlap, there are also differences between these functions. Let's consider what is different about the key terms, as used in this book, and then turn to what they have in common.

First, what do we mean by "governance"? The term has to do with the structure of control within an organization. The governance of organizations is often complex, involving layers of responsibility and a variety of different offices and positions, with lines of authority projecting in many different ways. The formal structure of governance, moreover, may not present a full picture of how the process actually works. Creating an office and endowing it with formal authority does not necessarily mean that the authority will actually be exercised or that the office will perform its job competently. Power and decision making in an organization may sometimes have more to do with history, personality, and interpersonal relationships than with job descriptions. Unless one is inside an organization, however, these subtle ebbs and flows are not readily observable. For the student of governance, risk management, and compliance, there is often no realistic option but to go by organizational charts, committee charters, and job descriptions—recognizing that the structure of authority presented in these documents may only partially reflect the actual distribution of power and influence within the organization.

"Governance" refers to the processes by which decisions relative to risk management and compliance are made within an organization.

Risk management takes account of the risks facing an organization. Unlike governance, risk management has a significant technical component. Organizations, especially these days, often attempt to quantify risk in precise ways, using where appropriate (and sometimes where not appropriate) complex mathematical formulas and analytical methods. The goal of risk management is not to eliminate risk but rather to manage it: The risk management function recognizes that the activities of the enterprise necessarily involve uncertain outcomes with different consequences for the success of the organization's mission.

"Risk management" refers to the processes by which risk is identified, analyzed, included in strategic planning, and either reduced through risk control and mitigation tactics or accepted as inherent in activities that the organization wishes to conduct.

We will use the term "compliance" in a somewhat specialized way. In normal usage, the term means that a person conforms to some set of norms. Here we mean something more particular: the *processes* by which an organization seeks to ensure that employees

and other constituents conform to applicable norms—norms that can include either the requirements of laws and regulations or the internal rules of the organization. The compliance function usually does not create or establish these norms; it accepts them as given and seeks only to ensure that they are observed.

> "Compliance" refers to the processes by which an organization polices its own behavior to ensure that it conforms to applicable rules.

As we will see repeatedly in the pages that follow, the functions of governance, risk management, and compliance are not hermetically separated. Much of the law pertinent to compliance has to do with governance; it dictates how responsibility for enforcing applicable norms is allocated within an organization. The same goes for risk management, although to a lesser extent: Much of the law governing risk management requires that the regulated entity act through defined offices and institutions. Thus governance has a close relationship with both risk management and compliance. Compliance and risk management also obviously have much in common: Non-compliance is itself a risk—and a significant one—that organizations must evaluate and attempt to control.

These overlaps are more than simply matters of definition. They arise out of a deep structural similarity between the three GRC functions. Considered from the most general perspective, governance, risk management, and compliance serve a common purpose: ensuring that organizations are managed well (effectively and in such a way as to enhance social welfare). The law of governance, risk management, and compliance is the body of rules, regulations, and best practices that, individually and collectively, are intended to ensure that organizations achieve this goal.

> The law of governance, risk management, and compliance is the body of rules, regulations, and best practices that, individually and collectively, are intended to ensure that organizations are managed effectively and in such a way as to enhance social welfare.

The law of governance, risk management, and compliance includes not only conventional rules and regulations, but also "soft law" recommendations from non-governmental organizations. Among the most important of these is the Committee of Sponsoring Organizations of the Treadway Commission (COSO), an umbrella organization of trade groups involved with GRC. COSO promotes the idea of "internal controls" to capture the essence of the GRC process. As set forth in the most recent iteration of its integrated framework, COSO defines internal control as "a process, implemented by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance." The COSO framework identifies the following key elements of internal control:

- Control environment: the general tone of the organization; its culture, attitudes, values, philosophy, human development procedures, and operating style. COSO views the control environment as the most important element of internal control.
- Risk assessment: the process by which the organization identifies and evaluates material risks to its operations, both internal (e.g., a fraud committed by senior officers) or external (e.g., changes in market prices).
- Control activities: the procedures and policies that an organization employs to ensure that decisions made by the board of directors and senior management are faithfully and competently executed throughout the organization.

- Information and communication: the means by which agents of the organization are supplied with the information needed to perform their duties.
- Monitoring: a process of quality assurance, both on an ongoing basis as operations are performed, and separate evaluations conducted after the fact.

What value can an effective system of internal controls add to an organization? According to COSO, internal controls help an organization achieve its objectives while reducing risk. The objectives of the organization include not only meeting profitability targets and reducing costs, but also ensuring compliance with applicable laws and regulations. At the same time, COSO warns that internal controls are no panacea or guarantee. They do not ensure success, are unable to predict adverse events, and cannot perform the alchemy of transforming a bad manager into a good one.

Questions and Comments

1. COSO is an umbrella organization of five organizations: the American Accounting Association, the American Institute of CPAs, Financial Executives International, the Association of Accountants and Financial Professionals in Business, and the Institute of Internal Auditors. Its mission is to improve and modernize practices for corporate directors and managers in the areas of internal controls, enterprise risk management, and fraud prevention. Together, COSO's sponsoring organizations carry considerable clout as spokespeople for authoritative opinion in the worlds of accounting, auditing, and corporate finance.
2. Do you see any logic inherent in the order of COSO's list of key internal control functions?
3. Is there anything in the report, as described above, that could not be divined through the exercise of common sense?
4. Why was the COSO report so influential? Does it offer something for everyone, without goring anyone's ox?
5. How, if at all, does the concept of internal controls serve the interests of COSO's sponsoring organizations?

Those who think about governance, risk management, and compliance display a nearly preternatural affection for metaphors. A leading metaphor in the field is that of the "three lines of defense." In conventional usage, the lines are the following:

The Three Lines of Defense

Line One: operating executives have initial responsibility for implementing internal controls within their own areas.
Line Two: risk-management and compliance operations catch problems that are not weeded out at the front line.
Line Three: internal audit checks up on everyone, including risk management and compliance, in an attempt to make sure that no problems remain.

Questions and Comments

1. Consider the image of the "three lines of defense." What human activity does it refer to?

2. What attitudes are invoked by this metaphor? Lines of defense are needed when a country is threatened by an external foe; the threat is to the institution as a whole and everyone in it. The enemy seeks to invade the organization's territory if given an opportunity. Everyone in the organization shares an interest in keeping the lines of defense as strong and as effective as possible.

3. The lines of defense metaphor seems to convey a mixed message about the organization's state of preparedness. The fact that three lines of defense are in place is reassuring; multiple backups minimize the chance that the destructive agent will penetrate to the organization's core. Yet the fact that three lines of defense are needed also warns that the threat is powerful and dangerous and that, if the worst case happens and the lines are penetrated, the consequences for the organization are likely to be grave.

4. Why is external audit not included in the lines of defense? Should it be considered a fourth line of defense?

5. What about regulators?

6. What purposes does the lines of defense metaphor serve?

7. Why is metaphoric language so powerful, and apparently so useful, in this supposedly scientific and rational enterprise?

8. The metaphor of the three lines of defense has tended to focus attention on the second and third lines—risk management and compliance, and internal audit. Is there a danger that the emphasis on the second and third lines will distract attention away from the place where the problems can most easily be avoided—the day-to-day business operations where appropriate diligence can prevent problems from arising in the first place?

B. THE ROLE OF ATTORNEYS

A distinctive feature of governance, risk management, and compliance is that these functions are inherently cross-disciplinary. Governance, for example, has a significant legal element: The rules allocating responsibility and authority for compliance and risk management are contained in formal legal documents such as charters, bylaws, and board resolutions—not to mention laws, regulations, letter rulings, judicial opinions, consent decrees, deferred prosecution agreements, and administrative orders. But governance also has important non-legal elements: Many decisions are made within the discretion of the board of directors or senior managers, without significant legal input.

The same holds for compliance. Many of the underlying norms and rules that are administered through the compliance function are legal in nature, but some are internal institutional policies or procedures not mandated by law. Lawyers are often used for investigations into allegations of misconduct by corporate employees; but investigations are also carried out by private investigators, computer technicians, forensic accountants, and other people. Much of the compliance function today, moreover, is outsourced to non-lawyer vendors who provide software systems that operate automatically and outside the direct control of lawyers.

Risk management, likewise, involves a combination of legal and non-legal considerations. Some of the most important risks an organization faces are explicitly legal in nature—for example, the risk that the institution will face onerous new regulations, or that it be required to pay a legal judgment or be subjected to punitive governmental sanctions. Yet other risks facing an organization have less to do with law: Examples are the risk that a financial institution will lose money in its trading operations, or the risk that private customer information will be stolen from a company's computerized records. Even these latter risks have a legal dimension, however: For example, most financial institutions are required to operate in a safe and sound manner, so that very large trading losses could represent a violation of legal obligations.

Lawyers thus play an important role in the area of governance, risk management, and compliance, but far from the only role. People specializing in other fields—management, accounting, investigation, finance, and information technology, among others—play major roles. Moreover, new professional roles have been developing at an astonishing pace. Many educational institutions offer certificates or degrees in the GRC area; Stanford University's Center for Professional Development, for example, awards a certificate in risk management. The Wharton School of the University of Pennsylvania, in cooperation with the Financial Industry Regulatory Authority (FINRA), offers a program of instruction whose graduates earn designation as Certified Regulatory and Compliance Professionals (CRCPs). An organization called "GRC Certify™" offers a menu of certifications in the combined field of governance, risk management, and compliance. And these are only a sample of dozens of programs offering instruction or certification in the area. We may in fact be witnessing the birth of two new professions—compliance and risk management—that combine elements of law, accounting, human resources, business, ethics, and more.

Questions and Comments

1. Notably missing from the list of COSO sponsors is any representation by lawyers. Neither the American Bar Association nor any other organization representing the legal profession sponsors this initiative. Given that one of the principal objectives of internal controls is "compliance with applicable laws and regulations," why are lawyers not represented?

2. Aware that GRC is a growth area for professional practice, law firms are now vigorously pursuing this line of work. The websites of many large law firms contain sections touting services in the area of compliance—services that range from specialized representations when a client gets into trouble to audits of compliance areas to full-scale outsourcing of tasks and responsibilities. Law firms are more tentative about offering risk management advice; but many clearly imply that their services will be valuable in controlling or mitigating legal, regulatory, and operational risks.

3. The growth of governance, risk management, and compliance as a discrete field of professional service, including important legal elements, raises the question whether professional service providers may offer a comprehensive and integrated package of services that includes both legal and non-legal expertise. Could one of the big accounting or consulting firms hire lawyers and put them to work providing

legal services to clients in engagements that also involve accountants, economists, marketing consultants, finance advisers, and other trained professionals?

4. Do attorneys perform their jobs differently than other compliance professionals? One might think so, given the special features of legal training—socialization into how to "think like a lawyer," sensitivity to legal rights and duties, awareness of the responsibility of zealous representation of clients, and immersion in an adversarial system of justice. A study of Australian firms concludes, however, that in general, lawyers don't perform their compliance jobs in a distinctive way. Robert Posen, Christine Parker & Vibeke Lehmann Nielsen, *The Framing Effects of Professionalism: Is There a Lawyer Cast of Mind? Lessons from Compliance Programs*, 40 Fordham Urb. L.J. 297 (2012).

C. SUBJECT AREAS

Our definitions of governance, risk management, and compliance are formulated at an abstract level that does not depend on any specific subject matter. Appropriately so: The functions served by governance, risk management, and compliance are quite general. All organizations—for-profit corporations, not-for-profit corporations, religious institutions, governments, and many others—must perform these functions. Thus the law in this area is not the law *of* any particular field of activity or area of commerce; it is a topic that pertains to all complex organizations.

At the same time, other elements of governance, risk management, and compliance are specific to particular subject matters. The ways in which governance, risk management, and compliance play out across areas of human endeavor is partially a function of the specific field. The rules pertaining to hospitals differ from the rules that apply to commercial airlines; those rules, in turn, differ from the rules that apply to securities broker-dealers. Each field has its own underlying policies and its own political environment that shapes the rules we observe. History also plays a role: We will see that rules often change in response to large and stressful events that are deemed, in one way or another, to have resulted from a breakdown in governance, risk management, or compliance.

This feature of governance, risk management, and compliance law—that it has a common structure but also includes specific and sometimes idiosyncratic rules—influences how this book is organized. We deal with issues in their general and abstract form, but also provide a "deep dive" into specific areas.

Part I of this book looks at the topic of governance from a general perspective. This part introduces the cast of characters within the organization: shareholders (Chapter 1), the board of directors and board committees (Chapter 2), and internal management (Chapter 3).

Part II turns to compliance. We take this up before reaching the topic of risk management—and thus deviate from the conventional order—because it is an area of particular pertinence to lawyers. Here, we examine in more detail what the compliance function is (Chapter 4). We then turn to the technology of compliance, examining the role of internal enforcement (Chapter 5), regulators (Chapter 6), prosecutors (Chapter 7), whistleblowers (Chapter 8), gatekeepers (Chapter 9), and plaintiffs' attorneys (Chapter 10). Next, we focus on specific topics where compliance plays a role: information security (Chapter 11), off-label drugs (Chapter 12),

foreign corrupt practices (Chapter 13), money laundering and bank secrecy (Chapter 14), and sexual harassment (Chapter 15). These specific topics are important in their own right and also illustrative of general issues that arise in the compliance space. We end the unit on compliance by examining activities beyond compliance such as charitable gifts, codes of ethics, corporate social responsibility, sustainability, and institutional culture (Chapter 16), and instances where compliance fails (Chapter 17).

Part III takes up the topic of risk management. After examining what risk management is (Chapter 18), we evaluate different approaches to risk management (Chapter 19). The book concludes with an examination of cases where risk management fails (Chapter 20).

Part I

Governance

Consider a company like Citigroup. In 2018, this vast financial firm serviced approximately 200 million customer accounts and did business in more than 160 countries and jurisdictions. With more than $72.8 billion in annual revenues, Citigroup would rank in the top 100 countries in the world by gross national product. Its nearly quarter million employees could represent the workforce of a substantial city. Even more staggering is the amount of assets under its control—$1.9 trillion and counting. And Citigroup is not even the largest financial institution in the United States; JPMorgan Chase and Bank of America are larger still.

Given the size and influence of complex organizations, it is obvious that decisions made by their managers have an impact on social welfare. If a company is well managed, it will tend to generate profits that enrich its shareholders and employees, who then are more willing to spend money and contribute to the health of the economy. Well-managed companies also represent efficient allocations of resources, since the assets under the control of the managers of these companies will be devoted to profitable uses. If a company is poorly managed, the opposite happens: People become poorer, spend less, and invest less; and the assets controlled by these companies are not put to their highest and best use. In the worst case, bad decisions can have systematic consequences: Poor investment policies by financial firms contributed to the financial crisis of 2007-2009. The question of governance—who decides what a complex organization will and will not do—is therefore one of considerable public importance.

For large organizations, the problem of governance is often conceptualized as that of the "separation of ownership and control"—a phrase that traces back to an influential book published in 1932 by Adolph Berle and Gardiner Means entitled *The Modern Corporation and Private Property*. Almost no one reads the book any more, but the concept of the separation of ownership and control remains a defining issue for corporate governance. The basic idea is this: Large corporations have thousands or millions of shareholders; even the largest of these owners has only a small percentage interest in the firm. The sheer number of shareholders makes it virtually impossible for them to exercise effective

governance. Rather, managers control what happens in big companies, subject to only minimal checks from shareholders or other constituencies. But managers, if not controlled from without, will too often give in to the temptation to expropriate the benefits of control for themselves. Managerial misconduct of this sort is given various names—"abuse" by those (such as Berle and Means) who were steeped in the political values of the Progressive Era; and "agency costs" by later scholars who work in the framework of law and economics. No matter what the conduct is called, its consequences are the same: Corporations will not be managed so as to serve the best interests either of shareholders or of society as a whole. This concern about managerial incompetence or misconduct is the essential problem of corporate governance.

The issue of corporate governance has long been at the front burner of policy debate, both in the United States and around the world. A host of white papers, best practice manifestos, and official government policies purport to define how companies ought to be managed. Prestigious institutes, think tanks, politicians, and scholarly organizations offer their opinions on a regular basis.

Over time, the focus of enthusiasm on the part of these experts has shifted. Beginning with an emphasis on the importance of independent boards of directors, the outer edge of policy has moved successively toward an emphasis on the "market for corporate control" (the corporate takeover market); to reliance on institutional investors with large ownership stakes; to a focus on board committees; and to the governance reforms *de jour* of the 2010s: revamping compensation practices and enhancing shareholder power.

Do these or other corporate governance reforms improve the welfare of society? Definitely yes, in the judgment of advocates. Empirical researchers tend to be more cautious. Some studies find benefits of reforms; others do not. In general, it may be fair to say that some corporate governance reforms improve how large institutions are managed and others observe the Hippocratic principle of "do no harm." Still, skeptics question whether the plethora of corporate governance reforms is worth the candle in terms of results obtained.

Consider in this respect the following excerpts, one from the Organization for Economic Cooperation and Development (OECD), and the other from the author of a treatise on the law of corporate governance.

OECD Principles of Corporate Governance

2004

. . . In today's economies, interest in corporate governance goes beyond that of shareholders in the performance of individual companies. As companies play a pivotal role in our economies and we rely increasingly on private sector institutions to manage personal savings and secure retirement incomes, good corporate governance is important to broad and growing segments of the population. . . . The [OECD's] Principles [of Corporate Governance] are a living instrument offering non-binding standards and good practices as well as guidance on implementation, which can be adapted to the specific circumstances of individual countries and regions. . . . To stay abreast of constantly changing circumstances, the OECD will closely follow developments in corporate governance, identifying trends and seeking remedies to new challenges.

Douglas M. Branson, Proposals for Corporate Governance Reform: Six Decades of Ineptitude and Counting

48 Wake Forest L. Rev. 673 (2013)

This article is a retrospective of corporate governance reforms various academics have authored over the last 60 years or so. . . . The first finding is as to periodicity: even casual inspection reveals that the reformer group which controls the "reform" agenda has authored a new and different reform proposal every five years, with clock-like regularity. The second finding flows from the first, namely, that not one of these proposals has made so much as a dent in the problems that are perceived to exist. The third inquiry is to ask why this is so? Possible answers include the top down nature of scholarship and reform proposals in corporate governance; the closed nature of the group controlling the agenda, confined as it is to 8-10 academics at elite institutions; the lack of any attempt to rethink or redefine the challenges which governance may or may not face; and the continued adhesion to the problem as the separation of ownership from control as Adolph Berle and Gardiner Means perceived it more than 80 years ago.

Questions and Comments

1. The OECD is a respected good-governance organization. According to its website, its mission is to "promote policies that will improve the economic and social well-being of people around the world. . . . We set international standards on a wide range of things, from agriculture and tax to the safety of chemicals."

2. The OECD Principles of Corporate Governance are not law. No country is obligated to adopt these principles as a matter of internal law. Yet recommended "best practices" such as these can be influential. Why? Consider the following possibilities:

   a. The OECD's standards are good ideas, and when they are understood by others, they are adopted because they are recognized as a better way to govern.
   b. The OECD's standards provide a focal point around which a consensus of regulators and policy makers can coalesce. Once many people get behind a proposed reform, it has greater prospects for success than, say, if the idea is being promoted by a solitary academic.
   c. The OECD's standards make it easier for governments to adopt internal reforms because domestic political interests find it hard to resist proposals that have the backing of prestigious international organizations.
   d. The OECD's standards serve the interests of organizations and individuals who pursue agendas that do not necessarily align with the public interest.

Which of these possibilities seems most plausible to you?

3. Notice the difference in tone between the two excerpts. Implicit in the OECD statement is an optimistic view about the potential for progress in improving corporate governance. Standards would not be necessary if all companies were already following the OECD's recommendations. The OECD's approach carries with it an idea that working together, governments and private organizations can genuinely improve corporate behavior and that the result will be beneficial for everyone.

4. The OECD seems confident that its recommendations are wise and appropriate. What is the basis for this confidence? The OECD's opinions about corporate governance seem to be grounded, not on controlled studies but, rather, on the consensus of government officials. Is this a reliable source of information? What shapes the opinions of the government officials who take part in the OECD's councils? Could it be that these officials rely on the views of prestigious organizations such as the OECD? Is the process circular?

5. Branson's analysis displays a markedly different tone. He wonders whether governance reforms do much good at all and doubts that much has been learned over the years.

6. What, in Branson's view, drives changes in corporate governance recommendations? He suggests that a handful of academics have shaped opinions for everyone else. Is this plausible?

7. On what basis does Branson conclude that corporate governance reforms haven't worked? One of his key exhibits is evidence that these reforms are creatures of fashion—every five years or so another proposal becomes popular and flourishes for a while, only to be supplanted by a newcomer. If governance reforms are so fickle, Branson suggests, perhaps they are not grounded in real benefits. Do you agree?

8. For other critiques of fashionable corporate governance requirements, see Roberta Romano, *Quack Corporate Governance*, 28 Reg. 36 (2005); Stephen Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, UCLA School of Law Law-Econ Research Paper No. 10-12 (2010); Luigi Zingales & Dirk A. Zetzsche, Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive, European Corporate Governance Institute Law Working Paper No. 249/2014 (2014).

9. Even though at this point you may not yet have a well-developed opinion about the value of governance reforms, whose view seems more persuasive?

Corporate governance was once largely within the discretion of the regulated entity—subject, perhaps, to the gentle pressure of "best practice" principles but not otherwise within the purview of outside influences. No more. At least in the area of financial institutions, and increasingly in other industries, regulators are taking a close look at corporate governance practices and, at times, imposing the heavy hand of compulsory rules. Consider in this regard the following excerpt from the Basel Committee on Banking Supervision's "Core Principles of Banking Supervision," a document that purports to identify minimum acceptable standards for supervision of banks around the world.

Basel Committee on Banking Supervision Consultative Document—Core Principles for Effective Banking Supervision

December 2011

Principle 14: Corporate Governance

The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organizational structure, control environment, responsibilities of the banks'

boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.

Essential Criteria

- Laws, regulations, or the supervisor establish the responsibilities of the bank's board and senior management with respect to corporate governance to ensure there is effective control over the bank's entire business. The supervisor provides guidance to banks and banking groups on expectations for sound corporate governance.
- The supervisor regularly assesses a bank's corporate governance policies and practices, and their implementation, and determines that the bank has robust corporate governance policies and processes commensurate with its risk profile and systemic importance. The supervisor requires banks and banking groups to correct deficiencies in a timely manner.
- The supervisor determines that governance structures and processes for nominating and appointing a board member are appropriate for the bank and across the banking group. Board membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile and systemic importance, board structures include audit, risk oversight, and remuneration committees with experienced non-executive members.
- Board members are suitably qualified, effective, and exercise their "duty of care" and "duty of loyalty."
- The supervisor determines that the bank's board approves and oversees implementation of the bank's strategic direction, risk appetite and strategy, and related policies, establishes and communicates corporate culture and values (e.g. through a code of conduct), and establishes conflicts of interest policies and a strong control environment.
- The supervisor determines that the bank's board, except where required otherwise by laws or regulations, has established fit and proper standards in selecting senior management, plans for succession, and actively and critically oversees senior management's execution of board strategies, including monitoring senior management's performance against standards established for them.
- The supervisor determines that the bank's board actively oversees the design and operation of the bank's and banking group's compensation system, and that it has appropriate incentives, which are aligned with prudent risk taking. The compensation system, and related performance standards, are consistent with long term objectives and financial soundness of the bank and is rectified if there are deficiencies.
- The supervisor determines that the bank's board and senior management know and understand the bank's and banking group's operational structure and its risks, including those arising from the use of structures that impede transparency (e.g. special-purpose or related structures). The supervisor determines that risks are effectively managed and mitigated, where appropriate.
- The supervisor has the power to require changes in the composition of the bank's board if it believes that any individuals are not fulfilling their duties related to the satisfaction of these criteria.

Questions and Comments

1. Should regulators be dictating corporate governance of banks?
2. Is there a danger of abuse, if the regulators are self-interested or vindictive?
3. These are set forth as minimum requirements. What else would you recommend, if anything?

1

Shareholders

A. PROS AND CONS OF SHAREHOLDER POWER

Shareholders have economic interests in the success or failure of corporations in which they hold shares. If the company does well, shareholders get a portion of the income (net of expenses, including the cost of debt service). If the company does poorly, they share in the loss. In the case of profits, shareholders gain in either of two ways: The company may declare a dividend distributing some of the surplus back to its owners; or the share price may rise to reflect the value of profits that have not been distributed. Shareholders incur losses when the value of their interest falls. If the company becomes insolvent, they forfeit the entire value of their investments. If the company winds up its business—say, by voluntary dissolution (rare) or by being acquired by another firm (common)—they get a distribution reflecting some measure of the value of their ownership interests.

One might think that shareholders would control the management of their firms for several reasons:

- Giving shareholders control rights can reduce the "agency costs" of management—the fact that executives, if not closely monitored, may expropriate for themselves an excessive share of the company's value, or may simply be lazy or incompetent.
- Because shareholders get the first portion of profits and losses, they want companies they own to make a profit, and therefore have an incentive to make profit-maximizing decisions about how the firm is run.

A little thought, however, reveals several reasons why shareholders cannot be the managers of the companies they officially own. The following are especially salient:

- It is not practical to ask shareholders to make most management decisions. These decisions must be made quickly. A business opportunity arises, and the company must decide *now* whether to take it or not. If all decisions had to be given to shareholders for a vote, the company would never "strike while the iron is hot."

- In addition to being time consuming, it is costly to ascertain shareholder preferences. The company must communicate the information necessary for an informed decision; the shareholders must consider how to vote; they must actually vote; and the votes must be collected and tabulated. This may not be too burdensome in small companies with only a few dozen shareholders; but for public firms with millions of shareholders, the costs are substantial. Proxy solicitation firms make a living doing nothing other than helping large companies manage the process of shareholder voting.
- Shareholders may not be well informed about decisions that they do make. Most shareholders don't have a lot invested in any particular company. Suppose you have inherited 20 shares in General Motors from Grandma. You might spend the time needed to research the condition of General Motors, to study the company's proxy materials, and to find out what analysts and others are saying about the company's prospects. Probably you won't do so, however. While your shares in General Motors are not irrelevant to your welfare, you aren't going to stay up at night worrying about them. If you have not examined the issue under consideration, your vote will not be an informed one, and will not contribute to the efficient management of the company.
- Most shareholders hold diversified portfolios of equity securities. Diversified shareholders are unlikely to care deeply about the fortunes of any particular company, simply because their ownership of many different companies effectively gives them a hedge: If the fortunes of one company go down, that bad result is likely to be offset by an improvement in the fortunes of another company also held by the shareholder. The feature of diversification reduces the shareholder's interest in monitoring the management of any particular company.
- If the company is publicly traded, shareholders have an easy option if they are not happy with how the company is performing. Rather than exercise "voice" by voting to throw out the incumbent board of directors, the simpler solution is just to sell one's stock. Then any shortcomings at the company become someone else's problem.
- Even if no issues with the company arise, shareholders often sell their interests for reasons such as rebalancing their portfolios or liquidating investments in order to raise cash for expenses. If the shareholder anticipates selling her stock, she has a reduced interest in tracking what is going on at the company.
- Of course, some shareholders are better informed. Institutional investors, such as pension funds, hire people to analyze the performance of companies in which they invest; broker-dealers such as Merrill Lynch employ experts who investigate company performance and make buy-sell recommendations; and professional proxy advisors make recommendations about how shareholders should vote. If informed shareholders control the outcome of shareholder votes, then arguably the fact that many shareholders are uninformed should not make a difference from the standpoint of social policy. However, informed shareholders do not possess the judgment needed to make day-to-day management decisions. Informed shareholders may not even be able to make accurate judgments about the most fundamental issues facing the company, such as what its stock is worth. Among the many painful lessons of the financial crisis of 2007-2009 was the fact that the stock market (along with nearly everyone else) appeared to have miscalculated the risks posed by subprime mortgage-backed securities.

- Even if shareholders could effectively exercise control on an informed basis, it is not clear that we would want them to do so. Shareholders' interests do not, in fact, align optimally with what society would prefer. They capture all the upside of a risky venture if the activity turns out well, but if the activity turns out poorly and the company becomes insolvent, some of the downside is borne by the creditors. In a sense, creditors provide a policy of insurance to shareholders protecting them against the costs of bankruptcy: If the company fails, the shareholder loses the deductible (the value of her share interest) but all the remaining costs are incurred by the creditors (the policy guarantee). All insurance policies create a problem of moral hazard—when you are insured against a risk you lose much of your incentive to prevent the loss from coming to pass. The "insurance" policy provided to shareholders by creditors is no different: When a company has debt in its balance sheet (and almost all do), then, and to that extent, the equity holders have an incentive to take on too much risk—not only more risk than creditors would prefer, but also more risk than would be socially optimal. Although creditors can limit this problem to some extent—for example, by insisting that borrowers agree to risk-controlling terms in their loan agreements—their control over shareholder risk taking can never be perfect. Accordingly, giving shareholders power to manage a company carries with it the risk that shareholders will make socially inefficient decisions.

It is evident, therefore, that the decision about what role shareholders should play in management presents a subtle problem of legal engineering. Shareholders should not be given control over all decisions a company has to make—this would be unworkable and not in anyone's best interests. On the other hand, if shareholders were cut out of any role in management, the result would be equally undesirable: People whose interests do not necessarily align with those of the firm will make all the decisions, and, not being subject to checks and balances, will often serve their own interests rather than the interests of the company or of society as a whole.

The law's answer to the problem is that shareholders get to make *fundamental* decisions and the board of directors and senior managers get to make the others. Four decisions are treated as fundamental in this sense:

- Election of the board of directors: While shareholders don't make managerial decisions, they do select who, at the highest level, does make these decisions: the members of the board of directors.
- Changes in the company charter: Shareholders vote on changes in the company's charter. Shareholder power over charter amendments, however, is generally an up-or-down vote on proposals placed on the ballot by the board of directors; they don't draft or propose amendments on their own.
- Fundamental corporate changes: Shareholders vote on fundamental corporate changes: mergers, sales of substantially all the assets, or dissolutions.
- Selection of the company's independent auditor: The law doesn't usually require a shareholder vote on the selection of a company's independent auditor. However, many large companies allow shareholders to vote on whether to ratify the selection of the independent auditor.

Questions and Comments

1. In general, shareholders have a right of approval when substantially all the assets of their firm are sold to another company, but not when their company acquires substantially all the assets of another company. The reason is that big companies often acquire substantially all the assets of smaller firms; it would not make sense if shareholders of the acquiring firm had to vote on each such acquisition. However, clever lawyers can structure a transaction such that—in form if not in substance—a big company sells substantially all its assets to a smaller firm. The result will be that the shareholders of the smaller company may lose certain legal protections, including the right to vote on the deal or the right to obtain a judicial appraisal of the consideration they receive. State courts disagree over whether the form of the transaction should prevail over the substance in this circumstance. *Compare* Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958) (giving shareholders the same rights as they would receive in a statutory merger) *with* Hariton v. Arco Electronics, Inc., 182 A.2d 22 (Del. Ch. 1962), *aff'd*, 188 A.2d 123 (Del. 1963) (privileging form over substance).

2. Several studies find that audit fees tend to be higher in companies that allow shareholders to vote on auditor selection; on the other hand, companies that submit the auditor's selection for shareholder ratification also have a lower likelihood of experiencing a restatement of earnings. How do you interpret these findings?

3. Should shareholder votes to ratify the selection of a company's independent auditor be mandatory, rather than in the discretion of the company's managers?

4. Although shareholders have the right to vote on charter amendments, managers can make important changes in a company's governance through board actions that do not require shareholder vote. Examples include "poison pill" shareholder rights plans, which can reduce the chance that a company will be acquired in a hostile takeover, see Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985); and bylaw amendments designating Delaware courts as the sole forums for lawsuits alleging breach of fiduciary duty in Delaware corporations, see Boilermakers Local 154 Retirement Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013).

5. A shareholder vote isn't necessarily the end of the story. Consider the case of Big Lots, a Fortune 500 retailing company. In 2013, shareholders unhappy with the company's executive compensation policies obtained a "no" vote against the re-election of independent board member Russell Solt. It was then up to the remaining board members to fill the resulting vacancy; they deliberated and decided to appoint—Solt! A spokesman for the company explained that the board had interpreted the "no" vote on Solt as an expression of dissatisfaction with the company's governance in general rather than as a referendum on Solt. Because the board had taken substantive actions to address the governance concerns, including revamping its executive compensation policies, it deemed it best for the company to retain Solt in his position—and made him the chairman of its compensation committee to boot.

The traditional topics for shareholder vote—election of directors, charter amendments, fundamental corporate changes, and ratification of independent auditors—can all be understood as efforts to draw the line between cases where shareholder voting is desirable and when it is not. However, critics of American

corporate governance have long complained that these powers mean little. For reasons already mentioned, most shareholders are rationally indifferent about the affairs of their corporations; they will usually go along with management's recommendations unless something is much amiss. Moreover, many shares were traditionally voted by institutional investors who abided by the "Wall Street Rule": Either vote with management, or if you don't like what management is doing, sell your shares. The result, in the view of many critics, was that shareholders had little control over management even in the limited areas where they officially enjoyed rights to express their opinion. Do you agree with the critics? Consider in this regard the following excerpts, which take different positions about the value of shareholder power.

Lucian Bebchuk, The Case for Increasing Shareholder Power

118 Harv. L. Rev. 833 (2005)*

This article reconsiders the basic allocation of power between boards and shareholders in publicly traded companies with dispersed ownership. U.S. corporate law has long precluded shareholders from initiating any changes in the company's basic governance arrangements. Professor Bebchuk's analysis and his empirical evidence indicate that shareholders' existing power to replace directors is insufficient to secure the adoption of value-increasing governance arrangements that management disfavors. He puts forward an alternative regime that would allow shareholders to initiate and adopt rules-of-the-game decisions to change the company's charter or state of incorporation. Providing shareholders with such power would operate over time to improve all corporate governance arrangements.

Furthermore, Professor Bebchuk argues that, as part of their power to amend governance arrangements, shareholders should be able to adopt provisions that would give them subsequently a specified power to intervene in additional corporate decisions. Power to intervene in game-ending decisions (to merge, sell all assets, or dissolve) could address management's bias in favor of the company's continued existence. Power to intervene in scaling-down decisions (to make cash or in-kind distributions) could address management's tendency to retain excessive funds and engage in empire-building. Shareholders' ability to adopt, when necessary, provisions that give themselves a specified additional power to intervene could thus produce benefits in many companies.

A regime with shareholder power to intervene, Professor Bebchuk shows, would address governance problems that have long troubled legal scholars and financial economists. These benefits would result largely from inducing management to act in shareholder interests without shareholders having to exercise their power to intervene. Professor Bebchuk also discusses how such a regime could best be designed to address concerns that supporters of management insulation could raise; for example, shareholder-initiated changes in governance arrangements could be adopted only if they enjoy shareholder support in two consecutive annual meetings. Finally, examining a wide range of possible objections, Professor Bebchuk concludes that they do not provide a good basis for opposing the proposed increase in shareholder power.

* The following is excerpted from an abstract of Professor Bebchuk's article.

Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights

53 UCLA L. Rev. 601 (2006)

. . . [I]n large corporations, authority-based decision making structures are desirable because of the potential for division and specialization of labor. Bounded rationality and complexity, as well as the practical costs of losing time when one shifts jobs, make it efficient for corporate constituents to specialize. Directors and managers specialize in the efficient coordination of other specialists. In order to reap the benefits of specialization, all other corporate constituents should prefer to specialize in functions unrelated to decision making, such as risk-bearing (shareholders) or labor (employees), delegating decision making to the board and senior management. This natural division of labor, however, requires that the chosen directors and officers be vested with discretion to make binding decisions. Separating ownership and control by vesting decision making authority in a centralized nexus distinct from the shareholders and all other constituents is what makes the large public corporation feasible.

Even if one could overcome the seemingly intractable collective action problems plaguing shareholder decision making, active shareholder participation in corporate decision making would still be precluded by the shareholders' widely divergent interests and distinctly different levels of information. Although neoclassical economics assumes that shareholders come to the corporation with wealth maximization as their goal, and most presumably do, once uncertainty is introduced it would be surprising if shareholder opinions did not differ on which course would maximize share value. . . . Shareholder investment time horizons are likely to vary from short-term speculation to long-term buy-and-hold strategies, for example, which in turn is likely to result in disagreements about corporate strategy. Even more prosaically, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as are shareholders who disagree about the merits of allowing management to invest the firm's free cash flow in new projects. . . .

Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly, of course. Even if one could do so, moreover, shareholders lack both the information and the incentives necessary to make sound decisions on either operational or policy questions. . . . Accordingly, shareholders will prefer to irrevocably delegate decision making authority to some smaller group, as, in the long run, this will maximize shareholder wealth.

What is that group? The Delaware Code, like the corporate law of virtually every other state, gives us a clear answer: The corporation's "business and affairs . . . shall be managed by or under the direction of a board of directors." . . .

Questions and Comments

1. If corporations are democracies, then why shouldn't shareholders exercise genuine power to guide the decisions corporations make? Are there significant differences between shareholder voting and voting in political elections?

2. Does Bebchuk address the problem that the interests of shareholders don't fully align with the interests of society, because shareholders have an incentive to cause their companies to take on more risk than society would prefer?

3. Bainbridge, in support of the traditional allocation of authority between shareholders and managers, argues that the separation of ownership and control is not a problem but rather a solution to a problem. Corporations can't be run effectively by shareholders as a whole; they need to delegate responsibility to specialists who will make decisions on a timely and informed basis. How does Bainbridge deal with the problem that, given free rein, managers will be tempted to favor their own interests over the interests of the firms they are charged with managing?

4. Bainbridge objects to shareholder power on the ground that shareholders often disagree about what to do. Is this really a problem? Why not let the shareholders decide by majority vote?

5. In a part of his article not excerpted above, Bainbridge argues that shareholders are not well equipped to make sensible decisions about management because they rely on the market price. If the price of a company's stock is low—indicating that management is not performing well—the shareholder can simply sell rather than take the trouble of becoming informed about how and why management is falling down on the job. Do you agree?

6. What is the proper role of the board of directors in interacting with shareholders? Should board members be passive and allow the company's senior managers and investor relations department to take the leading oar, or should they take a more active role? For an analysis favoring the latter, see Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. Ill. L. Rev. 821.

7. For a further response to Bebchuk's call for increased shareholder power, written by the Chief Justice of the Delaware Supreme Court, see Leo Strine Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 Colum. L. Rev. 449 (2014).

8. Even when shareholders combine forces, their powers may be limited in the face of determined resistance by the incumbent managers. In 2014, shareholders of oil company Nabors Industries Ltd. rejected all three members of the board's compensation committee. No matter: The board of directors simply reappointed them (although it moved two of them off its compensation committee). The company issued an announcement praising the rejected directors and explaining the steps it had undertaken to improve governance and reform its executive pay practices.

B. SHAREHOLDER PROPOSALS

Dissatisfaction with management's power vis-à-vis shareholders is one motivation for the Securities and Exchange Commission's (SEC) rule on shareholder proposals. Notice in the following excerpt that the rule is not phrased in classic "legalese." Instead it is set forth in a question-and-answer format and written, so far as possible, in "plain language" that ordinary people can understand.

Securities and Exchange Commission Rule 14a-8

17 C.F.R. §240.14a-8

This section addresses when a company must include a shareholder's proposal in its proxy statement and identify the proposal in its form of proxy when the company

holds an annual or special meeting of shareholders. In summary, in order to have your shareholder proposal included on a company's proxy card, and included along with any supporting statement in its proxy statement, you must be eligible and follow certain procedures. Under a few specific circumstances, the company is permitted to exclude your proposal, but only after submitting its reasons to the Commission. We structured this section in a question-and-answer format so that it is easier to understand. The references to "you" are to a shareholder seeking to submit the proposal.

What Is a Proposal?

A shareholder proposal is your recommendation or requirement that the company and/or its board of directors take action, which you intend to present at a meeting of the company's shareholders. Your proposal should state as clearly as possible the course of action that you believe the company should follow. If your proposal is placed on the company's proxy card, the company must also provide in the form of proxy means for shareholders to specify by boxes a choice between approval or disapproval, or abstention. Unless otherwise indicated, the word "proposal" as used in this section refers both to your proposal, and to your corresponding statement in support of your proposal (if any).

Who Is Eligible to Submit a Proposal, and How Do I Demonstrate to the Company That I Am Eligible?

In order to be eligible to submit a proposal, you must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date you submit the proposal. You must continue to hold those securities through the date of the meeting. . . .

Who Has the Burden of Persuading the Commission or Its Staff That My Proposal Can Be Excluded?

Except as otherwise noted, the burden is on the company to demonstrate that it is entitled to exclude a proposal. . . .

If I Have Complied with the Procedural Requirements, on What Other Bases May a Company Rely to Exclude My Proposal?

(1) Improper under state law: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization; . . . Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise.

(2) Violation of law: If the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject; . . .

(3) Violation of proxy rules: If the proposal or supporting statement is contrary to any of the Commission's proxy rules . . . ;

(4) Personal grievance; special interest: If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is

designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large;

(5) Relevance: If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;

(6) Absence of power/authority: If the company would lack the power or authority to implement the proposal;

(7) Management functions: If the proposal deals with a matter relating to the company's ordinary business operations;

(8) Director elections: If the proposal:

(i) Would disqualify a nominee who is standing for election;

(ii) Would remove a director from office before his or her term expired;

(iii) Questions the competence, business judgment, or character of one or more nominees or directors;

(iv) Seeks to include a specific individual in the company's proxy materials for election to the board of directors; or

(v) Otherwise could affect the outcome of the upcoming election of directors.

(9) Conflicts with company's proposal: If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting; . . .

(10) Substantially implemented: If the company has already substantially implemented the proposal; . . .

(11) Duplication: If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting;

(12) Resubmissions: If the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company's proxy materials within the preceding 5 calendar years, a company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the proposal received [a specified low percentages of the vote].

(13) Specific amount of dividends: If the proposal relates to specific amounts of cash or stock dividends. . . .

Questions and Comments

1. What do you think of the SEC's catechism-style of regulation?

2. The rule, in form, gives proponents broad rights to include proposals on the company's proxy statement, but also gives companies broad and vaguely defined justifications for excluding the proposals. Litigation over the rule tends to turn on the interpretation given to one or another of the exclusions.

3. Exclusion (1) covers proposals that are "improper under state law." In general, as noted above, state laws restrict the scope of shareholder authority. Thus, any proposal that purported to impose mandatory duties on a company's managers would potentially run afoul of this provision. In practice, advocates avoid this hurdle by phrasing their proposals as recommendations, suggestions, or requests—thus purporting to make the votes advisory only. In addition to surmounting a potentially fatal legal objection, the softening of proposals into requests or recommendations

has the advantage of making them appear more reasonable, and therefore potentially swinging undecided votes. You can see that the SEC is receptive to this strategy: It assumes that proposals couched as requests for management action are proper unless the company can demonstrate that they are not.

4. The fourth ground for exclusion concerns proposals that relate to a "personal grievance" or a "special interest." In theory, the SEC could have interpreted this exclusion broadly to apply to proposals, regardless of the topic, which are put forward by individuals or institutions for purposes of advancing a particular political or social agenda. Unions, for example, tend to dislike Walmart because they view its policies as being hostile to the cause of unionization in its stores. Suppose that a labor union, for the apparent purpose of embarrassing or pressuring Walmart, makes a proposal for shareholder vote at Walmart that doesn't have anything in particular to do with union interests. The SEC has consistently taken the position in such cases that it will not look behind the proposal to the possible motivations of the proponent: If the proposal itself doesn't relate to a special interest of the proponent, the proponent's underlying strategy is not considered.

5. Proponents who wish to influence a company would obtain leverage if they could put their own director candidates on the ballot. Since voting on directors is a proper subject for shareholder action, such a proposal is probably not excludable on the ground that it is not authorized by law. However, exclusion (8) allows a company to reject any attempt to nominate a director and even any proposal that "could affect the outcome of the upcoming election of directors." This rule seems to interpose a significant obstacle to shareholder proposals that affect voting for directors. What is the purpose of excluding such proposals? If the selection of directors is truly fundamental to shareholder welfare, why not expand the shareholder franchise in this respect?

6. Does exclusion (8) completely bar attempts to influence shareholder elections? In American Federation of State, County & Municipal Employees v. American International Group, Inc., 462 F.3d 121 (2d Cir. 2006), a union submitted a proposal that would amend AIG's bylaws to require the company to publish the names of shareholder-nominated candidates for director positions. The union argued that the proposal survived exclusion (8) because it did not relate to any particular election but rather sought to establish a procedure to govern elections generally. Rejecting the interpretation offered by the SEC, the court agreed with the union. The text of Rule 14a-8 excerpted above reflects the court's interpretation.

7. What about exclusion (5), allowing management to reject a proposal if it "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business"? This seems to provide broad authority to exclude proposals that don't relate to core company activities. However, the exclusion has proven to be less effective than managers of targeted companies might wish. Proposals for reforming corporate governance, for example, are often allowed on the ballot even though the proponent cannot demonstrate that, if implemented, they would have a material impact on the company's financial results; the SEC's theory is that, whether or not the results can be quantified, anything having to do with governance is probably important and therefore qualifies as a matter "significantly related to the company's business." Proposals on matters of current political debate are also often allowed, even though they relate to a small portion of the company's

business; here the theory is that if the company gets swept up in controversy the result could be bad for its financial position. *See* Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554 (D.D.C. 1985) (the term "otherwise significantly related" includes matters of ethical and social significance).

8. Rule14a-8(i)(9) allows management to exclude shareholder proposals that directly conflict with one of the company's own proposals to be submitted to shareholders at the same meeting. This opens the possibility that management will repetitively submit proposals for action that are inconsistent with a proposal that management knows or suspects will be forthcoming by shareholder activists, and then use the management proposal as a rationale for excluding the shareholder proposal.

For example, on September 13, 2013, a shareholder submitted a proposal to the board of The Walt Disney Company requesting that the board take the steps necessary to allow holders of 10 percent of Disney stock to call a special shareholders meeting. Disney's board responded on October 4, 2013 by voting to submit its own proposal, which would authorize a special meeting only if called by 25 percent of the shareholders. Disney then sought and obtained a no-action letter from the SEC allowing the company to exclude the shareholder's proposal on the ground that it directly conflicted with the company's version. Since the chance that 25 percent of the shareholders would call for a special meeting is extremely low, the effect was to nullify the shareholder's initiative.

9. Section 971 of the Dodd-Frank Act, 15 U.S.C. §78n(a)(2), provides that the SEC may adopt a rule requiring that "a solicitation of proxy, consent, or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer"; and "a requirement that an issuer follow a certain procedure in relation to a solicitation. . . ." In other words, the SEC may allow shareholders to nominate directors.

In 2010, the SEC adopted Rule 14a-11, which required reporting companies to include in proxy materials the name of persons nominated by qualifying shareholders for election to the board of directors. The rule provided that, to qualify, a shareholder or group of shareholders must have continuously held at least 3 percent of the voting power of the company's securities for at least three years prior to the date the nominating shareholder or group submits notice of its intent to use the rule, and must continue to own those securities through the date of the annual meeting. However, business interests successfully challenged the rule on the ground that the SEC had failed to conduct a statutorily required cost-benefit analysis. Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). As a result, the rule never became effective. Is Rule 14a-11 a good idea? What are the pros and cons?

C. SAY ON PAY

Section 951 of the Dodd-Frank Act, 15 U.S.C. §78n-1, requires that "[n]ot less frequently than once every 3 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives. . . ."

Congress thus mandated shareholder votes on management compensation in firms subject to the proxy rules. Shareholders can by resolution determine whether these votes must occur more frequently than once every three years. These "say-on-pay" votes are advisory only; management is legally permitted to ignore them. However, if a pay package is disapproved by shareholders, it could be unwise for a company's managers to flout the shareholders' express wishes.

Questions and Comments

1. Although SEC-reporting companies are required to hold say-on-pay votes only every three years (subject to shareholder override), most have elected to hold these votes every year. This decision may reflect a change of heart on the part of management in favor of giving shareholders more power in the compensation process. Other factors may enter the calculation as well: the concern that anything less frequent than annual say-on-pay votes would appear uncharitable and defensive, or possibly the hope that annual voting will lose its novelty value and therefore its salience to many shareholders.

2. In general, shareholders have approved management pay packages. Of 2,215 companies in the Russell 3000 index that held say-on-pay votes in 2012, only 57 failed to gain approval. 73 percent of companies received more than 90 percent approval votes on their pay packages in 2012.

3. A *Wall Street Journal* study in 2013 found that compensation of senior managers had remained relatively flat for the previous three years—suggesting that the say-on-pay rules that went into effect in 2011 may have had some effect (although it is difficult to disentangle the effect of say on pay from the lingering influence of the financial crisis of 2007-2009). Regardless, managers are hardly suffering. According to Fortune Magazine, every one of the 100 highest paid CEOs in the United States made more than $15 million in 2012; the highest paid was John H. Hammergren of McKessen, who brought in a cool $131 million (and change).

4. The following factors appear to influence a "no" vote:

   a. Poor performance: Companies that are performing badly relative to comparable institutions are more likely to experience negative say-on-pay votes.
   b. Generous packages: Pay packages that appear significantly more generous than the packages at peer group institutions are more likely to be rejected.
   c. Prior "no" votes: Pay packages appear more likely to be rejected if shareholders rejected a package in a previous vote.
   d. Negative recommendations from proxy advisory firms: An important factor in say on pay is the view of proxy advisory firms. Two firms—Institutional Shareholder Services, Inc. (ISS) and Glass, Lewis & Co.—dominate proxy advisory services. Together, they counsel clients that control 25 to 50 percent of the voting shares of large U.S. firms. In 2012, 94 percent of say-on-pay votes passed when ISS recommended a vote to approve the package but only 64 percent received shareholder endorsement where ISS recommended disapproval.

5. Arguably, the say-on-pay process will result in greater uniformity of management compensation practices—the theory being that companies wishing to avoid

a "no" vote will structure their pay packages so as to be justifiable in light of what everyone else is doing. Would this be a constructive development? Is there a value in experimentation or in providing exceptional pay for exceptional results? Could management compensation consultants engineer a gradual change in pay practices that "raises all the ships"—thus effectively increasing executive pay over what it had been before say on pay?

6. Say on pay represented a victory for activists who had long promoted the idea as a counterweight to exorbitant executive compensation. Yet, could the success boomerang? In the past, companies that enriched their executives were vulnerable to criticism for flouting shareholder interests. Now, if a pay package survives a say-on-pay vote, the company has a built-in defense to criticism: The package was submitted to shareholders, with full disclosure, and they approved.

7. The United States is far from the only country to experiment with shareholder votes on compensation. Much of the impetus for say on pay came from other countries: a 2004 recommendation by the European Commission and a G-20 declaration in 2009. In 2013, the United Kingdom revised its company law to split the report to shareholders on remuneration into two parts: (a) an "implementation report" that discloses how the company's policy has been implemented in the previous year, and (b) a "policy report" that discloses the company's current remuneration policies for executives. The implementation report is subject to a non-binding shareholders' vote every year. The policy report, however, is subject to a binding shareholder vote at least once every three years—a significant change as compared with prior practice. Perhaps surprisingly, stodgy Switzerland has gone even further: In March 2013, Swiss voters required public companies to give shareholders a binding (not advisory) annual vote on senior executive pay.

8. Voting on pay packages is only as good as the information available to shareholders. The SEC has long required reporting companies to disclose information about executive compensation, but has upgraded the requirements in recent years. Item 402 of the SEC's regulation S-K requires "clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to [officers and directors] by any person for all services rendered in all capacities to the registrant and its subsidiaries, unless otherwise specifically excluded from disclosure." Supplementing this Rule, §953(b) of the Dodd-Frank Act instructs the SEC to mandate disclosure of "(A) the median of the annual total compensation of all employees of the issuer, except the chief executive officer . . .; (B) the annual total compensation of the chief executive officer . . .; and (C) the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B)." The SEC adopted a final rule implementing this requirement in 2015.

9. In practice, reporting firms tend to offer even more fulsome disclosures about executive compensation than the SEC requires. Open the proxy statement of any major company and you are likely to find pages devoted to an elaborate analysis of the firm's compensation philosophy and practices. Why are firms so forthcoming? Is it because they wish to provide all the information shareholders need in order to make an informed vote on compensation? To demonstrate their commitment to the say-on-pay process, and thus dissuade activists or proxy advisory firms from targeting them? To overwhelm shareholders with detail in hopes that they will throw up their hands and vote "yes"?

10. What is the purpose of requiring disclosure of the ratio between the chief executive officer's pay and that of the median employee? Is this information