CORPORATE GOVERNANCE, POLITICS, AND THE SEC

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I am delighted to have been asked to write this foreword for the *Harvard Business Law Review*. The *Review* is a welcome addition to the field of legal publications, especially given the need to stimulate debate on appropriate responses to the financial crisis. One focus of recent legislative action has been an expansion of the role of the Securities and Exchange Commission in regulating corporate governance. In this issue, articles by Professors J. Robert Brown, Jr. and Mark J. Roe highlight the interaction between federal and state law on corporate governance and disclosure. Both authors examine the tension and uncertainty that result from this interaction given that corporations are creatures of state, rather than federal, law.

Publicly held corporations typically solicit votes or consents by proxy from their shareholders with respect to any proposed action requiring shareholder approval. This solicitation process involves the SEC because of its statutory role in overseeing disclosure in a company's proxy statement.[1] During this process, the SEC acts as a gatekeeper that decides under its rules whether shareholders' proposals must be included in a company's proxy statement at the company's expense.

I was appointed Director of the Division of Corporation Finance of the SEC in March 1979. In September 1980, under the direction of Chairman Harold Williams, the SEC issued a staff report prepared by my division entitled *Corporate Accountability: A Re-examination of Rules Relating to Shareholder Communications and Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally*.[2] At that stage in the SEC's history, although the agency oversaw the disclosure in a company's proxy statement and developed rules requiring certain shareholder proposals to be included, there was no federal mandate as to how much access shareholders had as a matter of right to the company's proxy statement or which issues had to be submitted to a shareholder vote under federal law. The SEC rules relating to including shareholder proposals in company

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[1] *See* Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n (2012); 17 C.F.R. § 240.14a-8 (2012).

[2] Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, Staff Report on Corporate Accountability: A Re-examination of Rules Relating to Shareholder Communication, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally (Sept. 4, 1980) (printed for the use of S. Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.) [hereinafter Staff Report].

proxy statements were deferential to what was required or permitted under state corporate law, in particular Delaware law. Consequently, shareholders were denied access to the company's proxy statement to contest a board election by proposing an alternate slate of directors and dissenting shareholders were required to solicit their own proxies at their own expense. Most proposals permitted to be included under the SEC's rules were precatory, that is, not binding on the company.

Recent federal legislation, including the Sarbanes-Oxley Act[3] and the Dodd-Frank Act,[4] has imposed new requirements on publicly held companies with respect to disclosure, governance, and proxy access. The stated goal of these requirements is to enhance corporate governance and accountability. As a consequence, the SEC's interaction with traditional state corporate governance has increased and become more complicated, most significantly as a result of Dodd-Frank's provisions relating to board structure,[5] executive compensation (including advisory say-on-pay votes and certain compensation-related disclosures),[6] and proxy access.[7] Further, disclosures mandated in legislative enactments, such as Dodd-Frank's provisions on median compensation and executive compensation, are increasingly being used to directly influence actions by corporations.[8]

In recent decades, state corporate governance has been dominated by Delaware, where most major corporations have chosen to incorporate. The traditional explanation for Delaware's dominant position is that states compete for incorporation fees, and that Delaware, the state most friendly to corporate management, has emerged as the most desirable home. In their contribution to this issue, Professors William J. Carney, George B. Shepherd, and Joanna Shepherd Bailey offer evidence to support an alternative explanation: Delaware's preeminence in the legal industry and legal education helps it maintain and increase its dominance.[9]

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[3] Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[5] *Id.* § 165 (requiring that certain covered financial services companies have mandatory risk committees to promote sound risk management); *id.* § 952 (requiring greater independence for compensation committees); *id.* § 956 (requiring disclosure of incentive-based compensation structures for covered financial institutions).

[6] *Id.* § 951 (requiring companies to solicit advisory say-on-pay and golden parachute votes from shareholders); *id.* § 953 (requiring executive compensation disclosures); *id.* § 954 (requiring companies to institute "clawback" provisions).

[7] *Id.* § 971 (granting explicit authority to the SEC to adopt rules giving shareholders access to the company's proxy statement to propose competing candidates for election as directors).

[8] *Id.* § 953(b); *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), http://www.hblr.org/?p=1751 (noting that § 953(b) provides critical information to both shareholders and the board so that they may more effectively rein in excessive executive compensation).

[9] William J. Carney, George B. Shepherd & Joanna Shepherd Bailey, *Lawyers, Ignorance, and the Dominance of Delaware Corporate Law*, 2 HARV. BUS. L. REV. 123 (2012).

The contributions by Professors Brown and Roe examine how the debate on corporate governance has been influenced by larger political forces in the United States. As Professor Brown relates, in recent decades Congress has increasingly directed the SEC to become more involved in the corporate governance process through the mechanisms of disclosure and proxy access, state law notwithstanding. This intrusion has not been without certain costs, uncertainties, and inconsistencies.[10] Brown argues that the regulatory philosophy of the SEC at any given time tracks the politics of the political party in power, the consequences of which are increased politicization of the agency as well as major changes in approach as a result of changes in administrations. Thus, the challenge with respect to the role of the SEC remains an issue principally because of the SEC's highly discretionary authority as to what must be included in or may be excluded from a company's proxy statement. Brown recommends reforms to reduce the politically charged dimension of this discretion accorded to the SEC's staff by providing more transparent and objective standards about how the rules should operate.

Professor Roe's article reviews the broader political economy interests at work. He tracks what he sees as the SEC's dithering response with respect to proxy access by shareholders since the accounting scandals of Enron and WorldCom. He highlights the efforts of pro-management interest groups in Delaware to influence the choices available to the SEC in implementing federal law.[11] Roe stipulates that management-friendly interest groups anticipated the SEC's mandatory shareholder access proxy rule, Rule 14a-11, the authority for which was provided by Dodd-Frank. These interests sought to preempt the SEC by lobbying the Delaware state legislature to add to its corporate code § 112, a weaker and non-mandatory shareholder proxy access alternative to the eventual Rule 14a-11. Roe argues that this preexisting shareholder access rule within the Delaware corporate code helped sway the D.C. Circuit Court of Appeals to strike down Rule 14a-11 in *Business Roundtable and Chamber of Commerce v. SEC*.[12]

Now that the D.C. Circuit has struck down the SEC's proxy access rule, shareholders' access to the corporate ballot is limited to that provided by Delaware's weak § 112, the use of which itself requires an expensive proxy battle. The result is that shareholder access to the corporate boardroom continues to be limited, leaving the balance of power tilted in favor of the board of directors rather than the owners of the corporation. Accordingly, Chairman Williams's concluding remarks from the SEC's 1980 *Corporate Accountability* report remain relevant today:

[10] J. Robert Brown, Jr., *The Politicization of Corporate Governance: Bureaucratic Discretion, the SEC, and Shareholder Ratification of Auditors*, 2 HARV. BUS. L. REV. 61 (2012).

[11] Mark J. Roe, *The Corporate Shareholder's Vote and Its Political Economy, in Delaware and in Washington*, 2 HARV. BUS. L. REV. 1 (2012).

[12] 647 F.3d 1144 (D.C. Cir. 2011).

> The answers to the ultimate questions regarding an independent and vigorous corporate sector will, in the end, depend upon the wisdom and sensitivity of decision-making in these board rooms; whether the boards consider the long-term consequences of their actions or satisfy themselves with short-term expediencies; and finally, whether they recognize appropriately the legitimate interests of the society at large.[13]

By advancing the debate on corporate governance in the United States, the *Harvard Business Law Review* continues to provide insights into the most pressing issues in today's marketplace.

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[13] Staff Report, *supra* note 2, at 12.