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# **DOES SHAREHOLDER PROXY ACCESS DAMAGE SHARE VALUE IN SMALL PUBLICLY TRADED COMPANIES?**

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# DOES SHAREHOLDER PROXY ACCESS DAMAGE SHARE VALUE IN SMALL PUBLICLY TRADED COMPANIES?

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*The field of corporate governance has long considered the costs of the separation of ownership from control in publicly traded corporations and the regulatory and market structures designed to limit those costs. The debate over the efficiency of regulations designed to limit agency costs has recently focused on the SEC's new rule requiring companies to include shareholder nominees on the company financed proxy statement to facilitate insurgent challengers to incumbent board members in board elections. A recent vein of empirical literature has examined the stock price effects of events surrounding the new proxy access rule. We present a study that focuses on small companies who expected an exemption from the rule under the Dodd-Frank legislation that preceded the adoption of the SEC rule. We consider the effect of the August 25, 2010 announcement of the proxy access rule, comparing its effect on the value of firms that expected to be subject to the full rule against its effect on the value of small firms unexpectedly given only a temporary exemption from part of the rule (Rule 14a-11) and no exemption from part of the rule (Rule 14a-8). Supporters of proxy access have long argued that it will enhance shareholder value. Critics of proxy access have argued that it will empower investors with conflicted agendas that will destroy shareholder wealth. The unexpected application of the rule to small-cap companies on August 25 provides a natural experiment for this question and allows us to examine the differential effect of the rule on firms above and below the arbitrary SEC cutoff of \$75 million dollars in market capitalization. We find that the unanticipated application of the proxy access rule to small firms, particularly when combined with the presence of investors with a 3% interest able to use the rule, resulted in negative abnormal returns. We present multiple methods to measure that effect and demonstrate losses for our sample of roughly 1,000 small companies of as much as \$335 million.<sup>1</sup>*

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1. We arrive at this figure by multiplying the coefficient .753, found in table 2, by the average market capitalization of the sample of firms with between \$25 and \$75 million market capitalization (\$47 million) and multiplied by the number of firms in the sample (980) to arrive at \$335 million.

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#### INTRODUCTION

The separation of ownership from control has long been a focal point for debate in corporate governance literature. Much of the academic community views shareholders as facing a collective action problem in exercising their right to vote in elections for directors of publicly traded corporations. It is argued that finding ways to empower shareholders, for instance, by making election contests easier or less costly, will generate positive shareholder returns through a reduction in agency costs. A few members of the academic community have urged caution, citing the benefits of a director-centric structure or the risks of conflicted shareholders using their voting rights to push social or political agendas.

The most recent and lively iteration of this debate has been over granting shareholders access to the corporate proxy. Under the status quo incumbent directors have their election expenses, including the cost of sending out proxies, paid for by the company. The proxy card, essentially an absentee voting card, is the primary voting and vote solicitation vehicle for director elections because most shareholders do not attend the company’s annual meeting. Proponents of shareholder empowerment have pushed in recent years to give shareholders, under certain circumstances, the right to include nominees on the company proxy card rather than requiring challengers to send out their own proxy card. The U.S. Securities and Exchange Commission (“SEC”) considered proposed rules to provide for proxy access three times in the last decade, but, owing to

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the controversial nature of the topic, did not follow through with those proposals.

On August 25, 2010 the SEC adopted a rule granting shareholders with over a 3% equity interest in publicly traded companies the right to place nominees on the company's proxy statement. The rule was adopted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The Dodd-Frank Act gave the SEC authority to adopt the rule, but instructed the SEC to consider an exemption for small firms.

The language of the Dodd-Frank Act led to three surprise events on August 25, 2010 that each increased the probability and magnitude of proxy access use at small firms compared to expectations based on the initial Dodd-Frank legislation released on June 25, 2010. The rule ultimately adopted by the SEC did not permanently exempt small firms from the proxy access rule. Instead, it gave small firms only a temporary exemption from one section of the proxy access rule (Rule 14a-11) which provided for a minimum proxy access default rule, and provided for immediate application for another section of the proxy access rule (Rule 14a-8) which allowed shareholders to modify the SEC's default rule to make it easier for shareholders to use. Additionally, the SEC's proposed rule in 2009 required 5% stock ownership for a shareholder to use proxy access at small firms, but the rule adopted on August 25, 2010 would require only 3% ownership, making it much easier for shareholders to use proxy access at small firms than shareholders would have assumed based on the SEC's prior proposal. The final rule therefore increased the likelihood of small firms experiencing proxy contests or dissident board members by denying a permanent exemption for small firms from Section 14a-11, by providing for immediate application of Rule 14a-8, and by decreasing the shareholder ownership barrier to proxy access for small firm shareholders. The unexpected nature of these events form a suitable experiment to determine the effect anticipated by shareholders of proxy access on small firm value.

Our paper rests on the assumption that shareholders of small firms anticipated a permanent exemption from Rules 14a-11 and 14a-8, and that, even if the proxy access rule applied to them, it would require a 5% ownership threshold to limit use of the mechanism. We considered the possibility of an alternative explanation to our assumption that the market anticipated a complete opt-out from the rule, and considered whether it could be that the market already knew of the details of the August 25 rule prior to its announcement. There are three reasons why this is unlikely. First, no publicly available comment from legislators or regulatory officials at the SEC prior to August 25 indicates the unexpected changes. Second, no available news media on the topic of proxy access hints at the changes prior to the event, and the SEC's news release describing the new rule was not released until the meeting at which the rule was adopted. Third, the SEC staff are subject to stringent ethics rules which provide criminal and civil penalties in the event the staff shares information with indi-

viduals they are aware will trade on the information.<sup>2</sup> Our results will remain consistent as long as shareholders viewed it to be more likely than not that a full exemption and a higher ownership threshold would be included in the August 25 rule, indeed if shareholders assumed a full exemption and a high ownership threshold for small firms was just barely more likely to be included in the August 25 rule than not then our results actually underestimate the negative impact of the rule on small firms.

This paper considers the existing institutional literature on shareholder proxy access, which precedes the debate leading up to the adoption of the proxy access rule in 2010. It also reviews the existing empirical literature on proxy access and shareholder empowerment. Two empirical studies considered the effect of an announcement of the proxy access rule on firm value using dates prior to the Dodd-Frank Act and discovered that events that increase (decrease) the probability of proxy access result in lower (higher) abnormal returns. Still another study considered the effect of the legal challenge to the rule, and the resulting announcement by the SEC that it would delay application of the rule until after the legal challenge has been resolved. None, however, have focused on the small firm exemption.

This paper's contribution to the debate is to offer a stock price event study to determine the stock price effects of the SEC's 2010 proxy access rule. It considers the date of August 25, 2010, when we assume the prevailing assumption was that firms with market capitalization of less than \$75 million would be exempt from the rule and a surprise announcement from the SEC revealed that they would be subject to part of the rule, only temporarily exempted from the remainder of the rule, and subject to a lower ownership threshold. Our focus is the disparate impact of the SEC's proxy access rule announcement on firms with a market capitalization of greater than \$75 million, which are subject to the rule, against firms with a market capitalization of less than \$75 million which are currently exempt for a three year period from only part of the rule. We also consider the effect of the presence of institutional owners with greater than 3% ownership.

We provide a methodological improvement over previous event studies in this area of research. Previous studies did analyze the effect of an event, but the nature of the event did not allow them to use a control group to precisely identify the effect of the event. Given that the 2010 proxy access rule applied differentially across an artificial divide (\$75 million market capitalization), we can not only examine how the event effected the firms that were only temporarily exempted by the SEC, but also how these firms performed relative to firms for whom the SEC announcement was not a surprise.

The objective of this study is to determine the unanticipated impact of the proxy access rule on firms with less than \$75 million in market capitalization,

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2. That is not to suggest it does not happen, merely that there are rules to disincentivize the practice.

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and whether, contrary to the rule's proponents, the rule might actually impose a net cost on small firms. In the event proxy access is perceived by the market to result in a net cost, some support will accrue to the hypothesis that conflicted objectives of some institutional investors limit the value of proxy access.

#### I. AGENCY COSTS AND SHAREHOLDER VOTING

A significant portion of corporate governance literature has considered the consequences of the separation of ownership from control in publicly traded companies. Some have argued in favor of new rules to empower shareholders as a way to minimize agency costs in the shareholder/board relationship.<sup>3</sup> Others have argued that doing so would empower special interests like union and state pension funds in a manner that may ultimately destroy shareholder value.<sup>4</sup>

The debate has its origins in the work of Berle and Means, who first considered the implications of the separation of ownership from control in publicly traded companies.<sup>5</sup> Bebchuk has argued in favor of shareholder access to the proxy as a means to limit agency costs, such as inappropriate compensation or shirking, and as a way to legitimize the deference typically given to directors in shareholder lawsuits.<sup>6</sup> Romano was one of the first commentators to urge caution in the shareholder primacy debate by noting that many shareholders, such as state pension fund investors run by elected officials or union pension funds run by union managers, may use increased shareholder leverage as a bargaining chip to push agendas unrelated to maximization of shareholder value.<sup>7</sup> Bainbridge has argued that the director-centric nature of the corporation, characterized by little actual power for shareholders, is not actually a problem to be solved.<sup>8</sup> His director primacy model instead holds that the board serves as a guardian for the various contracts that make up the corporation, and suggests

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3. See Letter from Lucian A. Bebchuk on Behalf of a Bi-Partisan Grp. of Eighty Professors of Law, Bus., Econ., or Fin. to Elizabeth M. Murphy, Sec'y, U.S. Sec. and Exchange Comm'n 2 (Aug. 17, 2009), available at <http://www.sec.gov/comments/s7-10-09/s71009-282.pdf> [hereinafter Bebchuk Comment Letter] (recommending that the SEC adopt its proposed proxy access rule and that "[i]n evaluating eligibility and procedural requirements, the SEC should also keep in mind that many institutional investors lack incentives to invest actively in seeking governance benefits that would be shared by their fellow shareholders.").

4. See, e.g., Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006). See also Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003).

5. Adolf A. Berle & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 90 (1932).

6. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 676 (2007).

7. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993).

8. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. REV. 547, 550-51 (2003).

that dissatisfied shareholders can always withhold their capital or sell their shares when they do not favor board decisions.<sup>9</sup>

The contents of the proxy card function as an absentee ballot in director elections. The proxy card is of primary importance in determining the election outcome as very few shareholders actually attend the election and nearly all shares voted at board elections occur through the proxy card.<sup>10</sup> The SEC adopted a rule in August of 2010 pursuant to the Dodd-Frank Act to require, under certain circumstances, that boards of directors include nominees of large shareholders for board elections on the company proxy statement.<sup>11</sup> Supporters of proxy access urged that the election process for membership on the board of directors of publicly traded companies is unfair, as the election expenses, including mailing of the proxy statement, are paid for by the company while challengers have to pay their own expenses.<sup>12</sup> Proponents of proxy access further argued that it would make boards more accountable to their shareholders and reduce agency costs.<sup>13</sup> Bebchuk, for example, urges that the low incidence of proxy contests demonstrates they are an underutilized mechanism for shareholder oversight of the board.<sup>14</sup>

Opponents of the rule focused on three distinct costs. First, they argued that the newly empowered interest groups would use proxy access as leverage to obtain side benefits.<sup>15</sup> For example, a union pension fund might use the threat of an election contest to obtain concessions from managers during bargaining over a company's labor contract with the union. Argawal presents evidence arguing that AFL-CIO affiliated shareholders tailor their support or opposition to management nominees depending on whether a union within the AFL-CIO umbrella represents employees at that company.<sup>16</sup> He also argues that his findings support the thesis that the differences are more pronounced at firms with a prior history of labor disputes, and that union pension fund opposition to management nominees to the board is associated with negative abnormal stock returns.<sup>17</sup>

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9. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 604 (2006).

10. Facilitating Shareholder Director Nominations, Securities Act Release No. 9,136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668, 56,670 (Sept. 16, 2010, adopted Aug. 25, 2010) [hereinafter Proxy Access Adopting Release] (*Rule 14a-11 vacated by* Bus. Roundtable v. SEC, No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011)).

11. *Id.* at 56,674.

12. Bebchuk Comment Letter, *supra* note 3, at 2.

13. *Id.*

14. Bebchuk, *supra* note 6, at 687.

15. *E.g.*, Lipton & Rosenblum, *supra* note 4, at 79.

16. Ashwini Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting* 17 (Rev. of Fin. Stud., forthcoming; NYU Stern Working Paper Series No. Fin-08-006, 2010), available at <http://ssrn.com/abstract=1285084>.

17. *Id.* at 21, 26-27.

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Second, opponents argued that compliance with proxy access will result in more contested elections, which could cost anywhere from \$800,000 to \$3 million for smaller companies and \$4 million to \$14 million for larger companies.<sup>18</sup>

Third, critics considered the effect of what Grundfest has termed “megaphone externalities,” or the ability of groups to use proxy contests as a platform to raise social agendas only tenuously related to company practices, even in instances where the nominating shareholder knows with certainty that their campaign will be unsuccessful.<sup>19</sup>

By contrast, Kahan and Rock argue that proxy access is largely not important.<sup>20</sup> They argue in part that proxy access will have little effect on the full cost of a proxy contest, since the costs of hiring lawyers and advertising for one’s nominee is still the responsibility of shareholder challengers, and that the restrictions on proxy access will make its use highly difficult.<sup>21</sup> They also argue that even a successful proxy access contest will have little effect on targeted companies.<sup>22</sup>

This background to the debate helps to frame our study’s consideration of proxy access by way of a stock price event study, since nearly all proponents of proxy access have argued that it will directly result in increased shareholder value.<sup>23</sup>

## II. THE SEC AND THE PROXY ACCESS RULE

The Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”)<sup>24</sup> was adopted by Congress in response to the financial crisis of 2008.<sup>25</sup> As part of that law, Congress confirmed the SEC’s authority to adopt a rule granting shareholder access to the corporate proxy.<sup>26</sup> Proxy access is one

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18. Opening Brief of Petitioners at 18, *Bus. Roundtable v. SEC*, No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011), 2011 WL 2014800 at \*18, available at <http://www.centerforcapitalmarkets.com/keyissues/proxy-access>.

19. Joseph A. Grundfest, *The SEC’s Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 *BUS. LAW.* 361, 380-82 (2010).

20. Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access* 84 (Univ. of Pa., Inst. for Law & Econ. Research Paper No. 10-26, 2010; NYU Law and Econ. Research Paper No. 10-51, 2010), available at <http://ssrn.com/abstract=1695682>.

21. *Id.* at 84-85.

22. *Id.* at 87-88.

23. *E.g.*, Bebchuk, *supra* note 6, at 676.

24. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

25. See Jean Eaglesham, *Overhaul Grows and Slows*, *WALL ST. J.*, May 2, 2011, available at [http://online.wsj.com/article/SB10001424052748703346704576295873060349068.html?mod=ITP\\_moneyandinvesting\\_0](http://online.wsj.com/article/SB10001424052748703346704576295873060349068.html?mod=ITP_moneyandinvesting_0).

26. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 971(a)-(b), 124 Stat. 1376, 1915 (2010) (“The Commission may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of

of the most controversial issues considered by the SEC over the last ten years. Unions have strongly supported the rule and business groups have strongly opposed the rule.<sup>27</sup> But long before the current public debate, academics were considering the question at some length.<sup>28</sup>

The academic debate over shareholder empowerment informed the adoption of a rule that makes it easier for shareholders to run alternative solicitations. That rule was adopted by the SEC pursuant to the specific grant of authority in the Dodd-Frank Act. The events leading up to that rule all potentially affected stock prices, and so present a unique opportunity to consider how the market anticipates proxy access will affect securities prices. Our study adds to a growing literature that takes such an approach. Knowledge of the timeline of events leading up to the proxy access rule's adoption is required in order to understand the prevailing assumptions factored into stock prices on the day of the event. This will provide context for understanding how the event we target altered the existing market assumptions about whether the proxy access rule would apply to small firms and to what degree it would be utilized.

The following timeline presents a picture of the events leading up to the Dodd-Frank legislation authorizing the SEC to adopt the proxy access rule and the SEC's attempt to adopt a proxy access rule in response:

June 25, 2010: The House/Senate Conference Committee adds a provision to the Dodd-Frank Act in the early morning hours instructing the SEC to consider the effect of a proxy access rule on small-cap companies.<sup>29</sup>

June 29, 2010: The Dodd-Frank Act is reported out of the House/Senate Conference Committee.<sup>30</sup>

June 30, 2010: The Dodd-Frank Act is adopted by the House.<sup>31</sup>

July 15, 2010: The Dodd-Frank Act is adopted by the Senate.<sup>32</sup>

July 21, 2010: The Dodd-Frank Act is signed by the President.<sup>33</sup>

August 25, 2010: The SEC adopts the proxy access rule, including the small issuer 3-year exemption for Rule 14a-11, but does not exempt small firms from Rule 14a-8.<sup>34</sup> It also sets a 3% ownership requirement for shareholders

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securities for the purpose of nominating individuals to membership on the board of directors of the issuer . . .").

27. Proxy Access Adopting Release, *supra* note 10 at 56,669-71 & nn.29-36.

28. *E.g.*, Romano, *supra* note 7.

29. See Ted Allen, *Lawmakers Reach Deal on Proxy Access*, ISS GOVERNANCE BLOG (June 25, 2010, 12:03 AM), <http://blog.riskmetrics.com/gov/2010/06/lawmakers-reach-deal-on-proxy-access.html>.

30. H.R. REP. NO. 111-517 (2010) (Conf. Rep.)

31. 156 CONG. REC. H5,261 (2010).

32. 156 CONG. REC. S5,933 (2010).

33. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

34. Proxy Access Adopting Release, *supra* note 10, at 56,668.

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using the rule, in contrast to an earlier rule proposal in 2009 that contemplated a 5% ownership requirement for proxy access at small firms.<sup>35</sup>

Sept. 29, 2010: The Business Roundtable files petition in the Court of Appeals for the District of Columbia challenging the rule.<sup>36</sup>

October 4, 2010: The SEC announced it would delay implementation of the rule pending the outcome of the D.C. Circuit Case.<sup>37</sup>

July 22, 2011: The D.C. Circuit vacates Rule 14a-11 in *Business Roundtable v. SEC*<sup>38</sup>. The rule is found to be arbitrary and capricious because it did not meet the SEC's statutory obligation to consider the effect of rules on "efficiency, competition and capital formation." The Court found that the SEC failed to conduct sufficient cost-benefit analysis, including a lack of empirical support for the rule's anticipated effect on stock prices.<sup>39</sup> The SEC is currently considering its options for either challenging the holding or for re-issuing the rule based on further economic analysis sufficient to meet its burden as defined in the case.<sup>40</sup>

The 2010 proxy access rule had two key operational aspects. The first created a new regulation, Rule 14a-11, which mandated certain aspects of proxy access mechanics. Rule 14a-11 required publicly traded companies covered by the rule to include in the company proxy nominees put forward by shareholders, provided that the nominating shareholder held shares for the previous three years making up at least 3 percent of voting stock in the company.<sup>41</sup> Shareholders making use of proxy access are required to certify that they do not intend to use their nominations to facilitate an acquisition of control.<sup>42</sup> Shareholders are permitted to pool their shares to meet the 3% ownership requirement.<sup>43</sup> The second part of the rule, an amendment to Rule 14a-8, required companies to include in their proxy materials shareholder proposals to alter the process whereby proxy contests are conducted (provided that the shareholder proposal could make the mandatory Rule 14a-11 process easier for shareholders to conduct, but not more difficult).<sup>44</sup>

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35. *Id.* at 56,674-75.

36. Petition for Review, *Bus. Roundtable v. SEC*, No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011).

37. Order Granting Stay, *In re Motion for Stay of Effect of Commission's Facilitating Shareholder Director Nominations Rules*, Securities Act Release No. 9,149, Exchange Act Release No. 63,031, Investment Company Act Release No. 29,546 (Oct. 4, 2010).

38. No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011).

39. *Id.* at \*10.

40. See Steven M. Davidoff, *Proxy Access in Limbo After Court Rules Against It*, DEALBOOK (July 27, 2011, 3:36 PM), <http://dealbook.nytimes.com/2011/07/27/proxy-access-in-limbo-after-court-rules-against-it/>.

41. Kahan & Rock, *supra* note 20, at 10.

42. *Id.* at 10-11.

43. *Id.* at 10.

44. Proxy Access Adopting Release, *supra* note 10, at 56,676-77.

The 2010 proxy access rule exempted firms with a market capitalization of less than \$75 million dollars from application of Rule 14a-11 for a period of three years, after which Rule 14a-11 would apply to them.<sup>45</sup> The 2010 proxy access rule did not exempt any firms from application of its changes to Rule 14a-8.<sup>46</sup>

To appreciate the prevailing expectations between the date of the Dodd-Frank legislation and the date of the SEC's adoption of the proxy access rule, it is useful to consider the SEC's proposal from 2009 that was never finalized (for fear of challenge to their legal authority to adopt the rule, which was solved through passage of the Dodd-Frank Act). The SEC issued a rule proposal in 2009 that included changes to Rule 14a-11 and 14a-8 that were substantially similar to those adopted in 2010, but with different ownership thresholds and holding periods.<sup>47</sup> In that proposal, the SEC requested input from the public on whether it should adopt a permanent exemption for smaller issuers.<sup>48</sup> Importantly, the SEC proposal in 2009 had a 5% ownership requirement for shareholders to use proxy access at small firms,<sup>49</sup> but the 2010 adopted rule provided for a 3% ownership requirement.<sup>50</sup> The new threshold in the 2010 rule makes it easier for a nominating shareholder to obtain sufficient shares to nominate pursuant to the proxy access rule. The SEC stayed adoption of that proposal because its authority to adopt proxy access was as yet uncertain.<sup>51</sup> The Dodd-Frank legislation in 2010 clarified the SEC's authority under the Securities Exchange Act of 1934 to adopt rules regulating proxy access, which spurred the SEC to adopt its final rule on August 25, 2010. The Dodd-Frank legislation's proxy access provision did not differentiate between the SEC's 2009 14a-8 proposal and its 2009 14a-11 proposal, either in the amendment authorizing proxy access or in the amendment authorizing and encouraging the SEC to exempt small issuers.<sup>52</sup>

News reports circulated on June 25, 2010 that described the compromise that resulted in statutory language that instructed the SEC to consider a small business exemption.<sup>53</sup> The text of the proxy access amendment agreed to by the conference committee was:

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45. *Id.* at 56,668.

46. *Id.*

47. Kahan & Rock, *supra* note 20, at 10.

48. Facilitating Shareholder Director Nominations, Securities Act Release No. 9,046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765, 74 Fed. Reg. 29,024, 29,032 (June 18, 2009) [hereinafter, Proxy Access Proposing Release].

49. *Id.* at 29,034.

50. Proxy Access Adopting Release, *supra* note 10, at 56,782.

51. Kahan & Rock, *supra* note 20, at 10.

52. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010).

53. *E.g.*, Ted Allen, *Lawmakers Reach Deal on Proxy Access*, ISS GOVERNANCE BLOG (June 25, 2010, 12:03 AM), <http://blog.riskmetrics.com/gov/2010/06/lawmakers-reach-deal-on-proxy-access.html>.

The Commission may, by rule or order, exempt an issuer or class of issuers from the requirement made by this section or an amendment made by this section. In determining whether to make an exemption under this subsection, the Commission shall take into account, among other considerations, whether the requirement in the amendment made by subsection (a) disproportionately burdens small issuers.<sup>54</sup>

Though the \$75 million definition was not expressly mentioned in the legislation as the threshold for “small issuers”, it was highly likely to be the threshold for a small business exemption for many reasons. First, \$75 million was the upper boundary of the lowest market capitalization group referenced in the SEC’s proxy access rule proposal in 2009.<sup>55</sup> The debate among supporters and opponents of an exemption for smaller issuers also focused on the SEC’s three classifications for company size used in other rules, the smallest of which is firms with less than a \$75 million market cap.<sup>56</sup> This would have made it clear to shareholders that \$75 million market capitalization was what Congress intended by its reference to small firms in the legislation, since the legislation itself was a response to the SEC’s rule proposal of 2009. Second, it was the threshold for the SEC’s previous exemptions. The SEC adopted rules with small firm exemptions for companies under \$75 million market capitalization for two other notable rulemakings: internal controls reporting provisions adopted pursuant to the Sarbanes-Oxley Act in 2003 and the movement to XBRL interactive data reporting in 2008.<sup>57</sup> It is also useful to note that the Sarbanes-Oxley legislation authorizing the SEC to adopt internal controls rules did not suggest or refer to a small-firm exemption from the rule, indicating that the SEC might have been willing to consider a permanent small firm exemption even in the absence of the strong statutory language in Dodd-Frank urging them to do so.<sup>58</sup>

The SEC depends upon Congress for its annual budget authorization and, though an independent agency, astute agency chairmen coordinate with Congressional overseers to limit the impact of Congressional pressure in the form of oversight investigations, hearings, holds placed on nominees to future positions, or statutory changes to limit agency discretion.<sup>59</sup> The result of the conference committee negotiations, and the eventual passage of the Dodd-Frank Act

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54. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 971(c), 124 Stat. at 1915.

55. Proxy Access Proposing Release, *supra* note 48, at 29,038.

56. *See* Proxy Access Adopting Release, *supra* note 10, at 56,686-87.

57. *See* Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8,238, Exchange Act Release No. 47,968, 69 Fed. Reg. 9,722, 9,722 (June 5, 2003); Interactive Data to Improve Financial Reporting, Securities Act Release No. 9,002, Exchange Act Release No. 59,324, 74 Fed. Reg. 6,776, 6,776 (Jan. 30, 2009).

58. Sarbanes-Oxley Act of 2002, Pub.L. 107-204 § 404, 116 Stat. 745, 789 (2002).

59. *See* Roberta Karmel, *The Future of the Securities Exchange Commission as a Market Regulator*, 78 U. CIN. L. REV. 501, 507 (2009). *See also* Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 1013 (2006).

in both chambers of Congress and the signature from the President, made it clear that a small issuer exemption from proxy access was highly likely to be included in the SEC's proxy access rule when the rule was eventually adopted by the SEC, even though the language of the amendment was couched as a recommendation. For the purposes of our paper, we rest on the assumption that, at a minimum, the market assumed it was more likely than not that a small firm exemption from Rule 14a-11 longer than three years, or an exemption from Rule 14a-8 application, or an ownership threshold higher than 3% for small firms, would be part of the final rule. Further, the closer the market's assumption was to that minimum assumption that one of those items was more likely than not to occur, the more our estimate of shareholder losses from proxy access actually underestimates the total cost of the rule due to costs that would be already factored in to market expectations.

In the Proxy Access Adopting Release the SEC exempted firms below a market capitalization of \$75 million from its new Rule 14a-11 procedure.<sup>60</sup> The SEC release explained that the exemption would not be permanent (as would be expected according to the Dodd-Frank legislative language) but would instead be temporary.<sup>61</sup> Of particular note is the fact that Rule 14a-8 was not stayed for smaller reporting issuers under the August release, only Rule 14a-11.

We therefore see three unanticipated events on August 25 that had a differential effect on firms above and below the \$75 million capitalization mark. The SEC did not choose to exempt small firms from the application of changes to Rule 14a-8 at all, only granted small firms a 3-year delayed implementation for Rule 14a-11, and the threshold for shareholders to use proxy access at small firms when Rule 14a-11 eventually did go into effect was lowered from 5% to 3% to make it even easier for shareholders to use proxy access.

We support the assumption that the limits on the small firm exemption were not already anticipated in part through a search of the ALLNEWS Westlaw database for the period from June 24, 2010 to August 24, 2010. The database includes all news sources as well as many prominent blogs and law firm white papers. The search term "proxy access" generates 135 sources for that time period, none of which speak to the small firm exemption other than to describe its presence in the legislation.

This study considers the effect of the August 25<sup>th</sup> announcement on small firms whose shareholders would have reasonably expected a full exemption from proxy access pursuant to the language adopted in the Dodd-Frank Act, but who discovered on August 25<sup>th</sup> that they would not receive an exemption from the new changes to Rule 14a-8, would only obtain an exemption from Rule 14a-11 for a limited three-year period, and would face the probability of more frequent proxy contests due to the lower ownership threshold of 3% as opposed to the anticipated 5%. In sharp contrast to the literature reviewed below, most

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60. Proxy Access Adopting Release, *supra* note 10, at 56,687.

61. *Id.*

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of which relies on examination of all publicly traded firms, our study allows for a much more targeted focus because the arbitrary \$75 million market capitalization distinction allows for consideration of differential effects for firms just above and below the dividing line.

Empirical study of this rule also has legal implications. Rules promulgated by the SEC are subject to a legislative efficiency mandate. The SEC is required by law to consider in its deliberations over proposed rules the effect they will have on “efficiency, competition, and capital formation.”<sup>62</sup> The D.C. Circuit has interpreted this statutory mandate to mean that the SEC is required to “appraise itself...of the economic consequences of a proposed regulation.”<sup>63</sup> Three rules in the last two decades promulgated by the SEC have been struck down by the D.C. Circuit for failure to adequately address this mandate.<sup>64</sup> The 2010 proxy access rule was challenged on precisely that basis.

The three-part mandate of promoting efficiency, competition, and capital formation that SEC rules must meet, combined with the DC Circuit’s willingness to overturn SEC rules that lack sufficient empirical foundation, has no doubt contributed to the popularity of SEC rules as targets of empirical study. Stock price event studies have been the most popular method for commentators considering the effect of events that alter the probability that proxy access legislation or rules will be implemented.

Going forward, the demand for such work is likely to increase as the D.C. Circuit recently issued its strongest admonition of the SEC to date. The D.C. Circuit vacated the proxy access rule on July 22, 2011.<sup>65</sup> It held that the SEC failed to meet its statutory burden to consider the effect of new rules on efficiency, competition, and capital formation.<sup>66</sup>

In pertinent part, the court held:

The petitioners also maintain, and we agree, the Commission relied upon insufficient empirical data when it concluded that Rule 14a-11 will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees. The Commission acknowledged the numerous studies submitted by commenters that reached the opposite result. One commenter, for example, submitted an empirical study showing that ‘when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest.’<sup>67</sup>

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62. 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c) (2006).

63. Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).

64. Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

65. Bus. Roundtable v. SEC, No. 10-1305, 2011 WL 2936808, at \*1 (D.C. Cir. July 22, 2011).

66. *Id.*

67. *Id.* at \*5 (internal citations omitted).

The court reviewed the empirical literature considered by the SEC, also reviewed in part in our paper below, and found the SEC's justifications of the benefits of the rule to be insufficient in addressing the concerns of the competing literature.<sup>68</sup> This opinion means that the SEC will be required to engage in more thorough economic analysis of its rules going forward, and that the D.C. Circuit sees particular significance in stock price event studies which consider events tied to changes in the probability of a regulation's adoption. This will be true not only for the SEC's reconsideration of the proxy access rule, but also for numerous other rules promulgated under the nations' securities laws.

### III. LITERATURE

Corporate governance reforms have become a fairly popular subject for empirical study. A number of studies have considered the effect of major corporate governance reforms on stock price, including the effect of the Dodd-Frank Act, the Williams Act, and the 1934 Securities Exchange Act.<sup>69</sup> This explains some of the academic community's interest in applying empirical approaches to the proxy access debate, particularly since until now empirical evidence was difficult to compile as the population of actual contested proxy solicitations was extremely small.

This paper's findings will be relevant to the ongoing debate over the next generation of the proxy access rule, currently being considered by the SEC.<sup>70</sup> These findings also have bearing for the broader debate over using the securities laws to empower shareholders to police management excess by reducing the costs of running proxy campaigns, improving disclosures to shareholders, and giving them statutory rights to vote over new types of corporate policy decisions. For example, the Dodd-Frank Act gave the SEC authority to promulgate a number of rules in addition to proxy access on this same premise, such as

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68. *Id.* at \*5.

69. *E.g.*, George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1976); James H. Fogelston et al., *Changing the Takeover Game: The Securities and Exchange Commission's Proposed Amendments to the Williams Act*, 17 HARV. J. ON LEGIS. 409 (1980); Pankaj K. Jain & Zabi-hollah Rezaee, *The Sarbanes-Oxley Act of 2002 and Security Behavior: Early Evidence*, 23 CONTEMP. ACCT. RESEARCH 629 (2006); Haidan Li et al., *Market Reactions to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management*, 51 J.L. & Econ. 111 (2008); Paul H. Malatesta & Rex Thompson, *Government Regulation and Structural Change in the Corporate Acquisitions Market: The Impact of the Williams Act*, 28 J. FIN. & QUANTITATIVE ANALYSIS 363 (1993); Katherine Schipper et al., *Disentangling Interrelated Effects of Regulatory Changes on Shareholder Wealth: The Case of Motor Carrier Deregulation*, 30 J.L. & ECON. 67 (1987); I.X. Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, 44 J. ACCT. & ECON. 74 (2007).

70. The current SEC Chairman has indicated her desire to reconsider and redraft the rule. See Press Release, U.S. Sec. and Exch. Comm'n, Statement by SEC Chairman Schapiro on Proxy Access Litigation (available at <http://www.sec.gov/news/press/2011/2011-179.htm>).

requiring a shareholder advisory vote on executive compensation<sup>71</sup> and a prohibition of broker-dealer discretionary voting on clients' behalf.<sup>72</sup>

Our analysis will therefore also inform debates about other corporate governance practices such as the ongoing academic and policy debate over the impact of staggered boards.<sup>73</sup> Coates, Subramanian, and Bebchuk have argued that staggered boards decrease shareholder wealth by limiting the ability of shareholders to replace a majority of the board in one election.<sup>74</sup> Our analysis adds to the literature calling that conclusion into question, particularly with respect to smaller firms, as the same shareholders who would make use of proxy access would also see their challenges facilitated by de-staggering of the board.<sup>75</sup> Thus our study would urge a re-examination of the staggered board question to consider the impact of de-staggering the board for smaller publicly

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71. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-900 (2010) ("Not 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 . . ."). See also Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9,178, Exchange Act Release No. 63,768, 76 Fed. Reg. 6010, 6010 (Feb. 10, 2011) (adopting release of SEC rule implementing § 951 by adding § 14(a) to the Exchange Act).

72. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 957, 124 Stat. 1376, 1906-07 (amending § 6(b) of the Exchange Act to require that the rules of each national securities exchange prohibit any broker-dealer from voting on its clients' behalf in certain shareholder votes, including those electing directors or approving executive compensation, unless the client has instructed the broker-dealer to vote the proxy in accordance with the voting instructions of the client). See also, e.g., Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Amend NYSE Rule 452 and Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting on Executive Compensation Matters, Exchange Act Release No. 62,874, 75 Fed. Reg. 56,152 (September 15, 2010) (notice of SEC approval of the New York Stock Exchange's rule change that implemented § 957).

73. See *infra* note 75.

74. See Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002).

75. A Stanford Law Review symposium issue considered the implications of Bebchuk, Coates and Subramanian's work on staggered boards. See Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 856-57 (2002); Steven M. Bainbridge, *Director Primacy in Corporate Takeovers*, 55 STAN. L. REV. 791, 807 n.92 (2002); Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 823, 837 (2002); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885 (2002). The arguments of the various participants did not focus on the impact of firm size or on the type of shareholders in a firm as a determinant of the effect of staggered boards, but this Article suggests both of those variables will inform the future of the debate over the effect of staggered boards on corporate governance.

traded companies and taking into account the types of investors in those companies.<sup>76</sup>

The principal use of our work will be to provide a thoroughly novel method for measuring the impact of proxy access over the rougher approaches in the prior literature. One early study of self-financed proxy contests, which looked at 185 proxy contests, found significant negative returns of roughly 20 percent in the 2-year period following those contested elections in which the dissident shareholders were successful.<sup>77</sup> But the limited sample size was a barrier to study significance.<sup>78</sup> It also focused on the incidence of self-funded proxy contests, which represents one of the central limitations of the corporate governance literature preceding our study. One of the principal challenges that academics and regulators have faced in weighing the benefits and costs of proxy access is that there are almost no naturally occurring instances of proxy access in the financial markets. Thus the arguments over proxy access in the law, economics and finance literature focused on three methodological approaches. The first approach relied principally on institutional, transaction cost-based arguments.<sup>79</sup> The second demonstrated differences in returns at companies with governance provisions associated with entrenchment, or the impact of activism more generally. Given these results, the authors would infer that proxy access would resolve any problems demonstrated, or would present similar benefits to those demonstrated by studying related phenomena.<sup>80</sup> The third ap-

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76. A mandatory de-staggered provision was originally included in the legislation that became the Dodd-Frank Act, but that provision was ultimately eliminated from the final text. Dodd Discussion Draft, Nov. 10, 2009, available at [http://banking.senate.gov/public/\\_files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/_files/AYO09D44_xml.pdf). Given the importance of de-staggering to the institutional investor community the issue would seem likely to continue to be part of the debate.

77. Michael Fleming, *New Evidence on the Effectiveness of the Proxy Mechanism* 3 (Federal Reserve Bank of New York Research Paper No. 9503, 1995), available at [http://www.newyorkfed.org/research/staff\\_reports/research\\_papers/9503.pdf](http://www.newyorkfed.org/research/staff_reports/research_papers/9503.pdf).

78. *Id.*

79. See, e.g., Lucian A. Bebchuk, *Letting Shareholders Set the Rule*, 119 HARV. L. REV. 1784 (2006). See also Martin Lipton & Steven A. Rosenblum, *supra* note 4; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006); Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564-65 (2006); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Jonathan Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph Kvetch About Contested Director Elections and Mozart's Seraglio*, 93 VA. L. REV. 759 (2007); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

80. See, e.g., Paul A. Gomers et al., *Corporate Governance and Equity Prices*, 18 Q. J. ECON. 107 (2003); Lucian Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV.

proach studied the effect and incidence of self-financed proxy contests.<sup>81</sup> The first method was useful to generate the debate, and will remain important in interpreting the empirical data that future studies are able to derive, but considered alone it left a degree of imprecision and an inability use the comparative statics essential to regulatory cost-benefit analysis.<sup>82</sup> The second method was limited in that even if the authors could demonstrate the existence of net agency losses from entrenchment, it did not necessarily follow that proxy access could alleviate those investor losses. The third method was limited in that a study of self-financed proxy contests does not show that contests taking place on the issuer's proxy would function similarly, or attract use by the same types of shareholders with the same focus as an entirely self-financed contest would attract. Studying the impact of events that lead to proxy access allows a more direct measurement of the impact of proxy access on stock prices. This advantage led to four prior academic studies of events leading up to proxy access that precede our argument. While our study also offers an event study proxy access regulation, it is superior to the prior four studies in that it offers a unique natural experiment that compares an unexpected impact on a treatment group against the expected impact on a control group, across an artificial dividing line. This natural experiment eliminates the impact of any events other than the proxy access rule in the market that would impact securities prices on the event date we study. This advantage is something the other four empirical studies of events leading up to the adoption of proxy access were unable to achieve.

Cohn, Gillan, and Hartzell study events surrounding the passage of the Dodd-Frank Act and the 2010 proxy access rule with reference to the effect on

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FIN. STUD. 783 (2009); Lucian A. Bebchuk & Michael Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUD. 939 (2010); Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681 (2007).

81. See, e.g., Bebchuk, *supra* note 6. See also *id.* at p. 698 n.39 (citing a number of prior studies on the expense and incidence of election contests, including Melvin A. Eisenberg, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 121-27 (1976); Frank D. Emerson & Franklin C. Latham, *Proxy Contests: A Study in Shareholder Sovereignty*, 41 CAL. L. REV. 393, 435-36 (1953); Daniel M. Friedman, *Expenses of Corporate Proxy Contests*, 51 COLUM. L. REV. 951 (1951); Comment, *Proxy Contests: Corporate Reimbursement of Insurgents' Expenses*, 23 U. CHI. L. REV. 682 (1956)). See also *id.* at 712 n.68 (citing Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, 21 FIN. MGMT. 22 (1992); Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 402 (1983); David Ikenberry & Josef Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432-33 (1993); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 280 (1998)).

82. For the importance of comparative statics in regulatory cost-benefit analysis, see Donald A. Wittman, *ECONOMIC FOUNDATIONS OF LAW AND ORGANIZATION* 69-71 (2006).

companies that have shareholders classified as being among the top 50 activist shareholders on the “SharkWatch50” list, compiled by *lant.net*.<sup>83</sup> Their first event date is the announcement by Senator Christopher Dodd that he would push to increase the threshold ownership requirement for using proxy access to 5% of the companies securities, where the SEC’s then current proposal envisioned 1% for large companies, 3% for medium sized companies, and 5% for small companies.<sup>84</sup> They argue that Senator Dodd’s proposal made proxy access more difficult for large and medium sized firms.<sup>85</sup> They demonstrate their argument by showing that the announcement was associated with lower abnormal returns for medium and large firms that also had a SharkRepellant50 investor.<sup>86</sup> The authors also note that the predictive power of their method is limited for small stocks, since only 133 of the firms under \$75 million market capitalization have a SharkWatch50 investor.<sup>87</sup>

Many of the companies in the SharkWatch50 list used in the study are hedge funds that have actively engaged in self-funded proxy contests in the past.<sup>88</sup> The list does not include many of the large institutional investors, like public and union pension funds, who lobbied in favor of the proxy access rule.<sup>89</sup> The study thus does not capture the stock price effects on firms which have institutional investors not likely to self-finance proxy contests but who are likely to use the SEC’s new free proxy access regime in the future. The authors also admit they do not capture the implicit influence of institutional investors who use the threat of shareholder action as part of a larger negotiation over other issues, like labor disputes.<sup>90</sup> One hypothesis, for example, which may be consistent with their findings, would be that firms with hedge fund shareholders experienced positive abnormal returns from the proxy access rule and firms with union or state pension fund shareholders experienced negative abnormal returns from announcements that increased the probability of the proxy access rule’s adoption.

Larcker, Ormazabal, and Taylor focus on events prior to the adoption of the Dodd-Frank Act associated with changes in the probability of proxy access.<sup>91</sup> They find that events associated with an increase in the probability of

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83. Jonathan Cohn et al., *On the Optimality of Shareholder Control: Evidence from the Dodd-Frank Financial Reform Act 4* (January 17, 2011) (unpublished manuscript) (*available at* <http://ssrn.com/abstract=1742506>).

84. *Id.* at 16.

85. *Id.* at 17.

86. *Id.* at 18.

87. *Id.* at 19.

88. *Id.* at 6.

89. *See id.* at 44.

90. *Id.* at 5.

91. David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation 3* (J. Fin. Econ., forthcoming; Rock Ctr. for Corp. Governance at Stanford Univ. Working Paper Series No. 82, 2010), *available at* <http://ssrn.com/abstract=1650333>.

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proxy access are associated with significant negative abnormal returns for firms with large institutional shareholders who are likely to make use of proxy access.<sup>92</sup> They use two measures of ownership to estimate the likelihood of existing institutional investors using proxy access, including the number of institutional investors with a greater than 1% interest (the threshold for ownership associated with the 2009 SEC rule proposal that is the focus of their event study) and the number of possible coalitions that could meet the 1% threshold.<sup>93</sup>

Decker, Bergstresser, and Subramanian consider the stock price effect of a discrete event, October 4, 2010, which is the date that the SEC agreed to stay implementation of the proxy access rule pending adjudication of the court challenge to the rule.<sup>94</sup> They found a 42 basis point spread between firms with high institutional ownership and firms with low institutional ownership for that day's returns.<sup>95</sup> Notably, the authors do not find a correlation between firm governance characteristics and the value of proxy access.<sup>96</sup> They do, however, find a stronger correlation for firms with poor recent performance.<sup>97</sup> They argue that their results demonstrate that "financial markets placed a positive value on shareholder access, as implemented in the SEC's August 2010 Rule."<sup>98</sup> The result would, however, also be consistent with a market assumption that upon successful challenge in court the SEC was expected to subsequently promulgate a rule that would be even more friendly to conflicted institutional investors. The result would also be consistent with a market assumption that the costs of uncertainty from firms not knowing what proxy regime would apply in the future, no matter what was ultimately decided, were significant. The latter alternative explanation could flow from boards needing to change the bylaws, charter, or organizational structure of the firms they control in order to deal with multiple different iterations of a potential future proxy access rule.

Decker and his co-authors also find that, among firms in the first and second lowest deciles of the S&P 1500 (firms below the median value of the S&P SmallCap 600), firms with institutional owners experienced positive abnormal returns at the event date on which proxy access was stayed pending appeal.<sup>99</sup> The median S&P SmallCap 600 company has a market capitalization of

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92. *Id.* at 4.

93. *Id.* at 20.

94. Bo Decker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge* 3-4 (Harvard Bus. Sch. Finance Working Paper No. 11-052; Harvard Bus. Sch. NOM Unit Working Paper No. 11-052; Harvard Law and Econ. Discussion Paper No. 685, 2011), available at <http://ssrn.com/abstract=1695666>.

95. *Id.* at 4.

96. *Id.* at 27.

97. *Id.* at 30.

98. *Id.* at 5.

99. *Id.* at 25-26.

around \$600 million.<sup>100</sup> This result may be consistent with our hypothesis, and inconsistent with their hypothesis, depending on how many firms in those two deciles have market capitalizations below \$75 million. It is consistent with the view that stockholders in small firms do not place value on proxy access and would have viewed the removal of Rules 14a-8 and 14a-11 as a positive result.

Akyol, Lim, and Verwijmeren present an event study that considers 17 events that either increase or decrease the probability of proxy access adoption.<sup>101</sup> They find consistently negative stock price reactions associated with 10 events that increase the probability of proxy access being adopted and consistently positive reactions associated with events that decrease the probability of proxy access adoption.<sup>102</sup> They work under the assumption that financial firms have an increased likelihood of being targeted for proxy fights, and they determine that financial firms have stronger shareholder reactions in line with their findings for all firms.<sup>103</sup> They similarly find stronger stock price reactions against proxy access at firms with more shareholders eligible to use proxy access.<sup>104</sup> They also consider factors that they assume make firms more prone to shareholder activism, like low market-to-book ratios, and find that the stock price effects of events that change the probability of proxy access passing are stronger at such firms.<sup>105</sup> They further find that firm size is not significantly related to stock price effects of events that change the probability of proxy access occurring, which would speak to a broader applicability of our findings to larger firms.<sup>106</sup>

One of the challenges to the prior studies is that they consider similar effects on a large group of firms but have a difficult time controlling for existing agency costs and other endogenous effects. Some use proxies for residual losses from agency costs, like market-to-book ratios, that offer a tenuous relation at best.<sup>107</sup> But the residual losses of agency costs exist precisely because they are characterized by the presence of unverifiable information, if that were not the case firms would have created appropriate monitoring and bonding mechanisms (which may or may not include proxy access) already.<sup>108</sup> They also consider events that have mixed effects on the probability and effectiveness of

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100. Kahan, *supra* note 20, at 29.

101. Ali C. Akyol et al., *Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations 2* (J. Fin. & Quantitative Analysis, forthcoming; 23rd Australasian Finance and Banking Conference 2010 Paper), available at <http://ssrn.com/abstract=1526081>.

102. *Id.* at 3-4.

103. *Id.* at 25.

104. *Id.* at 4.

105. *Id.* at 20.

106. *Id.*

107. *E.g., id.* at 14.

108. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structures*, 3 J. FIN. ECON. 305 (1976).

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proxy access, as well as events based on legislative developments even though legislators are free to, and frequently do, engage in insider trading on information that affects the stock market, unlike agency officials that are subject to rigid civil and criminal penalties.<sup>109</sup> Our study takes advantage of a natural experiment in the small issuer exemption that uses differential effects to limit the challenges faced in the existing literature.

Our design offers a superior lens over the prior empirical literature because it actually views the actual event of proxy access passage. Thus we do not have the problems that the four prior studies face in uncertainty over the future directional impact of proxy access. We have the advantage of a discrete event at a date certain with differential impact over a randomly assigned threshold. We also have the advantage that application to one of the groups is unexpected. Thus we can construct a treatment and a control group to test the impact of proxy access on small firms, since any other events affecting stocks market wide on that date would be expected to effect firms just above and below the artificial \$75 million threshold with equal force. The prior institutional literature offers an informative foundation for our study as it provides an explanation for the results, as our results favor the conflicted shareholder explanation explored by numerous authors.<sup>110</sup>

#### IV. STUDY DESIGN

Our study focuses on the announcement of the SEC's 2010 proxy access rule on August 25, 2010. The proxy access rule had two parts as designed by the SEC and announced in August. One is a mandatory regime that governs how candidates are to be added to the corporate proxy, the second allows shareholders to put bylaws onto the corporate ballot to alter the federally-mandated procedure and make it even easier (but not more restrictive) for shareholders to use it.<sup>111</sup> The August 25 announcement stayed application of the first rule for small firms, but not the second rule.<sup>112</sup> Such result was unexpected because of legislative developments on June 25, 2010. On June 25, it appeared that small firms would likely be exempt altogether based on the text of the Dodd-Frank Act.<sup>113</sup> The original SEC release issued in 2009 mentioned modifications to Rule 14a-8 as well as a new Rule 14a-11 procedure.<sup>114</sup> The text of the legislation agreed to by the conference committee in June requested consideration of a small business exemption to proxy access procedures as a

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109. Stephen Bainbridge, *Insider Trading Inside the Beltway* 3 (UCLA Sch. of Law, Law-Econ. Research Paper No. 10-08, 2010), available at <http://ssrn.com/abstract=1633123>.

110. See *supra* notes 15, 19, and 20.

111. Proxy Access Adopting Release, *supra* note 10, at 56,668.

112. *Id.*

113. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 971(c), (2010).

114. See *generally* Proxy Access Proposing Release, *supra* note 48.

general matter, not merely for a Rule 14a-11 procedure.<sup>115</sup> Thus the novel data affecting firms differentially across the \$75 million market capitalization threshold as of the SEC's issuance of the rule was that issuers under \$75 million in market capitalization would not receive an exemption from the application of changes to Rule 14a-8, and that the small firm exemption from 14a-11 would be only for a three-year period.

We test whether abnormal returns for companies with below a market capitalization of \$75 million were negative on August 25, 2010. We assume that, prior to August 25, the market expected a permanent exemption from the proxy access rules was highly likely for firms with a market capitalization below \$75 million. We hypothesize that the unexpected development on August 25, the news that small firms would only obtain a temporary exemption from Rule 14a-11 and would obtain no exemption from changes to Rule 14a-8, and would face a lower 3% ownership threshold for proxy access use, resulted in significant abnormal negative returns for small firm stock prices, particularly for those firms with institutional investors able to use proxy access. We define institutional investors likely to use proxy access as those with greater than 3% ownership in the firm.

Schipper and Thompson were one of the first commentators to initiate the event study methodology to consider the effect of events on abnormal stock price returns.<sup>116</sup> Empirical work in corporate governance has suffered from the challenge that corporate governance attributes that tend to alter the level of shareholder power are endogenous.<sup>117</sup> Our method provides an opportunity to consider the effect of the SEC's 2010 proxy access rule on firms below an artificial market capitalization of \$75 million against firms above that amount and limits that challenge in our study.

One requirement for event studies is that they must be based around an unexpected event. Here, the announcement of the SEC rule on August 25 was the first time the market learned about the rule's unexpected application. Further, it is less likely that information leaked from this event than from the events surrounding the legislation's passage targeted in other studies because the SEC has strict rules against insider trading by staff which do not apply for members of Congress.

Small companies will be able to make use of the proxy access rule's three-year exemption if they meet the SEC's pre-existing definition of a smaller reporting company, which includes those who:

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115. See Dodd-Frank Act § 971(c), 124 Stat. at 1915.

116. Katherine Schipper & Rex Thompson, *The Impact of Merger-Related Regulations on the Shareholders of Acquiring Firms*, 24 J. ACCT. RESEARCH 316 (1983).

117. Benjamin E. Hermalin & Michael W. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96 (1998) (showing "the CEO's bargaining power over the board-selection process depends on his *perceived* ability." (emphasis added)).

Had a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter, computed by multiplying the aggregate worldwide number of shares of its voting and non-voting common equity held by non-affiliates by the price at which the common equity was last sold, or the average of the bid and asked prices of common equity, in the principal market for the common equity; or in the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than \$75 million as of a date within 30 days of the date of the filing of the registration statement, computed by multiplying the aggregate worldwide number of such shares held by non-affiliates before the registration plus, in the case of a Securities Act registration statement, the number of such shares included in the registration statement by the estimated public offering price of the shares; or in the case of an issuer whose public float as calculated under paragraph (1) or (2) of this definition was zero, had annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. Whether or not an issuer is a smaller reporting company is determined on an annual basis.

This convoluted definition presents a unique challenge for studying firms that expect to be subject to the exemption against firms that do not, since firms could not know for certain whether or not they would meet the definition in future years because they do not know for certain what their market capitalization will be. Firm market capitalization is not static, and particularly those firms just above or below the exemption will not know with certainty whether they will meet the exemption in future years. For this reason, we compare groups of firms with market capitalizations above and below \$75 million market capitalization in symmetric groups. We compare ranges of firms abutting the \$75 million threshold and ranges of groups somewhat removed from that threshold, assuming that uncertainty about whether a firm's market capitalization will exceed \$75 million is related to the proximity of current market capitalization to \$75 million.

Some might argue that since small company stocks are traded less regularly than large-cap stocks and have a less extensive analyst following, the focus on stock returns to small firms is flawed. Kahan and Rock note that the market for small firms is inefficient compared to large- and mid-cap companies because of reduced liquidity and analyst following.<sup>118</sup> But such a challenge here would not hold for two unique reasons. First, merely arguing that some markets are more efficient than the small-cap market doesn't put the validity of the test in jeopardy. Indeed, many of the other empirical studies available that support the proxy access rule include small-cap firms in their study and make observations about the effect of the rule on small-cap firms.<sup>119</sup>

Second, if it is true that proxy access would stand to significantly alter the relations between boards and shareholders, and dramatically diminish agency

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118. Kahan & Rock, *supra* note 20, at 20.

119. *See, e.g.*, Cohn et al., *supra* note 83, at 18;

costs as Decker and his co-authors suggest,<sup>120</sup> then one would expect that the such a highly significant event would itself increase the trading volume in that market. Kahan and Rock note that hedge funds are at the center of a majority of small-cap proxy contests and company insiders are also at the center of a significant number of proxy contests.<sup>121</sup> Given that hedge funds and insiders have significant information advantages, and given that proxy access is purported to dramatically alter the relationship between shareholders and boards in a way that significantly reduces agency costs, it may be safe to assume that the event in question would give rise to a higher volume of highly informed trading.

We have considered the presence of institutional investors with a greater than 3% ownership, a population that includes union and state pension fund investors. Kahan and Rock note that hedge funds are the dissidents in a large percentage of proxy contests at firms.<sup>122</sup> They also describe how these types of investors have the highest success rates for all proxy contests, and that other types of investors rarely attempt proxy contests and/or rarely succeed.<sup>123</sup> This description of existing contests is useful, but should be considered with the caveat that the types of investors interested in self-financed proxy contests are not necessarily the types of investors interested in contests using the corporate proxy as provided in the proxy access rule. For example, the latter will be required to certify away any control purpose and are limited in the number of candidates they can nominate, the former are not.<sup>124</sup> Kahan and Rock also describe how active union pension fund and employee organizations are in using the company proxy for shareholder proposals, accounting for nearly 40% of shareholder proposals in a typical proxy season.<sup>125</sup> This speaks to the likelihood that union and pension fund investors will be more likely to nominate candidates to the corporate proxy than they would to fund their own solicitations.

Other empirical examinations of the proxy access rule have also performed a check of the Wall Street Journal “Business and Finance” section the day after the event being studied to consider whether macroeconomic events could have skewed their results. A similar examination of the Business and Finance section for August 25, 2010 and August 26, 2010 offers no obvious events that would have a consistent differential effect across firms just above and below a market capitalization of \$75 million. Those items are listed in an Appendix.

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120. *See supra* pp. 21-22.

121. Kahan & Rock, *supra* note 20, at 21.

122. *Id.* at 21.

123. *Id.* at 22.

124. *See Proxy Access Adopting Release*, *supra* note 10, at 56,714.

125. Kahan & Rock, *supra* note 20, at 23.

## V. EMPIRICAL MODEL

To compute abnormal returns, we first estimated one set of regressions based on the 2005 estimation window and one based on the 2006 estimation window. We chose windows in those years, rather than in late 2009 or early 2010, because market volatility in the latter years is greater than in the earlier years. We also used two more recent estimation windows to check the sensitivity of our results to the choice of those windows. The time frame for these other two windows is August 2009 to April 2010 and November 2009 to July 2010.<sup>126</sup>

After computing abnormal returns, we test whether firms with between \$25 and \$75 million market capitalization experience negative returns on August 25 that are statistically different from zero. To test the sensitivity of our results to the choice of firms we also tested whether firms between \$25 and \$60 million market capitalization experience negative and statistically significant return on August 25.

Contrary to many event studies that examine whether an event leads to an increase or decrease in abnormal returns for a particular firm, we have a control group to identify the abnormal return. This strengthens our identification strategy. In our empirical model, firms with a market capitalization of \$75 million and below constitute the treatment group while the group of firms with more than \$75 and less than \$125 million market capitalization form the control group.

This estimation strategy is motivated by the fact that there may be a concern that all firms in the market experienced a shock which may have lead to negative returns. Therefore, we constructed a control group to test whether the returns of firms that we focus on are different from those of our treatment groups, companies with less than \$75 million market capitalization. In these specifications we test whether firms with a market capitalization of between \$25 and \$75 million performed differently on August 25 compared to firms with a market capitalization between \$75 and \$125 million. Again, to test the sensitivity of our results, we also compare firms with between \$25 and \$60 million market capitalization to firms with between \$90 and \$125 million market capitalization.

## VI. DATA

We obtained data for publicly traded companies from The Center for Research in Security Prices (“CRSP”) through the Wharton Research Data Services. We downloaded daily data for all publicly traded companies included in the CRSP database that were traded over the time period we study in our empirical

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126. We followed the procedures described in [http://dss.princeton.edu/online\\_help/stats\\_packages/stata/eventstudy.html](http://dss.princeton.edu/online_help/stats_packages/stata/eventstudy.html).

model and which had a less than \$125 million in market capitalization on August 25, 2010. We computed market capitalization as the shares outstanding times share price on August 25, 2010.

To compute abnormal returns, we retrieved daily return data for the companies in our sample, for the periods February 1, 2005 to November 31, 2005, February 1, 2006 to November 31, 2006, August 1, 2009 to April 30, 2010, and November 1, 2009 to July 31, 2010.

For each of these four estimation windows we used a simple regression to regress daily return of the firms (*ret*) on the market return (the value-weighted return variable (*vwretd*) from CRSP. We then used the coefficients from this estimation to calculate the predicted daily firm returns during the event window. As is standard in the literature, we computed the abnormal return as the predicted return minus the actual return.

We further dropped observation from the dataset for which the share price was negative, the trading volume was zero, the share price was not listed, the trade volume was not listed, the return was not listed, or the *vwretd* was not listed.

## VII. RESULTS

Table 1 shows the effects of the announcement of the proxy access rule on abnormal returns for our four estimation windows. It shows the results from testing the hypothesis that abnormal returns for small firms were negative on August 25. The first column shows estimates for the companies with between \$25 and \$75 million market capitalization and the second column shows estimates for companies with between \$25 and \$60 market capitalization. Robust standard errors are in brackets.

Table 1 shows that firms with a market capitalization between \$25 and \$75 million had statistically significant negative abnormal returns on August 25, regardless of the estimation window considered. All estimates are statistically significant at the one percent level. Depending on the estimation window considered, these firms stock market value decreased between 0.39 and 0.59 percentage points. Table 1, column 2 shows that we find very similar results when we examine firms with a \$25 to \$60 million market capitalization. These results provide some evidence that the SEC announcement on August 25 lowered the returns of firms with below \$75 million market capitalization.

We also examined firms which had at least one institutional investor who held 3 percent of the shares. In column three and column four we re-estimate the specifications in the first two columns, using only firms with institutional investors who have at least a 3 percent stake in the firm. Here we find that the point estimates on the interaction terms are larger than the corresponding point estimates in the first two columns. All point estimates on the interactions are statistically significant, providing evidence that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional

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investors with at least a 3 percent ownership stake. This is relevant given that in order to make use of the proxy access mechanism, a shareholder would need to have at least a 3% ownership stake or be able to assemble a group of shareholders constituting 3% ownership.

Our model in Table 2 is  $AR(i) = b_0 + b_1 * D + e$ , where  $AR(i)$  is the abnormal return of firm  $i$  on August 25, if the firm has a market capitalization between \$25 million and \$125 million;  $b_0$  is the intercept,  $b_1$  the slope parameter to be estimated on  $D$ , where  $D$  is defined to equal one if the firm has a market capitalization between \$25 million and less than \$75 million and zero otherwise. The term  $e$  is an iid error term.  $b_1$ -hat is an estimate of the difference in the abnormal return between small and large firms. We could have also done a simple t-test, which would have given us the difference in means between the abnormal return between small and large firms. That difference (obtained from the t-test for differences in means) is identical to the estimated  $b_1$ . We chose to estimate the regression because this gives us robust standard errors. The t-test does not give us robust standard errors. The columns in Table 2 differ in that the regression in the first column uses the entire sample, while the regression in the second column uses only the subsample of firms that have at least one institutional investor owning at least 3% of the firm. Table 3 has the same specifications as Table 2, but excludes firms with between \$60 and \$90 million market capitalization.

Table 2 shows results that are based on the same four estimation windows as those in Table 1, but now compares firms with a market capitalization between \$25 and \$75 million against those with a market capitalization between \$75 and \$125 million. We expect that the results from this sample definition will suffer from less noise than those in Table 1. This is because, for example, it is more uncertain whether firms that on August 25 have a market capitalization of \$75 million, as opposed to \$60 million, will have upon implementation of the SEC rule a capitalization below or above \$75 million. There is no reason to suggest that this uncertainty regarding future market capitalization changes between the treatment group and the control group, so we assume in designing the ranges of market capitalization we study that this uncertainty is associated with proximity to the \$75 million threshold. The point estimates in Table 2 are statistically significant using all four estimation windows. Further the point estimates on this interaction term are larger than their counterparts in Table 1. Table 2 shows that firms in the treatment group of \$25 million to \$75 million market capitalizations had statistically significant negative abnormal returns on August 25 relative to the control group of \$75 million to 125 million market capitalizations regardless of the estimation window considered. All estimates are statistically significant at the one percent level. Depending on the estimation window considered, the differential impact of the August 25 event ranges from -.64% to -.7%. These results provide further evidence that the SEC announcement on August 25 lowered the returns of firms with below \$75 million market capitalization.

We also examined the differential impact on firms which had at least one institutional investor who held three percent of the shares. In column two we re-estimate the specifications in the first column, using only firms with institutional investors who have at least a 3 percent stake in the firm. Here we find that the point estimates on the interaction terms are larger than the corresponding point estimates in the first column. All point estimates on the interactions are statistically significant, providing evidence that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional investors with at least a 3 percent ownership stake.

Table 3 shows results that are based on the same four estimation windows as those in Table 1 and 2 and compares firms with a market capitalization between \$25 and \$60 million against those with a market capitalization between \$90 and \$125 million. The point estimates in Table 3 are statistically significant using all four estimation windows. Further the point estimates on this interaction term are larger than their counterparts in Table 2. This is consistent with our hypothesis that the unanticipated impact on small firms of the proxy access rule was the cause of the differential impact and that proximity of firm market capitalization to \$75 million is associated with the probability that a firm will exceed the \$75 million market capitalization threshold and thus whether or not it expected prior to August 25 that it would be subject to the proxy access rule in the future.

Table 3 shows that firms in the treatment group of \$25 million to \$60 million market capitalizations had statistically significant negative abnormal returns on August 25 relative to the control group of \$90 million to \$125 million market capitalization regardless of the estimation window considered. All estimates are statistically significant at the one percent level. Depending on the estimation window considered, the differential impact of the August 25 event ranges from  $-.67\%$  to  $-.92\%$ . These results provide further evidence that the SEC announcement on August 25 lowered the returns of firms with below \$75 million market capitalization.

We also examined the differential impact on firms which had at least one institutional investor who held three percent of the shares. In column two we re-estimate the specifications in the first column, using only firms with institutional investors who have at least a 3 percent stake in the firm. Here we find that the point estimates on the interaction terms are larger than the corresponding point estimates in the first column. All point estimates on the interactions are statistically significant, providing evidence that negative returns on the day of the SEC announcement were more concentrated in firms that had institutional investors with at least a 3 percent ownership stake.

If the prevailing assumption was that proxy access was a net benefit to small firms, then the news that small firms would in fact not be permanently exempt from the proxy access Rule 14a-11 mandatory procedure, and that investors could begin proposing proxy access bylaws right away, and that the ownership requirement was only 3% of outstanding shares rather than 5%,

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should have resulted in abnormally positive returns for firms below \$75 million as compared to our control group. That was not the case. If the prevailing assumption was that proxy access was a net cost to stock price returns at small firms, then the news that proxy access under Rule 14a-11 would in fact apply in 3 years, and that changes to Rule 14a-8 would apply immediately, should have resulted in significant negative abnormal returns for small firms. This was precisely what we found.

Our focus on small firms offers a particularly acute test for the market's understanding of the value of proxy access. The 3% ownership threshold is much easier to meet in a smaller firm because many large institutional shareholders are legally restricted in how much of their portfolio they can invest in any one company.<sup>127</sup> Thus it becomes easier for any one shareholder to amass a sufficient stake to run a contest. It also becomes easier for a group of shareholders to coordinate as a group to initiate a proxy access nomination since a smaller number of shareholders will be required to meet the ownership threshold. Some commentators have suggested that proxy access nominations are least likely at the largest firms in the S&P 500. Kahan and Rock note that "proxy contests are overwhelmingly a phenomenon of small and very small publicly held firms . . . ."<sup>128</sup> Thus, in addition to demonstrating that proxy access actually damages shareholder value at small-cap firms, our results also call into question whether proxy access also is a net cost to medium-cap and large-cap firms as well.

#### CONCLUSION

Our results serve to inform the ongoing debate over the proxy access rule adopted by the SEC last summer under its new authority under the Dodd-Frank Act. That rule was the subject of a challenge that was successfully argued before the D.C. Circuit. Since the challenge to the proxy access rule was successful, and the rule was in effect remanded by the D.C. Circuit to the SEC for further consideration, our results urge the SEC to consider a permanent exemption for small firms. Our results do not, however, demonstrate that a market capitalization threshold as low as \$75 million is required, and an optimal exemption may in fact be higher than that amount. Further, our results caution against reliance on the existing empirical literature to justify a future proxy access rule for larger firms. If the impact of any benefits associated with proxy access is concentrated among smaller firms, at which investors are more likely to be able to actually amass ownership stakes sufficient to meet the requisite thresholds, then a finding of negative abnormal returns for proxy access application to small firms would call into question whether a broader cost-benefit analysis of

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127. Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 *BUS. LAW* 95, 95 (2003).

128. Kahan & Rock, *supra* note 20, at 20.

the full rule results in a net benefit to efficiency, competition and capital formation and is thus consistent with the outcome of *Business Roundtable v. SEC*.

TABLE 1.

The effects of the announcement of the SEC proxy access rule regulation on abnormal returns: Testing whether the average abnormal return on August 25, 2010 is statistically different from zero.

Estimation window	All Firms				Firms with at least 3% institutional ownership			
	25-75 market cap		25-60 market cap		25-75 market cap		25-60 market cap	
	Coefficient	SE	Coefficient	SE	Coefficient	SE	Coefficient	SE
2005 N	-0.384*** 558	[0.140]	-0.371** 413	[0.177]	-0.543*** 364	[0.164]	-0.551*** 272	[0.203]
2006 N	-0.492*** 606	[0.141]	-0.489*** 454	[0.177]	-0.563*** 399	[0.167]	-0.558*** 300	[0.207]
8/09-4/10 N	-0.590*** 770	[0.126]	-0.593*** 574	[0.159]	-0.616*** 490	[0.148]	-0.614*** 360	[0.188]
11/09-7/10 N	-0.474*** 777	[0.127]	-0.461*** 579	[0.159]	-0.479*** 495	[0.148]	-0.474** 364	[0.186]

Robust standard errors in brackets.

\* 10 percent level of statistical significance, \*\* 5 percent level of statistical significance, \*\*\* 1 percent level of statistical significance.

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TABLE 2.

The effects of the announcement of the SEC proxy access rule regulation on abnormal returns: Testing whether the average abnormal return on August 25, 2010 differs between companies with 25 to \$75 million dollar market capitalization versus companies with 75 to 125 million market capitalization.

Estimation window		All Firms		Firms with a shareholder holding at least 3% institutional ownership	
		Coefficient	SE	Coefficient	SE
2005	25-75 v. 75-125	-0.702***	[0.212]	-1.050***	[0.256]
	Intercept	0.318**	[0.159]	0.507***	[0.196]
	N	905		602	
	R-squared	0.01		0.03	
2006	25-75 v. 75-125	-0.753***	[0.207]	-1.045***	[0.252]
	Intercept	0.262*	[0.153]	0.482***	[0.188]
	N	980		655	
	R-squared	0.01		0.02	
8/09-4/10	25-75 v. 75-125	-0.670***	[0.191]	-0.812***	[0.233]
	Intercept	0.080	[0.144]	0.197	[0.180]
	N	1225		800	
	R-squared	0.01		0.01	
11/09-7/10	25-75 v. 75-125	-0.644***	[0.194]	-0.792***	[0.237]
	Intercept	0.171	[0.147]	0.313*	[0.185]
	N	1236		808	
	R-squared	0.01		0.01	

Robust standard errors in brackets.

\* 10 percent level of statistical significance, \*\* 5 percent level of statistical significance, \*\*\* 1 percent level of statistical significance.

TABLE 3.

The effects of the announcement of the SEC proxy access rule regulation on abnormal returns: Testing whether the average abnormal return on August 25, 2010 differs between companies with 25 to 60 million dollar market capitalization versus companies with 90 to 125 million market capitalization.

Estimation window		All Firms		Firms with a shareholder holding at least 3% institutional ownership	
		Coefficient	SE	Coefficient	SE
2005	25-60 v. 90-125	-0.810***	[0.251]	-1.271***	[0.304]
	Intercept	0.439**	[0.178]	0.721***	[0.227]
	N	654		443	
	R-squared	0.01		0.04	
2006	25-60 v. 90-125	-0.919***	[0.246]	-1.271***	[0.300]
	Intercept	0.430**	[0.171]	0.713***	[0.217]
	N	715		485	
	R-squared	0.02		0.03	
8/09-4/10	25-60 v. 90-125	-0.752***	[0.229]	-1.031***	[0.287]
	Intercept	0.159	[0.165]	0.417***	[0.217]
	N	889		580	
	R-squared	0.01		0.02	
11/09-7/10	25-60 v. 90-125	-0.670***	[0.228]	-0.962***	[0.285]
	Intercept	0.209	[0.164]	0.487**	[0.216]
	N	897		586	
	R-squared	0.01		0.02	

Robust standard errors in brackets.

\* 10 percent level of statistical significance, \*\* 5 percent level of statistical significance, \*\*\* 1 percent level of statistical significance.

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APPENDIX A: CONTEMPORANEOUS FINANCIAL MARKETS NEWS ON AUGUST 25<sup>TH</sup>  
AND AUGUST 26<sup>TH</sup> 2010A. *Excerpt of Business and Finance Summary from Page A1 of the Wall Street Journal for August 25, 2010*

Global economic woes roiled financial markets world-wide. The Dow industrials dropped 133.96 points, or 1.3%, to 10040.45. Japan's Nikkei fell 1.3%, pulling the index into bear-market territory. An auction of two-year Treasury notes settled at the lowest yield ever as investors sought safety.

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Sales of previously owned homes in the U.S. fell in July to a level not seen in more than a decade, spurring fears of renewed weakness in housing prices and the economy.

Some of the largest commercial-property owners are defaulting on debts and surrendering buildings valued at less than their loans.

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FASB said its longstanding chairman, Robert Herz, would retire, causing new uncertainty over highly contentious accounting issues.

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Germany's fastest rate of growth in 20 years in the second quarter couldn't stop its budget deficit from more than doubling in the first half.

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Cattle prices have risen 11% since early July, pushing up the cost of beef in stores and adding to the risk of a broader wave of food inflation.

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An obscure export cartel has emerged as a key negotiating issue for BHP and other potential buyers circling Canada's Potash.

BHP is likely to ask Canadian regulators to strike down Potash's poison pill.

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LyondellBasell has decided to quit Iran to avoid U.S. sanctions, a setback to Tehran's bid to expand its petrochemical industry.

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Apple is in talks with big TV companies to offer 99-cent rentals of shows and is working on a new device to stream video to TV sets.

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Barnes & Noble swung to a quarterly loss as its same-store sales fell and it faced costs from its digital strategy and a proxy fight.

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Global regulators and bankers are weighing the merits of a system that would impose losses on bondholders of failing banks before taxpayers have to rescue them.

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India blocked Vedanta from mining in an area considered sacred by its tribal population, a move that could bode ill for dozens of projects.

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John McCain won re-nomination to his Senate seat in Arizona, one of five states voting Tuesday.

B. *Excerpt of Business and Finance Summary from Page A1 of the Wall Street Journal for August 26, 2010*

Stocks staged a meager advance, bringing an end to a four-day slide. The Dow Jones Industrial Average recovered from a steep loss in the morning, gaining 19.61 points, or 0.2%, to 10060.06, even as economic data continued to disappoint.

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The SEC approved a rule giving shareholders greater clout to place directors on corporate boards. The party-line vote at the agency points to new skirmishes ahead.

Barnes & Noble's board launched a blistering attack on the proxy bid by investor Ron Burkle, the bookseller's second-largest investor.

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BP's chief said there is no reason for his company to raise its bid for fertilizer giant Potash despite rumblings of possible rival offers

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Weakness in durable-goods orders and a drop in new-home sales to historic lows offered more signs that the economy is losing momentum.

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The USDA expects unusually tame food-price inflation this year despite a broad rally in agricultural commodity prices this summer.

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Fairfax Financial has bet nearly \$200 million using derivative contracts that wager on deflation. If prices fall, the position could reap billions.

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Japan's policy makers stepped closer toward concerted moves to curb the yen's rise, hinting at intervening in the currency market.

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Germany plans to tighten personal privacy protections with a new law that would make it much harder for firms to monitor employees.

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GE and Hitachi are making a fresh push to win nuclear-plant contracts as their joint venture faces increasing competition in the field.

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“Hindenburg Omen” creator Jim Miekka defended his indicator of stock-market trouble even as skeptics dismissed the buzz surrounding it.

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CME is investigating whether a computer glitch at a large high-speed trading firm caused a sudden spike in oil prices in February.

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Three Chinese car makers posted strong earnings growth, powered by Beijing’s measures to encourage purchases of automobiles.

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GM has priced its new Cruze compact car higher than competing Hondas and Toyotas as it tries a new approach to boosting profit.

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Fibertech, which leases fiber-optic networks to businesses, is changing private-equity owners in a deal valued at about \$500 million.

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A U.S. judge overseeing the liquidation of Madoff’s firm asked a Gibraltar court to release more than \$73 million so the funds can go to victims.

*C. List of headlines from the “Money and Investing” Section of the Wall Street Journal for August 25, 2010 and August 26, 2010 (for those stories not involving solely individual companies)*

*1. August 25, 2010*

Jingle-Mail Developers Are Giving Up on Properties, C1

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Ahead of the Tape, C1 (describing Cisco Systems’ failure to meet quarterly earnings expectations and possibility of demand shocks causing chip developers to cut prices)

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Dow Industrials Fall to 7 Week Low---Global Economic Fears Push Investors Out of Stocks, Commodities and Into Safety of US Debt, C1

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What’s the Beef? Food Inflation Fears, C1

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Dollar Falls Broadly; Franc Hits High on Euro, C2

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Europe, Asia Fall Broadly; Materials Pace Declines, C2

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International Finance: Bondholders Face a Push to Impose Bank Bail-Ins, C2

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International Finance: Japan's Yen Fuels Bear Market—Nikkei Stands Down 20.7% from Recent Peak; Calls to Rein in Currency's Gain, C2

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International Finance: LSE: Circuits Helped Avert Market Crash, C2

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International Finance: S&P Lowers Ireland Rating, C2

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Margin Debt Rebounds, C3

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The M&A-Stock Dichotomy, C3

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Jumbo Yields Fall to .38%, C5

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Short Selling: Bearish Bets Rise on NYSE, Fall on Nasdaq, C5

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Home Builders Get a Bump as Investors Sense a Bottom, C6

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Large Stock Focus: Off 3.7%, Boeing Hits Dow, C6

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VIX Jump Gives Investors a (Brief) Scare, C6

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Sturdy Houston Sees Its Market Go Wobbly—Aviation and Energy Have Boosted the Bayou City During the Downturn, But Changes in the Industries Loom, C8

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