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October 1, 2007

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attn: Nancy M. Morris, Secretary

Re: Shareholder Proposals
(Release No. 34-56160; IC-27913; File No. S7-16-0703)

Ladies and Gentlemen:

This letter is submitted in response to the Commission's request for comments on its release captioned "Shareholder Proposals," issued July 27, 2007. The Release seeks comment on a proposed rule ("shareholder access") whereby certain shareholders could include their proposals for bylaw amendments regarding the procedures for nominating candidates to the board of directors in company proxy materials.

Based on Nobel laureate Douglass C. North's notion of 'adaptive efficiency', James Madison's definition of 'faction' in *Federalist #10*, and Sir Karl Popper's 'theory of democracy', this letter urges the Commission to consider that there are:

- Two types of economic efficiency (Allocative, Adaptive)
- Three forms of democracy (Direct, Delegative, Deliberative)
- Two interpretations of fair suffrage (Appointment, Dismissal).

From these three considerations—and using SEC Chairman Christopher Cox's own criterion for efficacious rulemaking in his opening remarks before the SEC Open Meeting on July 27, 2007—I conclude that the proposed shareholder access rule would:

- Do great harm
- Not be measured and incremental
- Frustrate the exercise of state law shareholder voting rights
- Require a new regulatory regime for full and fair disclosure
- Repeat a "recent experience that ended badly" for the SEC.

Specifically the proposed shareholder access rule would:

- Change the incentive structure of U.S. public corporations from long-term economic performance to short-term economic performance
- Radically restructure Delaware's form of corporate governance from a 'corporate republic' (deliberative democracy) to a direct democracy
- Frustrate Delaware shareholders from participating in annual meetings (i.e., proxy cards are not functionally designed to be absentee ballots)
- Require shareholder access proponents and fund-of-funds to disclose relationships with hedge funds, private equity funds and investment subadvisors
- Be superfluous (i.e., majority voting standard now provides fair corporate suffrage).

Given the likelihood of these unintended consequences, the proposed rule is not—as Section 14(a) of the Securities Exchange Act of 1934 states—"in the public interest." The following explains my conclusions.

I. Do Great Harm—Change Incentive Structure to Short-term Economic Performance

The proposed shareholder access rule would "do great harm" because of theoretical and public policy reasons. From economics theory, there are at least two types of economic efficiency:

- Allocative Efficiency
- Adaptive Efficiency.

Allocative efficiency is concerned with the meta-problem of allocating scarce resources, while what Nobel laureate Douglass C. North calls 'adaptive efficiency' is concerned with solving new & novel problems in a dynamic (non-ergodic) world.[1] For allocative efficiency, the neoclassical economics meta-solution is to aggregate preferences through market-based choice, which is well suited for coordinating the supply and demand of physical commodities in the relatively static (ergodic) physical world.

For adaptive efficiency, the process of adaptation is simply problem solving using the method of trial-and-error, which can be characterized by the tetradic schema[2]

$$P_1 \rightarrow TS \rightarrow EE \rightarrow P_2$$

where P_1 is the "old" problem, TS is a trial solution, EE is a mechanism for error elimination, and P_2 is the "new" problem. In evolutionary biology, P_1, P_2 can arise from either a change in the environment or the organism itself (or from the organism's search for a better world), TS is a blind variation of a genome to solve the problem P_1, and EE is natural selection. For humans, this process of adaptation can be made more efficient (i.e., adaptive "efficiency") through the critical mode of thinking ("reason") with natural selection replaced by 'critical selection'. As the philosopher of science Karl Popper put it, "by killing our theories, we can let our theories die in our stead."[3]

More formally, "reason" here is what Popper calls 'critical rationalism': i.e., problem solving *through critical thinking* using the method of trial-and-error (NB. This is Popper's method of science). In terms of the tetradic schema, TS is a conjecture such as a business model for an organization or a policy/ regulatory regime for an institution (technically it is a 'theory-of-action' that maps intentional actions to desired outcomes), and EE is its refutation, falsification or stress testing through critical discussion and/or critical tests. [Note that in contrast to problem solving where the first step is to define "the problem" P_1 to be solved ("inquiry"), what we usually see is 'solutioneering'[4]—what Popper called 'utopian social engineering'[5]—where the first step is to jump to a pet utopian "solution" and then the problem becomes getting it accepted ("advocacy").] Put another way, problem solving is architect Louis Sullivan's design heuristic that "form should follow function" (cf. Nobel laureate Robert Merton's functional approach to finance[6]) whereas solutioneering is psychologist Abraham Maslow's observation that "if the only tool you have is a hammer, every problem tends to look like a nail."

In the case of Enron, CEO Jeff Skilling's hammer was the extension of Enron's "proven" business model to broadband, and for CFO Andy Fastow, it was the use of special purpose entities (SPEs) (which inadvertently embedded contingent liabilities—or what Warren Buffett calls financial WMDs—in its capital structure). It was these two architectural blunders that caused the collapse of Enron. Specifically, for Skilling, after having spent well over a billion dollars, Enron's broadband initiative failed to "create a customer." While Enron's "proven" business model in natural gas and electrical power was premised on scarcity, there was a surplus for broadband in 2001. In the case of Fastow, he failed to understand that for Enron to be a market-making principal intermediary, its financial integrity should have been without question to prevent a run-on-the-bank panic. Unlike commercial banks and insurance companies, he resisted government regulators, whose function is to attest to the financial soundness of a financial institution by coming in and examining their books. To make matters worse, instead of full transparency, Fastow employed opaque SPEs (perhaps to commit non-economic regulatory arbitrage). Some warned of these architectural blunders, but as the "smartest guys in the room" both Skilling and Fastow thought that they were infallible, hated criticism—and for Skilling, belittled those who "didn't get it."

In their testimony before a Senate subcommittee, Enron's outside directors remained resolute in their belief that they were diligent and dedicated to their charge—and that what had happened was a "systemic failure" of the U.S. corporate governance system. They relied on the candor and integrity of management, and had no cause for suspicion until it was too late. From the perspective of Professor Donald C. Langevoort's "Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors" (*University of Pennsylvania Law Review*, November 1997), the key questions are that given tough anti-fraud statutes, stiff criminal penalties, and public scrutiny as a public corporation, why did management mislead the board? Why did economic distress turn so quickly into financial distress? Why did seemingly manageable problems fester and grow? Why couldn't the corporation adapt? Why wasn't management able to problem-solve? I would point the finger at solutioneering, which, when it leads to defensive reasoning, an escalation of commitment, groupthink, dogmatism, "undiscussables," and the dysfunctional "state of denial," is an agency problem. (This state of denial where dogmatic "thinking" has diverged far from "reality" and criticism is not tolerated is what Popper called a 'closed society'.) So fraud did not cause Enron to fail but rather fraud followed failure. The fraud that was committed was a massive cover-up of a colossal business failure. As for Skilling, perhaps because of hubris he could not admit that he made a mistake until it was too late, but to his credit tried to clean up his mess before he resigned. Tragically, Fastow had already embedded financial WMDs that were soon triggered by Enron's declining stock price, which ultimately led to its catastrophic collapse.

To remedy this agency problem of solutioneering, Enron's board could have strengthened its risk oversight process by hiring a management consultant to stress test, falsify or criticize Enron's business model and capital structure. (Note how this resolves the asymmetric information problem faced by "part time" outside directors.) Enron did not have to die (i.e., natural selection); its board could have let its business model die in its stead (i.e., critical selection). What this all means is that role of the board (or more specifically the independent directors) is to be the Socratic Guardians of the corporation where its most important responsibility is risk oversight to keep the CEO's "thinking" (i.e., business model) close to economic "reality" by constantly stress testing it. (In military lingo, this is the function of intelligence agencies, and "red teams" in war games.) If there was a systemic failure, it was due to a lack of critical thinking in the boardroom. As George Soros put it in describing the secret behind his phenomenal investing success, "it is wise to be constantly looking for the fly in the ointment. When you know what it is, you are ahead of the game."[7]

This post-mortem of the catastrophic collapse of Enron and what boards can do about it is provided to the Commission in support of Professor Lynn A. Stout's observation of the "Enron effect" in which there is the "bizarre *non sequitur*" that shareholders should be given more power to prevent a future Enron.[8] The root cause of the collapse of Enron was due to the agency problem of solutioneering. The important lesson for the Commission here is that it should not engage in solutioneering, but rather problem solving. As North suggests by the title of his paper, "Institutions, Ideology and Economic Performance" (*Cato Journal*, Winter 1992), ideology plays a very important role in economic performance—whether it be a business model at Enron or a proxy solicitation regulatory regime now before the SEC. The decision before the Commission is whether it should radically restructure Delaware's corporate governance regime of director primacy (corporate republicanism) in favor of shareholder primacy (market fundamentalism). Market fundamentalists, like the Committee for Capital Market Regulation, base their ideology on neoclassical economics (market-based choice)—which is a theory designed to solve the criterion of allocative efficiency (allocating scarce resources). Perhaps more relevant to our modern global economy is North's criterion of adaptive efficiency (solving new & novel problems in a dynamic world), which is addressed by critical rationalism (problem solving through critical thinking via trial-and-error). In short, the Commission should consider both types of economic efficiency in its deliberations—or as John Maynard Keynes wrote, "The difficulty lies, not in the new ideas, but in escaping the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds."

Another way to look at the dichotomy between allocative efficiency and adaptive efficiency is in the valuation of the wealth-producing capacity of a corporation:

$$V = DCF + \text{Option Premium}$$

where DCF is the discounted cash flow valuation of the corporation as a strict going concern (i.e., the corporation currently as-configured), and Option Premium is the premium value of its portfolio of real options[9] (e.g., R&D for next-generation server chip). Here the operational effectiveness of the going concern addresses the issue of allocative efficiency while the portfolio of real options[10] addresses adaptive efficiency in a Knightian-uncertain, non-ergodic world. Note that because real options involve a corporation's business plans for the future, their valuation involves proprietary inside information[11]—particularly in hypercompetitive product markets. As a consequence, perhaps this is what Professors Bernard Black & Reinier H. Kraakman call a "hidden value"[12] in their analysis of hostile takeovers.

The agenda of market fundamentalists is to use the proposed shareholder access rule to dismantle takeover defenses such as the poison pill and staggered boards by gaining control of boards through what attorney Martin Lipton called contested elections "on the cheap."[13] In terms of the wealth-producing capacity of the public corporation, the likely consequence will be the premature termination of its real options, which in turn will lead to a loss of adaptability in the U.S. economy (adaptive efficiency). For Section 23(a)(2) of the Exchange Act, this premature termination will lead to a decrease of competition in the product markets (e.g., no "next generation" server chip market). For managers, since the only thing that counts will be short-term operational effectiveness, this will bias the incentive structure of the U.S. corporate governance system towards short-term economic performance (allocative efficiency).[14] For shareholders, they may be giving up what fund manager Peter Lynch calls a "ten-bagger" stock for a measly 20% takeover premium (at probably bargain basement prices!). For non-shareholder constituencies, the predictable result will be what Andrei Shleifer & Lawrence Summers called a "breach of trust"[15], which destroys what economists Armen Alchian & Harold Demsetz called 'team production'[16] in corporations. Perhaps it was these sound economic rationales that led thirty-one state legislatures during the last hostile takeover wave to make the clear public policy pronouncement of repudiating market fundamentalism (shareholder primacy) by passing non-shareholder constituency statutes that allowed boards to consider, beyond those of share-"owner" property rights, the interests of non-shareholders.

To be sure, allocative efficiency is important—particularly for reallocating the capital of a corporation in a declining industry such as a mass producer of buggy whips in the age of the automobile—and its "safety valve" is the tender offer. In such an environment where the future is predictably ergodic, the value of a corporation's real option is nil, and hence the value of its wealth-producing capacity is $V \approx DCF$. Thus if its stock is trading below its liquidation value, corporate raiders should be able take advantage of this arbitrage by taking it private and dismantling it.[17] [18] As Peter F. Drucker has pointed out, "the raiders perform a needed function. … 'If there are no grave diggers, one needs vultures.'"[19] Moreover, as Oracle's successful hostile takeover of PeopleSoft (later) showed, a target board cannot "just say no" forever. In short, the "system" works!

Note that from a theoretical perspective, choice is an instantaneous event and hence allocative efficiency is economic efficiency at a *moment of time*; in contrast, problem-solving via trial-and-error is a process, which means that adaptive efficiency is economic efficiency *through time*. As the economist Joseph Schumpeter pointed out, "A system that at every given point of time fully utilizes its possibilities to the best advantage may yet in the long run be inferior to a system that does so at no given point of time."[20] According to the late Alfred Chandler[21], the phenomenal success of the U.S. economy since the 1850's can be attributed to the visible hand of management (vs. the invisible hand of the market). Promulgating the proposed shareholder access rule would be tantamount to mangling this visible hand, thus crippling it by biasing its incentive structure towards short-term economic performance and disabling its ability to solve new & novel problems in a dynamic world. Perhaps this is why North advises, "it is adaptive [efficiency] rather than allocative efficiency which should be the guide to policy."[22] Thus for both theoretical and public policy reasons, the proposed shareholder access rule would do great harm and therefore is not "in the public interest."

II. Not Be Measured and Incremental—Radically Restructure Delaware's Corporate Republicanism

A. *The Federalist Papers*: Republic versus Democracy

In his "Toward A True Corporate Republic: A Traditionalist Response to Bebchuk's Solution For Improving Corporate America" (*Harvard Law Review*, April 2006), Delaware Vice Chancellor Leo E. Strine, Jr. called Delaware's form of corporate governance, 'corporate republicanism'. The proposed rule would radically restructure Delaware's form of corporate governance from a republic to a direct democracy—and hence be neither measured nor incremental. To understand the distinction between a 'republic' and a 'democracy' perhaps it might be helpful for the Commission to reflect on James Madison's definition of 'faction' in *Federalist #10*:

> By a faction, I understand a number of citizens, whether amounting to a majority or a minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adversed to the rights of other citizens, or to the permanent and aggregate interests of the community.

What this means is that there is not one but rather three forms of democracy:

- Direct Democracy
- Delegative Democracy
- Deliberative Democracy (Republic)

based on the following modes of political discourse:

- Popular Will (Passion)
- Political Bargaining (Power)
- Deliberation (Reason).

Direct democracy is simply majority rule through the aggregation of voter preferences whereby elected officials mechanically carry out the "will of the people." In a delegative democracy, elected officials are simply 'delegates' who pursue the self-interests—and carry out the instructions—of their sponsoring special interest group. In *Federalist #10*, Madison explained that the problem that the Framers of the U.S. Constitution were trying to solve was controlling the "mischiefs of faction," and concluded that:

> a pure democracy…can admit of no cure for the mischiefs of faction. … A republic, by which I mean a government in which the scheme of representation takes place, opens a different prospect, and promises the cure for which we are seeking.

For example, the mischief in a direct democracy is the tyranny of the majority (majority faction), and in a delegative democracy, power plays by special interest groups (minority faction). Called 'illiberal democracies'[23] by *Newsweek's* Fareed Zakaria, a factional mischief in a direct democracy is the election of Hamas in the Palestinian Authority, and in a delegative democracy, the sectarian impasse in Iraq. For corporate governance, examples are respectively coercive tender offers that do not provide adequate time for informed shareholder deliberation, and the undue influence of a corporate raider whose "delegates" were perhaps elected on a short slate. In modern parlance, a republic is what Professor Cass Sunstein calls a 'deliberative democracy'[24]. From *Federalist #57*:

> The aim of every political constitution is, or ought to be, first to obtain for rulers men who possess most wisdom to discern, and most virtue to pursue, the common good of the society; and in the next place, to take the most effectual precautions for keeping them virtuous whilst they continue to hold their public trust.

Thus elected officials ("representatives") are like trustees who deliberate to pursue the interests of the common good. Perhaps influenced by Edmund Burke where in his 1774 Speech to the Electors of Bristol said:

> Your representative owes you, not his industry only, but his judgment; and he betrays, instead of serving you, if he sacrifices it to your opinion

Madison described the role of a representative in *Federalist #10* as:

> to refine and enlarge the public views, by passing them through the medium of a chosen body of citizens, whose wisdom may best discern the true interest of their country, and whose patriotism and love of justice will be least likely to sacrifice it to temporary or partial considerations.

This notion that representatives should have the discretion to deliberate—versus delegates who are like "tools" that mechanically carry out the instructions of their constituents—was reiterated by Madison during the August 15, 1789 House debate on amending the Constitution:

> The right of freedom of speech is secured; the liberty of the press is expressly declared to be beyond the reach of this Government; the people may therefore publicly address their representatives, may privately advise them, or declare their sentiments by petition to the whole body; in all these ways they may communicate their will. If gentlemen mean to go further, and to say that the people have a right to instruct their representatives in such a sense as that the delegates are obliged to conform to those instructions, the declaration is not true.

And regarding majority rule (passion), Alexander Hamilton in *Federalist* #71 wrote:

> The republican principle demands that the deliberate sense of the community should govern the conduct of those to whom they intrust the management of their affairs; but it does not require an unqualified complaisance to every sudden breeze of passion, or to every transient impulse which the people may receive from the arts of men, who flatter their prejudices to betray their interests. It is a just observation, that the people commonly INTEND the PUBLIC GOOD. This often applies to their very errors. But their good sense would despise the adulator who should pretend that they always REASON RIGHT about the MEANS of promoting it. They know from experience that they sometimes err; and the wonder is that they so seldom err as they do, beset, as they continually are, by the wiles of parasites and sycophants, by the snares of the ambitious, the avaricious, the desperate, by the artifices of men who possess their confidence more than they deserve it, and of those who seek to possess rather than to deserve it. When occasions present themselves, in which the interests of the people are at variance with their inclinations, it is the duty of the persons whom they have appointed to be the guardians of those interests, to withstand the temporary delusion, in order to give them time and opportunity for more cool and sedate reflection. Instances might be cited in which a conduct of this kind has saved the people from very fatal consequences of their own mistakes, and has procured lasting monuments of their gratitude to the men who had courage and magnanimity enough to serve them at the peril of their displeasure.

As an aside, the function of staggered terms in the U.S. Senate was to withstand popular passions, temporary delusions and transient impulses—and to foster values such as deliberation, reflection, continuity, and stability. As Madison wrote in *Notes of Debates in the Federal Convention of 1787*, "The use of the Senate is to consist in its proceedings with more coolness, with more system and with more wisdom, than the popular branch." Thus, analogous to North's policy guidance of favoring adaptive efficiency (efficiency through time) over allocative efficiency (efficiency at a moment of time), the Framers sought to create a republic (deliberation) rather than a direct democracy (popular passion).

* * * * *

In Delaware's corporate governance system the republican ideals of the pursuit of the common good, virtuous conduct and disinterested deliberation can be found in the speeches and judicial opinions of the Delaware judiciary (Professor Edward Rock calls them "corporate law sermons"[25]). For example, Chancellor William T. Allen described the central problem of corporate governance as:

> How can we offer reasonable assurance to investors that necessary discretion will be exercised in a good faith attempt to achieve the common good? That those possessing such discretion will act with integrity?[26]

and saw the role of the outside director as "a private office imbued with public responsibilities."[27] (Note that the Latin root of 'republic' is *res publica*—or "things public.") For the aspirational preference of virtuous conduct, Supreme Court Chief Justice E. Norman Veasey has noted that Delaware's approach to corporate governance rests on a "strong bond of trust" in the institution of the board of directors, which in turn is predicated on the character of directors: i.e., attributes such as "expertise, diligence, good faith, independence and professionalism." [28]

For the third republican ideal of disinterested deliberation, Chief Justice Veasey defined independence as follows:

> What is independence? At a minimum, it includes disinterest in the transaction. Beyond that, it means that the director must act only on the merits of the issue and not on extraneous concerns. Directors should not be controlled or be seen as controlled by others. …there should be a commonsense aversion to relationships that raise serious questions of appearances.[29]

And according to Vice Chancellor Strine (in *ATR-Kim Eng Financial v. PMHI Holdings*, 2006 Del. Ch. LEXIS 215), independence applies not only to disinterestedness from management but also from particular shareholders:

> Such behavior is not indicative of a good faith error in judgment; it reflects a conscious decision to approach one's role in a faithless manner by acting as a tool of a *particular* stockholder rather than an independent and impartial fiduciary honestly seeking to make decisions for the best interests of the corporation.

In their highly acclaimed book *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, 2004), Professors Henry Hansmann & Kraakman would probably identify the Delaware approach as the 'trusteeship strategy' in which agents respond to the "low powered" incentives of "conscience, pride and reputation" (p. 27). Chancellor Allen called these incentives 'soft concepts', which include "pride, self-respect, a sense of service, and an understanding of the legal and social requirements of the governance paradigm."[30]

B. Delaware's Trusteeship Strategy: Semi-personal Repeated Game

In Nobel laureate North's framework of institutional analysis[31], institutions are the "rules-of-the-game" whose architectural components consist of formal rules coupled with legal enforcement mechanisms and informal constraints coupled with private enforcement mechanisms. Formal rules can be categorized by:

- Political Rules (constitutions, statute & common law, regulations)
- Economic Rules (property rights: e.g., shareholder rights to sell, vote, sue)
- Specific Contracts (e.g., corporate charters, bylaws, shareholder agreements).

Informal constraints are informal approaches to coordinating human interaction. Some examples are:

- Internally-enforced Codes of Conduct (e.g., low-powered incentives)
- Conventions and Socially-sanctioned Norms (e.g., disinterested "public" directors).

And the three levels of enforcement mechanisms are:

- First Party (self-enforcement)
- Second Party (retaliation: e.g., sell, vote, sue)
- Third Party (state coercion, reputational sanctioning).

Although Delaware corporation law is a common law system characterized by the business judgment rule (process due care), fiduciary duties (loyalty, care, good faith[32]) and *ex-post* judicial review (e.g., Court of Chancery), as Chief Justice Veasey points out:

> There is a significant self-governing aspect to the corporation law in that daily functions of the enterprise are based largely on norms—i.e., nonlegally enforceable governance mechanisms. Self-governance works for the most part because of the sensitivity of directors to do what is right, what is professional, what is honorable, and what is profitable.[33]

In 2006, an important development occurred when a new formal rule was introduced: the majority-voting standard. Here Delaware's corporate law was amended whereby (i) directors may not undo a majority-voting bylaw approved by stockholders and (ii) a director's resignation may be irrevocable when the director does not secure a majority of votes cast in an uncontested election. The importance of this new formal rule is that it has created a new shareholder voting right: the negative majority power of dismissal (versus the positive majority power of appointment).

Through this new shareholder voting right, as described by Popper in "The Open Society and Its Enemies Revisited" (*Economist*, April 23, 1988) Election Day (i.e., the annual shareholder meeting) can now be seen as a political "Day of Judgment":

> as a day when a responsible government stands to account for its deeds and omissions, for its successes and failures, and a responsible opposition criticizes this record and explains what steps the government ought to have taken, and why.

As an aside, this is Popper's 'theory of democracy':

> I think that I may call it a theory of "democracy", even though it is emphatically not a theory of the "rule of the people", but rather the rule of law that postulates the bloodless dismissal of the government by a majority vote. … All these theoretical difficulties are avoided if one abandons the question "Who should rule?" and replaces it by the new and practical problem: how can we best avoid situations in which a bad ruler causes too much harm?

Regarding the so-called Berle & Means collective action problem of widely dispersed shareholders holding directors accountable for their corporate stewardship:

> According to Thucydides, Pericles [in 430 BC] expressed this idea in a very simple way: 'even if only a few of us are capable of devising a policy or putting it into practice, all of us are capable of judging it.' This succinct formula is, in my view, fundamental. Please note that it discounts the notion of rule by the people, and even of popular initiative. Both are replaced with the very different idea of *judgment by the people*.
>
> Pericles says here very briefly why the people is not able to govern, even when there are no other difficulties of any kind. Ideas—particularly new ideas—can only be the work of single individuals, even if they may be clarified and improved in collaboration with a few others. Many people are subsequently able to see whether the ideas were good or bad, especially if they have had direct experience of their consequences. And such assessments, such yes-no decisions, can be made by a broader electorate.
>
> An expression such as 'popular initiative' is thus misleading and propagandistic. It is usually the initiative of a few, which is at best presented to the people for critical evaluation. In such cases, then, it is important to know whether the measures being proposed are outside the competence of the electorate that evaluates them.

In corporate governance, the argument of ideas being the work of single individuals (e.g., a strong executive) corresponds to Professor Gordon Donaldson's warning of fractious boards where "No organization can tolerate more than one vision of the future at one time"[34] (the military calls this 'unity of command'). For Popper, perhaps playing the role of Socrates (and echoing the method of conjecture-and-refutation in critical rationalism [where refutation is the negative majority power of dismissal]), he said:

> The major thing regarding a change in government is this negative power, this threat of removal. The positive power to appoint a government or premier is a relatively unimportant counterpart. … What do we know, and what does the people know, of the error or even crime of which its chosen government will be guilty? … After a while we are able to judge a government or a policy, and perhaps we will give them our approval and therefore reelect the government. Perhaps we can extend it our approval in advance; but then we know nothing, we cannot know anything, we do not know the government, and so we cannot assume that it will not abuse our trust.[35]

For Madison in *Federalist #57*, Election Day as a political Day of Judgment was his prescription of "effectual precautions for keeping [rulers] virtuous":

> The elective mode of obtaining rulers is the characteristic policy of republican government. The means relied on in this form of government for preventing their degeneracy are numerous and various. The most effectual one, is such a limitation of the term of appointments as will maintain a proper responsibility to the people.

In his seminal book *Liberalism Against Populism: A Confrontation Between the Theory of Democracy and the Theory of Social Choice* (Waveland Press, 1982), the founder of positive political theory (i.e., rational choice theory including the application of game theory to political science) William H. Riker interpreted Madison's prescription as follows:

> The sharp dispute on these questions can be summarized in two views—one of which I call liberal or Madisonian, the other populist or Rousseauistic. In the liberal view, the function of voting is to control officials, *and no more*. Madison, who is the original spokesman for liberal democracy (or republicanism, as he called it) defined a republic as "a government that derives all its powers directly or indirectly from the great body of the people and is administered by people holding their offices during pleasure, for a limited period, as during good behavior (p. 9).
>
> … The liberal assumes not popular competence, but merely that the electorate can change officials if many people are dissatisfied or hope for better performance. It may seem that in the liberal view officials, who are only negatively controlled by voting, cannot really act as agents of the electorate. By reason of regular elections, however, officials may be rejected. In their efforts to avoid rejection the usually act in some rough way as agents of the electorate, at least attempting to avoid giving offense to some future majority. Since this future majority cannot at any moment be clearly specified, officials seeking to placate it in advance must anticipate several kinds of potential majorities, the union of which is often most of the electorate. By reason of this anticipation of the next election, officials are, even in the liberal view, subject to electoral discipline as the agents of democratic self-control. (p. 10-11).
>
> … The essence of the liberal interpretation of voting is the notion that voting permits the rejection of candidates or officials who have offended so many voters that they cannot win an election. This is, of course, a negative ideal. It does *not* require that voting produce a clear, consistent, meaningful statement of popular will. It requires only that voting produce a decisive result: that this official or this party is retained in office or rejected (p. 242).
>
> … Liberals can cheerfully acknowledge that elections do not necessarily or even usually reveal popular will. All elections do or have to do is to permit people to get rid of rulers. The people who do this do not themselves need to have a coherent will. They can be—and often are—strange bedfellows. Voters on the far right and the far left, for example, can combine to throw out a ruler in the center (p. 244).

For corporate governance, according to former SEC Commissioner and now Professor Joseph A. Grundfest in "Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates" (*Stanford Law Review*, April 1993), all the procedural machinery for shareholders to use their new shareholder voting right of dismissal are already in place (i.e., by withholding authority) in the SEC proxy solicitation system (though it may need to be amended to exempt "just vote no" withhold campaigns in uncontested elections where technically there would be no change of control since incumbent independent directors would control the nomination of their own replacements). Moreover, the pending amendment to Rule 452 by the NYSE to eliminate discretionary broker voting on director elections further strengthens this new shareholder voting right. Note that even in a "failed" election or even if a corporation has not formally adopted the majority-voting standard (i.e., withhold votes are precatory), from Chancellor Allen's suggestion *in dictum* in the *Caremark* case where the federal sentencing guidelines had set a new norm for good corporate governance, the majority-voting standard now sets elements of the fiduciary duties of loyalty and good faith. In other words, to maintain their legitimacy to govern, in the face of a majority vote of dismissal, directors must either give good reason ("reason giving") for their obstinacy or else resign. The important point here is that there is now what Chief Justice Veasey has termed an 'evolving expectation'[36] that Election Day is a political Day of Judgment where shareholders hold directors accountable for their corporate stewardship.

For Delaware's trusteeship strategy, the significance of informal constraints coupled with private enforcement mechanisms is that they provide a solution to the three basic agency problems in corporate governance[37]:

- Opportunism of managers vis-à-vis shareholders
- Opportunism of controlling shareholders vis-à-vis minority shareholders
- Opportunism of shareholders as a class vis-à-vis other corporate constituencies.

That solution is the institution of the "public" director, which Professor Langevoort, in "The Social Construction of Sarbanes-Oxley" (*Michigan Law Review*, June 2007), suspects is the real motivation behind the Sarbanes-Oxley Act and the NYSE/Nasdaq Director Independence Listing Standards:

> [T]here is an alternative interpretation of SOX that explains its motivations and likely long-term effects. This raises the possibility that SOX's most important effects may be less about investor protection than about renegotiating the boundary between the public and private spaces in big corporations, a much deeper ideological issue. The legislation may reflect a political instinct that incentive structures in modern public corporations generate risks that require public (not just investor) accountability to be legitimate. I suggest the "independent" director, currently seen largely as an investor advocate, is being pushed toward becoming a "public" director whose main assignment is to keep risks and rewards in a socially acceptable balance.

In other words, more than directors who are independent of management, public directors are also trustees for the shareholders-at-large (i.e., the "common good").

From a game theoretic perspective, Chapter 2 of North's landmark *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, 2000) presents three requirements for wealth-maximizing individuals to find it worthwhile to cooperate (i.e., not be opportunistic) with other players:

- When they possess complete information about other players' past performance
- When there are a small number of players
- When play is repeated.

Note that these requirements are typically met for transactions involving face-to-face personal exchange (e.g., the clubby world of private equity firms), but not, at least theoretically, for mass-market impersonal exchanges (e.g., public equity markets). Put another way says North, "cooperation is difficult to sustain when the game is not repeated (or there is an end game), when information on the other players is lacking, and when there are large numbers of players." Thus one approach to solving the three basic agency problems in corporate governance is to have public directors fulfill these three requirements by forcing them to play a semi-personal repeated game.

For the first requirement, SEC proxy solicitation rules and massive Internet archives have "personalized" the impersonal exchange by providing a reputational nexus for shareholders to evaluate the past performance of candidate directors. For the second requirement of restricting the game to a small number of players, public directors are what Soros calls public-spirited 'encumbered individuals': i.e., "individuals in need of society, individuals who cannot exist in splendid isolation, … [individuals who] need to belong to something bigger and more enduring."[38] In addition, public directors have distinguished themselves in their previous careers. In the case of Athenian democracy (430 BC), Pericles, in his famous funeral oration, said:

> Our political system…is called a democracy. … When a citizen distinguishes himself, then he will be called to serve the state, in preference to others, not as a matter of privilege, but as a reward of merit.[39]

Perhaps this is what former President Jefferson—an egalitarian who wrote, "all men are created equal"—meant by a 'natural aristocracy' in his 1813 letter to former President John Adams:

> There is a natural aristocracy among men. The grounds of this are virtue and talents. … There is also an artificial aristocracy founded on wealth and birth, without either virtue or talents. … May we not even say that that form of government is the best which provides the most effectually for a pure selection of these natural aristoi into the offices of government?

From the perspective of institutional economics, the purpose of self-selecting candidate directors from a small pool of prominent, distinguished and highly regarded individuals is to foster what Nobel laureate Herbert A. Simon called "identification" with, and loyalty to, the institution of the public director (versus a director's opportunistic pursuit of his own economic self-interest):

> Identification causes us to pay attention to those features of a situation that are relevant to the group or goal and to ignore features that are irrelevant. It causes us to choose what benefits the we, and to ignore whether it harms the they.
>
> … Group loyalty or identification is more than a matter of motivation, for it conditions the entire manner in which we think about our situation and the choices we have to make. We view the world from the standpoint of the goals of the groups with which we identify, and we judge the attention-worthiness of facts about the world by their relevance to the attainment of these goals.
>
> … The common claim that economic self-interest is the only important human motivation in the workings of a society is simply false, for it is an easily observable fact that, within organizations, organizational identification requires at least equal billing with self interest.[40]

Public directors currently view their private office as one of honor, prestige and a reward of merit, which in turn puts them on a high pedestal of public trust. Note that there is a tremendous psychological difference between candidate directors campaigning for office and standing for election (which the first six U.S. presidents did). The proposed shareholder access rule would subject candidate directors to the indignities of the former, which would not only "devalue"[41] the office, but as Lipton has pointed out, is something that they do not need at this stage of their careers:

> The best candidates for director typically do not need the job. They are individuals who have already achieved a high level of success professionally and financially. They are not dependent on the fees they are paid as directors.[42]

The NYSE Director Independence Listing Standards now require nominating committees to consist entirely of independent (public) directors: i.e., Jefferson's natural aristocrats selecting other natural aristocrats. (Note that on the one hand, to control the mischiefs of faction, the public directors would still control the nominating process; on the other, in Grundfest's advice-and-consent scheme, shareholders would still have "voice" because nominating committees would seek their advice in nominating directors lest they withhold their consent.) From a game-theoretic perspective, since not anyone can join this elite and exclusive club, public directors would think twice before defecting (i.e., being opportunistic). Important is loyalty to the institution of the pubic director (i.e., each public director is his brother's keeper). In other words, people identify themselves by the company they keep, and it should be a real honor to be invited to serve on a board—or as Groucho Marx otherwise put it, "I would not join any club that would have someone like me for a member."

For the third requirement, the game for public directors is repeated through the self-enforcement mechanism of avoiding the pang of conscious, and the third-party enforcement mechanism of reputational sanctioning. Delaware's aspirational preferences such pride, self-respect and sense of service, and the NYSE listing standard for independent nominating committees set up the self-enforcement mechanism. As framed by Chief Justice Veasey, "when the director looks in the mirror, how will he or she answer this question: will I be comfortable reading an investigative piece in the financial press or the tabloids displaying my behavior and my objectivity in carrying out my fiduciary duties as a director?"[43] For the reputational-sanctioning mechanism, the key is the *a priori* selection of reputation-sensitive directors who by pledging their good name for good conduct become what economist Oliver E. Williamson calls 'reputational hostages'[44]. As noted by Adam Smith in *The Theory of Moral Sentiments*, "the success…of most people…almost always depends upon the favor and good opinion of their neighbors and equals." Particularly after being put on the high pedestal of public trust, reputational enforcement includes what Veasey terms "negative motivators such as peer pressure, 'shaming,' and fear of lawsuits."[45] Moreover with the majority-voting standard, shareholders now have the negative majority power of dismissal to hold directors accountable for their corporate stewardship.

C. Deliberative Democracy: Political Philosophy of Open Society

As illustrated by the Eye of Providence (Reason) at the apex of an unfinished Great Pyramid on the reverse side of the Great Seal of the United States, the Founding Fathers hoped that to pursue the "common good of the society" the mode of political discourse of their new republic would be based on reason (deliberative democracy) (see mythologist Joseph Campbell's metaphorical interpretation in his *The Power of Myth* [Doubleday, 1988; pp. 24-32] interview with Bill Moyers). In the U.S. Constitution, the Framers sought to facilitate deliberation through a separation of power and a system of checks-and-balances such as a bicameral legislature in which, as George Washington explained to Thomas Jefferson who had been away in France during the 1787 Constitutional Convention, the more deliberative Senate was designed to "cool" the heated passions of the House. Clearly these rather complex institutional devices—which as Madison suggested in *Federalist #51* of ambition counteracting ambition—are not applicable to corporate governance.

To facilitate deliberation in the boardroom, what may be applicable is Popper's political philosophy of open society. Based on the three principles of:

- Reason
- Reasonableness
- Reason-giving

this political philosophy proposes changing the political rules of the game from solutioneering through unilateral control (advocacy) to problem solving through critical thinking (joint inquiry).[46] An example of advocacy is the approach used by the CIA that resulted in the Bay of Pigs debacle; for joint inquiry, this approached was used by President Kennedy to successfully resolve the Cuban missile crisis.[47]

1. Reason. Reason here is defined as Popper's critical rationalism—or more technically, the extensive form of Popper's tetradic schema[48]

$$P_1 \rightarrow \{TS_i\} \rightarrow EE \rightarrow P_2$$

where $\{TS_i\}$ is a set of tentative solutions. Here the pursuit of the "common" good can be realized by solving our "common" problems (P_1, P_2): e.g., the enemy of my enemy is my friend. For boardroom deliberations, an example of a common problem is Drucker's purpose of business enterprise—which is to "create a customer"[49] (profitability is a hard constraint that must be met). (Recall that for Enron, after spending well over a billion dollars on its broadband initiative, it failed to create a single customer.) Given this prime directive (P_1), other examples are the different "new" problems (P_2) that businesses face in each of the different stages of the market life cycle: e.g., disruptive innovation, product innovation, process innovation, etc.[50] The political-economic interpretation of this extensive form is that it is an open design competition. Some institutional examples of this extensive form are the problem-solving format of the U.S. Army staff study (Field Manual FM 101-5, Appendix D), the LMDC design competition for the WTC site plan, and presently, the SEC's open design competition for resolving the dilemma caused by the Second Circuit Court's decision (P_1) by putting forth two proposed rules (conjectures):

- T_1 : Shareholder Access Proposal (Release No. 34-56160)
- T_2 : No Access Proposal (Release No. 34-56161)

for public comment (refutation). As described by Chairman Cox in his opening remarks:

> By advancing two very different proposals, we will have the benefit of the full breadth of commentary about different ways of attacking this issue. By considering serious alternatives, we will have the benefit of thorough analysis of a variety of ways to accomplish our stated objectives. This approach will also give us a richer context in which to evaluate public comment concerning the potential costs and benefits of any new rule. And exposing both of these proposals to public comment will enable us to better understand the impact that any new rule would have on competition—an analysis that we're required to undertake pursuant to Section 23(a)(2) of the Exchange Act. For all of these reasons, it is my intention to support both Releases at the proposing stage.

For efficacious rulemaking, the Commission should follow social science methodologists Donald T. Campbell and Julian C. Stanley[51], and Chris Argyris'[52] criterion for error elimination (EE):

- External Validity
- Internal Validity
- Implementable Validity.

External validity is a revolutionary constraint, and its purpose is progressive: solving new and novel problems. It is also Nobel laureate Simon's notion of 'satisficing'[53] (e.g., does the trial solution TS_i solve the problem P_1?). Internal validity is a conservative constraint, and its purpose is to prevent regression: i.e., still solving the old problems with no side effects and internal inconsistencies. Implementable validity is a piecemeal constraint, and its concern is 'do-ability': i.e. successful implementation requires "the problem" to be well defined and concrete. (A counterexample of implementable validity is the SEC's troubled implementation of Section 404 of the Sarbanes-Oxley Act.) In other words, attempting to solve an open-ended abstract problem might be utopian ('utopia' literally means "nowhere"), particularly should political firestorms from unwanted consequences stall the reform. This is the key point behind Popper's piecemeal social engineering:

> The piecemeal engineer knows, like Socrates, how little he knows. He knows that we can learn only from our mistakes. Accordingly, he will make his way, step by step, carefully comparing the results expected with the results achieved, and always on the lookout for the unavoidable unwanted consequences of any reform; and he will avoid undertaking reforms of a complexity and scope which make it impossible for him to disentangle causes and effects, and to now what he really doing.[54]

Taken together, these three criteria are analogous to the common law jurisprudence doctrines of *stare decisis* and incrementalism, in which courts decide cases in accordance with precedence and in the narrow factual context of a particular trial record. Finally, if there are undesirable unintended consequences to the Commission's rulemaking, new problems will emerge (P_2). In general, should the SEC's open design competition succeed, it may well have hit upon a method of democracy!

2. Reasonableness. Reasonableness is a willingness to be persuaded, which in turn requires the recognition of human fallibility. Metaphorically, perhaps that is why the Great Pyramid is unfinished; rather than boasting of the creation of a perfect utopian society, our Founding Fathers knew that they had created an imperfect work-in-progress new order that should be open to improvement through reason. Recognizing that government is fallible, they guaranteed the freedom of speech to criticize it, and the right to vote to dismiss it. Incidentally, an important distinction between a private and a public corporation is the critical feedback mechanisms of shareholder exit, voice and judgment[55], which is facilitated through the SEC regulatory regimes of stock market surveillance, material information disclosure, and proxy solicitation. This critical feedback loop is the genius behind the U.S. public corporation (and in general, explains Nobel laureate Amartya Sen's remarkable finding that "no substantial famine has ever occurred in any independent and democratic country with a relatively free press" [56]). Thus, the key to facilitating reasonableness is to change the political rules of the game from solutioneering (advocacy) to problem solving (joint inquiry). This is the only way for a leader to change his mind without being politically embarrassed. It is also the key to facilitating civil political discourse. After all, what should matter is not whose pet policy "solution" wins, but rather that our common problem "gets solved." (Again, from a metaphorical perspective, when one takes a side of the Great Pyramid [advocacy], one can't see the other points of view; it is only when one is trying to solve a common problem [joint inquiry] that one wants to be at the apex in order to see all the points of view.)

The implication for corporate governance is that public directors should not campaign for office (since they would need to make campaign promises to differentiate themselves from the incumbent board). The difficulty here is that once elected, it might be political suicide for them to change their minds ("flip flop")—even when they later have access to inside information or the business climate has changed. For example, consider the hypothetical situation of a prominent shareholder activist who, after gaining control of a board by campaigning to divest a major division, still went through with the sale in the midst of what one central banker called a "heart attack" in the credit markets (and further reduced the price agreed for that sale by almost 18 per cent to $8.5 billion!). But rather than postpone the deal to wait for more favorable credit market conditions—and thus risk losing credibility with his sponsoring shareholder constituency—he decided to keep his campaign promise. For the shareholders-at-large though, selling a major division at the bottom of the market may have not been in their best interest (particularly should the private equity buyers take the division public at a handsome profit five years hence).

To ensure reasonableness, public directors should be disinterested—much like what society demands of judges and juries. Thus instead of campaigning for office in a contested election, independent (disinterested) nominating committees now put forth candidate public directors who stand in an uncontested election. Should a candidate fail to secure a majority of votes, in Grundfest's advice-and-consent scheme[57], nominating committees would seek the advice of shareholders lest they withhold their consent again. In addition to controlling the mischiefs of faction, the purpose of ostensibly disinterested public directors being replaced by a fresh crop of disinterested pubic directors (i.e., Burkean representatives) is not to perpetuate the status quo, but rather to bring a "fresh pair of eyes" into the boardroom (e.g., to review whether the board should continue to defend against a hostile tender offer).

Another dimension of reasonableness is that in the U.S. corporate governance paradigm of the monitoring board, public directors are the Socratic Guardians of the corporation where their most important responsibility is to ensure that their CEO's "thinking" does not diverge from economic "reality." An often untapped candidate pool for public directors is retired CEOs[58]. These distinguished men of merit who have seen it all are elder statesman who have the wisdom to discern whether their charismatic CEO has "lost it" and turned into a tyrannical CEO (one telltale sign would be the mass firings of vice presidents), and the sagacity to provide him with reflective backtalk[59] (because no one else in the corporate hierarchy can). As Drucker warns, "Beware Charisma!":

> The charismatic leader, as this century shows, is always endangered. Like King Canute, he cannot command the tides. Reality is beyond his control. When he finds out that reality is the master, the charismatic leader becomes paranoid. Every one of the great charismatic leaders of this century ended up a maniac. He destroyed everything and finally himself—in Stalin's purges; in Hitler's "final solution"; in Mao's "cultural revolution." … Reality, is, however, always the master. It will not subordinate itself to the promises, the programs, the ideologies of the charismatic leader.[60]

As Professor Rakesh Khurana points out in "The Curse of the Superstar CEO" (*Harvard Business Review*, September 2002), an example of a charismatic CEO who became a tyrannical CEO is Jacques Nasser at Ford:

> On being appointed CEO of Ford in 1999, Nasser was hailed by Business Week as a "restless, Lebanese-born outsider," who "early on showed the impatience with Ford's bureaucratic fiefdoms that still fuels him today." The charismatic leader of Nasser's type stands in opposition to the past and in opposition to tradition. This kind of leader proclaims the company's destiny—usually in the form of a seductive vision—and demands that all roadblocks be removed. Today, in the troubled wake of Nasser's two-and-a-half-year reign, Ford is struggling to return to its roots as a high-quality manufacturer and a good employer.

Tyranny is an unintended consequence of the agency problem of solutioneering. In solving new & novel problems in a dynamic world, the virtuous circle of advocating a utopian pet-policy "solution" can turn into a vicious circle—leading to defensive reasoning, an escalation of commitment, groupthink, dogmatism, "undiscussables," and the dysfunctional "state of denial" (i.e. closed society). As the Socratic Guardians of the corporation, public directors check the agency problem of solutioneering.

3. Reason-giving. The purpose of reason-giving is to demonstrate that the deliberative process was conducted in good faith, with fair play, and in the pursuit of the common good:

> If individuals perceive the process of deliberation as fair, they are more likely to cooperate during implementation, even if they disagree with the chosen course of action.[61]

Reason-giving is an enforcement mechanism to ensure that the common good has been pursued. According to Popper, critical rationalism is predicated on the presumption that:

> Theories…can only be understood as tentative solutions of problems, and in relation to problem situations. … Without understanding the problem situation that gave rise to the theory, the theory is pointless—that is, it cannot be properly understood.[62]

Translating this into the realm of politics, according to a former British Member of Parliament:

> In politics solutions, real or attempted, are normally called policies. Every reputable political or social policy is a proposed solution to a problem; and we always need to be clear about the problem before we can propose a solution. We must always be able to ask of a policy: 'To what problem is this the solution?' If there is no problem to which a given policy is a solution then the policy is superfluous, and therefore harmful, if only because it consumes resources to no purpose. … It is essential to start from *problems*, and to arrive at the formulation of each policy only as a solution to a problem.[63]

In terms of reason giving, to introduce critical thinking into the boardroom the public directors should always ask of every pet policy proposal:

- To what "problem" (P_1) is this the solution?
- What are the "other" ways (TS_i) to solve this problem?
- And in all intellectual honesty, why was it the "best" way (EE) to solve the problem?
- …and what might be the unintended consequences (P_2)?

Thus, more than the mere informational disclosure of an end-result, reason-giving provides a "smell test" for whether the common good—or some private self-interest—is being pursed. As Supreme Court Justice Louis Brandeis said, sunlight is the best disinfectant. Interestingly, this problem solving approach is also how the U.S. Army trains its leaders in ethical reasoning (see Field Manual FM 22-100, pp. 4-8 to 4-10). For example, consider the challenge faced by audit committees. In the case of Enron, CFO Fastow was able to exploit complex, structured finance techniques to facilitate non-economic regulatory arbitrage (and in other cases, selecting critical accounting policies to intentionally misrepresent the company's financial statements). As a former partner and structured finance group chairman of a major law firm, and now Duke Law Professor Steven L. Schwarcz observed:

> In the hundreds of structured finance transactions deals that I've done, I would bet you that on a given deal only a handful of people at most understand the transaction.[64]

The problem is thus complexity. A simple remedy to this predicament is for CFOs to 'functionally certify'[65] that their actions have a legitimate business purpose—perhaps by having their staffs (or outside structured finance transaction engineers) prepare something akin to the U.S. Army staff study.

Reason-giving is also the pubic policy cornerstone upon which the poison pill rests. As Oracle's successful hostile takeover of PeopleSoft showed, the board of a target company cannot "just say no" forever.[66] To further Delaware's public policy bias toward adaptive efficiency (versus allocative efficiency) and under the enhanced scrutiny of its courts, the purpose of the poison pill is to provide some breathing space (cf. Hamilton's *Federalist #71*) for the target board to make its case of the real option value of the firm (which is often *a priori* "hidden" from shareholders). PeopleSoft's board, perhaps after having exhausted the reasons why PeopleSoft was worth more (and under the enhanced scrutiny of the Delaware Courts on whether they were acting in good faith), acquiesced when 61% of PeopleSoft's shareholders tendered their shares. By resisting for 17 months, PeopleSoft's shareholders did very well for themselves: from an unsolicited cash tender offer at $16.00 per share ending to a negotiated deal at $26.50 per share, they received a 75% premium over the pre-tender offer price. In terms of the so-called "proxy out," perhaps PeopleSoft's board saw the handwriting on the wall that it would likely be dismissed in the next board election. In short, "the system" worked!

To recap, the Committee for Capital Market Regulation has recommended that the Commission not impose a "one-size-fits-all" approach. I disagree. The shareholder access proposal would radically restructure Delaware's form of corporate governance from a republic to a direct democracy. As forewarned by Lipton:

> The use of shareholder-initiated binding bylaw amendments to compel specific changes in corporate policy amounts to yet another attempt by this small band of academic malcontents to dismantle the director-focused approach to corporate governance that has, by and large, served U.S. corporations and shareholders remarkably well for more than a century. As we have argued extensively elsewhere, and as corporate law provides, the directors have a duty to actively oversee the management of the affairs of the corporation and to actively exercise their business judgment to advance or protect the corporate enterprise, as the situation demands. The shareholder-centric vision—which seeks to reduce the board to a mere conduit for shareholder referenda, and which insists on board passivity at the very moments when active business judgment is most keenly needed—runs directly counter to these fundamental precepts. It is bad policy. Shareholder referenda are a remarkably poor tool for determining shareholder will, and an even worse tool for advancing shareholder interests. Shareholder referenda make sense only if one buys into the most cynical view that directors cannot be and should not be trusted to make good decisions; but there is no evidence of that. No one who has actually been in the boardroom of a major U.S. corporation in recent times could plausibly argue that directors are not keenly focused on shareholder interests.[67]

For Chairman Cox's criteria, this change would be neither measured nor incremental. Analogous to the doctrine of private ordering under Delaware corporation law is the doctrine of state sovereignty under the U.S. Constitution. Yet the Framers cared so much about the ideal of republicanism that they sought to constrain that doctrine by writing a one-size-fits-all clause in Article IV ("Guarantee Clause"):

> The United States shall guarantee to every State in this Union a Republican Form of Government….

(For interpreting original intent, since both Madison and Hamilton were on the Committee of Style that produced this wording in the Constitution, their *Federalist Papers*—which distinguished a republic from both a democracy and a monarchy—is an authoritative source.) Refusing to grant jurisdiction in 1912, the U.S. Supreme Court said in *Pacific States Telephone & Telegraph Co. v. Oregon* that the enforcement of the Guarantee Clause was a nonjusticiable political question for Congress.[68] Although Congress might be remiss in upholding its oath of supporting and defending the Constitution that does not mean that the Commission should disregard the wisdom of the Framers. (Described as "laws without government," this modern trend toward direct democracy in states such as California and Oregon has so disturbed *Washington Post* columnist David Broder that he wrote the book *Democracy Derailed: Initiative Campaigns and the Power of Money* [Harcourt, 2000]). Oh, the mischiefs of faction!

Thus in one fell swoop—by promulgating the shareholder access proposal—the Commission could endanger what former Delaware Supreme Court Chief Justice Veasey described as the "delicately balanced ecosystem"[69] of Delaware's corporate republicanism and federalism. As Madison and Hamilton pointed out, the demise of republics throughout history can be traced to the mischiefs of faction. The proposed shareholder access rule would invite these mischiefs into Delaware's corporate republicanism. (In fact, former HLS Dean Robert Clark predicts that "the law of fiduciary duties may be fought over, rethought, and spelled out in extremely interesting new ways to deal with intra-shareholder and intra-security-holder conflicts."[70]) Such mischiefs should not be welcomed because it will radically restructure Delaware's form of corporate governance from a republic to a direct democracy—a change that would neither be measured nor incremental. As the historian David McCullough said in a *CNN* interview on July 4, 2001, "If we don't know the ideals, the reasons that [the Founding Fathers] in their time cared so much about achieving what they did—that's not just regrettable, it's dangerous. We have to understand how all these benefits, this way of life that we have prospered by, and are so favored by, came to be." I urge the Commission not to invite the mischiefs of faction into the U.S. corporate governance system because it will surely lead to the demise of Delaware's corporate republicanism. In terms of Section 14(a) of the Securities Exchange Act of 1934, the shareholder access proposal is not "in the public interest."

III. Application of Criterion for Efficacious Rulemaking

For efficacious rulemaking, the Commission should evaluate both proposed rules using the three criteria of external validity, internal validity, and implementable validity. The following is my evaluation of the shareholder access proposal.

A. Internal Validity: Form Should Follow Function

Internal validity is concerned with internal inconsistencies, and for the SEC three of them are the use of:

- Rule 14a-8 shareholder proposal regime instead of the Rule 14a-12 contested election regime
- Schedule 13G "passive" investor certification for "activist" hostile insurgents
- Proxy card as a functional equivalent to an absentee ballot.

In Riker's rational choice approach to politics, one should not only consider 'rhetoric' (i.e., the art of verbal/written persuasion), but also 'heresthetics' (i.e., the direct manipulation of a political structure to win a specific outcome). As described in his landmark *The Art of Political Manipulati*on (Yale University Press, 1986), three categories of heresthetical strategies are:

- Agenda control: manipulating the agenda for favorable voting outcomes
- Strategic voting: using voting procedures to control outcomes
- Manipulation of dimensions: redefining the situation to create a stronger coalition.

Through strategic voting, proponents of the shareholder access bylaw proposal ("shareholder-access proponents") seek to change the political rules of the game (i.e., the procedure for board elections) so that they can win in the future. Given this heresthetic manipulation, the more appropriate regulatory regime is Rule 14a-12 for contested elections rather than Rule 14a-8 for shareholder proposals. Thus the Commission should revise the Rule 14a-8(i)(8) exclusion to read: "If the proposal relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election." Oh, the mischiefs of faction!

Another internal inconsistency is the requirement that shareholder-access proponents certify themselves as Schedule 13G "passive" investors when instead they are "activist" hostile insurgents seeking to change or influence the control of the issuer—otherwise, why else would they bother? In Release No. 34-39538 the SEC has noted, "control purpose reflects the state of mind of a filing person." While filing a Schedule 13G is a declaration that the shareholder-access proponent is not seeking to acquire or influence "control" of the issuer in the present, what is clear is that through heresthetical manipulation, the proponent is thinking ahead by laying the advanced groundwork to win in some yet to be contemplated contested election in the future. In other words the Schedule 13G certification is meaningless. Oh, the mischiefs of faction!

The SEC's proxy solicitation system is a "detailed and carefully crafted regulatory regime governing contested elections." One of the fundamental rights that shareholders have under state law is the right to appear in person and vote at an annual or special meeting. Unlike an absentee ballot that can only be revoked after going through the less convenient execution of a proper affidavit, proxy cards have been carefully crafted to be conveniently revocable. As described by Professor Stephen M. Bainbridge's textbook *Corporation Law and Economics* (Foundation Press, 2002; pp. 479-480):

> The sample card has been designed to comply with the rules of SEC Rule 14a-4, which governs the form of the proxy card. … The signature block may seem purely ministerial, but even it has a substantive component. Proxies of the sort at issue here are revocable. Shareholders are free to change their minds and revoke previously granted proxies at any time up to the moment of election. In practice there are two ways shareholders revoke prior proxies: (1) by showing up at the shareholders' meeting and voting the shares in person; or (2) by giving a later dated proxy. Where the shareholder signs more than one proxy card, only the most recent card counts—all earlier cards are thereupon revoked.

Thus the SEC proxy solicitation system presumes that shareholders are able to change their votes up until the moment of election at what the Delaware Supreme Court termed the "give-and-take of human assemblies" of annual meetings (*Empire of Carolina, Inc. v. Deltona Corp.*, 514 A.2d 1091, 1097 (Del. 1986)). The shareholder access bylaw seeks to change the function of the proxy card from a conveniently revocable grant of discretionary voting authority to a less conveniently revocable absentee ballot. As the SEC staff has pointed out in Release No. 34-56161, "the detailed and carefully crafted regulatory regime governing contested elections does not contemplate the presence of nominees from different vying factions in the same proxy materials." For example, in its *Amendments to Shareholder Proposals* (Release No. 34-40018, 1998) the Commission decided not to include a separate voting "box" because it may be "confusing if shareholders are also independently solicited by the proponent in support of the same proposal." Simply put, form should follow function: proxy cards are not functionally equivalent to absentee ballots. Thus an unintended consequence of a shareholder access bylaw will be to frustrate the exercise of state law shareholder voting rights by making it difficult for shareholders to change their votes up until the moment of election.

B. Implementable Validity: Who's Watching the Watchers?

Institutional investors such as public pension funds have held themselves out to be Schedule 13G passive investors who because of the large size of their holdings, buy but cannot sell their stocks lest they move the market. That may have been true during the 1990's, but today, directly or indirectly, they are also likely to have a "contract, arrangement, understanding, relationship or otherwise" with a limited partnership (e.g., fund-of-fund, hedge fund, private equity fund) whose investment strategies would benefit from an activist changing or influencing the control of an issuer (e.g., risk arbitrage, going-private buyouts). Information on a shareholder-access proponent's interest in these limited partnerships is something that "other shareholders ordinarily would find to be important and relevant to a decision when asked to consider a proposed bylaw amendment setting forth procedures for director nominations." It is also information that is not currently available to the investing public. Ruminating on the question of 'Who is watching the watchers?, attorney Ira M. Millstein said:

> This is an issue we're just beginning to wrestle with: the growth and concentration of equity holdings in the hands of the institutions themselves. … Is that a good thing or a bad thing? I don't know. But it's a thing. And to me, as an ex-antitrust lawyer, it's a big thing. Why? Because with that degree of concentration, one has to think that maybe there would be an effort at exercising control of one sort or another. And that, in addition to the concentration of power, one also ought to be thinking about who these people are who own so much of our major corporations. Who elected them? Who appointed them? Where did they come from? … Do we really know who all those people are? … How are they controlled? What are their agendas? To what do they pay attention? It is important for us to know that.[71]

So in addition to the meaninglessness of the Schedule 13G certification for shareholder-access proponents, a new regulatory regime would be needed because fund-of-funds currently are not obligated to disclose their own interests in hedge funds, private equity funds, or investment advisors. (This information is material because the effect of a shareholder access bylaw will be to increase the likelihood of these entities winning in either a contested election or a hostile tender offer.) In other words, a new regulatory regime for the full and fair disclosure of interests in limited partnerships is needed to peer through the opaque web of direct and indirect relationships from a shareholder-access proponent down to its frontline hedge funds, private equity funds, and investment subadvisors (ostensibly whose control-related activities could probably be gleaned from their Schedule 13D filings). For the criterion of implementable validity, is this do-able?

C. External Validity: To What "Problem" Is Shareholder Access The Solution?

In his open remarks, Chairman Cox described the Commission's last attempt to change the proxy solicitation system as a "recent experience that ended badly." In addition to the lessons that he described, another is that rather than solutioneering, the Commission should identify and clearly articulate "the problem" that it is trying to solve. For external validity, it should go beyond just responding to the Second Circuit Court decision and get to the root problem by answering the critical question:

To what "problem" is shareholder access the solution?

Note that this was the point made by then-SEC Commissioner Cynthia Glassman:

> The first step—defining the objective—has proven more elusive than one would have hoped. One thing we should all be able to agree upon is that providing shareholders more meaningful access to the nomination process for its own sake is not the ultimate objective, but rather a means to meet the ultimate objective. So what is the ultimate objective? What problem are we trying to solve?[72]

and the Business Roundtable:

> In the less than six months since this rulemaking was initiated, the Commission has offered shifting justifications for the Proposed Rules. Rather than identify a clear objective and then shape a rule to fit that goal, it appears that the Commission has fashioned a rule for which it is now in perpetual search of legally-sustainable justifications.[73]

As predicted in my February 10, 2005 comment letter in File No. S7-19-03: Security Holder Director Nominations, by not answering this critical question, there indeed was a political firestorm. Again, to what "problem" is shareholder access the solution?

* * * * *

In closing, this comment letter is a defense of Delaware's corporate republicanism. From Chairman Cox's own criterion for efficacious rulemaking, the proposed shareholder access rule would

- Do great harm
- Not be measured and incremental
- Frustrate the exercise of state law shareholder voting rights
- Require a new regulatory regime for full and fair disclosure
- Repeat a "recent experience that ended badly" for the SEC.

Specifically, great harm would be done to the U.S. economy because the effect of the shareholder access rule will be to spark a new wave of hostile takeovers—thus biasing the incentive structure of U.S. public corporations from long-term economic performance (adaptive efficiency) towards short-term economic performance (allocative efficiency). According to Nobel laureate North, it is adaptive efficiency rather than allocative efficiency that should be the guide to policy.

The effect of the shareholder access rule would not be measured and incremental because it will radically restructure Delaware's form of corporate governance from what Vice Chancellor Strine called a corporate republic into a direct democracy. It will also diminish the institution of the public director, recasting them from trustees or Burkean representatives who deliberate to pursue the interests of the shareholders-at-large to instructed delegates who mechanically carry out the will of the shareholders. In *Federalist #10*, Madison made a clear distinction between a republic and a democracy, writing that a pure democracy "can admit of no cure for the mischiefs of faction." In other *Federalist* papers, both Madison and Hamilton observed that it was this mischief that had led to the demise of republics throughout history. Regarding the Committee for Capital Market Regulation's argument that the Commission should not impose a "one-size-fits-all" approach, I disagree. In their wisdom the Framers of the U.S. Constitution imposed a "one-size-fits-all" requirement in Article IV that "The United States shall guarantee to every State in this Union a Republican Form of Government…." As history has shown, inviting the mischiefs of faction will surely lead to the demise of Delaware's corporate republicanism.

The effect of the proposed shareholder access rule would frustrate the exercise of state law shareholder voting rights—particularly the fundamental right to appear in person and vote at an annual or special meeting. The reason is that proxy cards are designed to be conveniently revocable while absentee ballots are not. As a consequence, unlike proxy cards, once shareholders cast their absentee ballots, they will not be able to conveniently change their vote up until the moment of election. Proxy cards were never designed to be functionally equivalent to absentee ballots.

The effect of the proposed shareholder access rule would also require a new regulatory regime for the full and fair disclosure of interests in limited partnerships to peer through the opaque web of direct and indirect relationships from a shareholder-access proponent down to its frontline hedge funds, private equity funds, and investment subadvisors. Particularly at the fund-of-funds level, the proposed use of Schedule 13G is inadequate to provide this transparency.

Finally, in its deliberations the Commission should ask, Is the U.S. corporate governance system really broken? (And if it is, exactly what concrete problems need to be solved?). At least according to former Delaware Supreme Court Chief Justice Veasey in "The Stockholder Franchise Is Not A Myth: A Response To Professor Bebchuk" (*Virginia Law Review*, May 2007), it is not broken:

> I do not agree, however, with Bebchuk's assertion [in "The Myth of the Shareholder Franchise"] that today, two decades later, "the shareholder franchise does not provide the solid foundation for the legitimacy of directorial power that it is supposed to supply." Rather, in my opinion, the stockholder power to hold boards accountable and to effect meaningful change has strengthened incrementally since the mid-1980s and into the twenty-first century. This has happened over time through an appropriate blend of increased director responsibility, investor influence, modest law reform, and new mores. What is not needed at this juncture is a lurching change in the name of "reform" that might upset the existing balance of law and culture.

Regarding fair corporate suffrage, the Commission should explicitly recognize the adoption of the majority voting standard by leading corporations that had been independently proposed by Grundfest and Millstein at the SEC Roundtable on Security Holder Director Nominations in March 2004. Specifically, this standard has created a new and very powerful shareholder voting right: i.e., the negative majority power of dismissal where Election Day is now a political Day of Judgment in which shareholders can hold directors accountable for their corporate stewardship. The issue before the Commission is to decide whether this negative majority power is enough, or whether the positive majority power of appointment—with its prospect of inviting the mischiefs of faction into Delaware's corporate republicanism—is needed. Chairman Cox has stated that his intention is "to have a clear, unambiguous rule in place in time for the next proxy season." I agree with Chief Justice Veasey that now is not the time for a "lurching change in the name of reform," and in accordance with Section 14(a) of the Securities Exchange Act of 1934, the shareholder access proposal (Release No. 34-56160) would not be "in the public interest." Instead, the Commission should take the more modest approach of Popper's piecemeal social engineering, which "permits repeated experiments and continuous readjustments": it should provisionally select the no-access proposal (Release No. 34-56161) and monitor whether the majority-voting standard is working. It is only when a concrete, non-abstract problem has emerged that the Commission should then take action.

Sincerely,

Michael S. Asato

Attachments
cc: Congressman Barney Frank, Chairman, House Committee on Financial Services
Senator Christopher J. Dodd, Chairman, U.S. Senate Committee on Housing, Banking and Urban Affairs

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