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The Case for Investor Ordering

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Whether corporate arrangements should be mandated by public law or "privately ordered" by corporations themselves has been a foundational question in corporate law scholarship. State corporation laws are generally privately ordered. But a significant and growing number of arrangements are governed by "corporate regulations" created by the U.S. Securities and Exchange Commission (SEC). SEC corporate regulations are invariably mandatory. Whether they should be is the focus of this Article.

This Article contributes to the ongoing debate by showing that whether mandatory or privately-ordered rules are optimal depends on the nature of investors, and their incentives in choosing corporate arrangements. The rise of institutional investors means that investors can now be relied on to choose optimal arrangements, because institutional investors will make informed decisions about corporate arrangements and will internalize their effects on the capital markets.

This Article thus makes the case for a third alternative: "investor ordering." For all but a few corporate regulations, investor ordering will result in the same or greater aggregate net benefit as mandatory regulations.

The optimality of investor ordering of SEC corporate regulations has important implications. First, the D.C. Circuit's jurisprudence on cost-benefit analysis will require the SEC to consider investor ordering. In the many cases where investor ordering would be superior to mandatory regulation, were the SEC to nevertheless implement a mandatory regulation, it would be susceptible to invalidation by the D.C. Circuit under the Administrative Procedure Act.

Second, investor ordering substantially reduces the burden of the D.C. Circuit's recent requirements for SEC cost-benefit analysis. This reduces the overall cost of SEC rule making, or permits the SEC to promulgate more regulations on its fixed budget. It also sidesteps the considerable academic debate about the value of cost-benefit analysis for corporate regulations.

Third, investor ordering reduces the need for retrospective analysis. To the extent retrospective analysis remains necessary, investor ordering makes it more straightforward and also permits lower-cost regulatory experimentation. Investor ordering therefore allows for a more dynamic regulatory system.

These benefits mean that the SEC should implement investor ordering as its default approach for new regulation and for deregulation. This Article considers a number of promising candidates for investor ordering among potential and proposed SEC regulations, and for deregulation of contentious existing SEC regulations. Investor ordering also has important implications for state corporation laws and for federal legislation.

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Table of Contents

Introduction

Corporate arrangements[1] in the United States are governed by two bodies of law with very different natures. Most corporate arrangements are governed by state corporation laws,[2] which require certain arrangements, but are generally enabling, permitting corporations to "privately order" their own arrangements.[3] However, a substantial and growing body of corporate arrangements are governed by "corporate regulations" promulgated by the U.S. Securities and Exchange Commission (SEC).[4] Since the creation of the SEC,[5] its corporate regulations have almost invariably been mandatory, either requiring or prohibiting corporate arrangements that relate to the internal affairs of corporations.[6]

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1 By "corporate arrangements" I refer to the rule governing the internal affairs of the corporation. *See, e.g.*, Bernard S. Black, *Is Corporate Law Trivial: A Political and Economic Analysis*, 84 Nw. U. L. Rev. 542, 546–47 (1990) (defining corporate law as "laws . . . that primarily govern the relationship between a company's managers and investors"); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1462 (1989) (considering legal rules that concern the internal organization of the corporation and the conduct of corporate actors).

2 *See, e.g.*, Del. Code Ann. tit. 8 (2017); Model Business Corporation Act (Am. Bar Ass'n. 2016). See *infra* Part V.*D*. for discussion of the application of investor ordering to state corporate law rules.

3 Inclusion or exclusion of such provisions is generally achieved by amending the corporation's certificate of incorporation. *E.g.*, Del. Code Ann. tit. 8, § 141(d) (regarding classified boards of directors); *id.* § 102(b)(7) (liability of directors for breach of fiduciary duty). In some cases, it may be achieved by amending the bylaws of the corporation, *e.g.*, *id.* § 112 (regarding inclusion of shareholder nominations in proxy soliciting materials); *id.* § 113 (regarding proxy expense reimbursement).

4 SEC regulations have long governed the proxy process that underlies shareholder meetings, the means by which shareholders appoint directors as their agents. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78n (2012). These rules have expanded to cover the information that public corporations must provide to their shareholders, which, while couched as disclosure regulations, drive the substantive choices of managers. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vand. L. Rev. 859, 875 (2003) (describing disclosure requirements as "forcing substance"). Successive legislative reforms have further expanded corporate regulations to cover additional areas, including offers by the corporation or others to buy shares from investors, 17 C.F.R. §§ 240.10A-3–240.10C-1 (2017); the composition of boards of directors and their committees, *id.* §§ 240.10A-3–240.10C-1; the internal controls of corporations, *id.* §§ 240.13a-15–240.15d-15; the attestation of accounts provided to investors, *id.* §§ 240.13a-14–240.15d-14; investor approval of executive compensation, *id.* § 240.14a-21 (2017); and investor nomination of directors, *id.* § 240.14a-11 (2010), *invalidated by* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011) [hereinafter *Bus. Roundtable II*], to name but a few.

5 Securities Exchange Act of 1934, 15 U.S.C. § 78d (2016).

6 That is, SEC regulations either require certain arrangements among managers and investors in those corporations, *e.g.*, *id.* § 78m (requiring periodic reporting), or prohibit such arrangements, *e.g.*, *id.* § 78l (prohibiting the issue of securities); *id.* § 78m (prohibiting loans to directors and officers); *id.* § 78n (prohibiting the solicitation of proxies); 17 C.F.R. § 240.14e-1 (2017) (prohibiting certain tender offer practices). On at least one occasion, Congress has created an "opt-in" rule in a corporate regulation. *See* Jumpstart Our Business Startups Act, 15 U.S.C. § 78c (2012) (permitting emerging growth companies to forgo certain disclosure exemptions, and thereby opt in to certain SEC requirements).

Why not allow the constituents of corporations to choose their own arrangements?[7] This question has been the subject of foundational debates regarding mandatory disclosure[8] and contractual freedom in corporate law.[9] Mandatory corporate arrangements have been justified on the grounds of externalities—that corporations would not take into account the effects of their arrangements on others—and agency costs—that managers of corporations may not choose the arrangements that are best for the corporation.[10]

This Article makes an observation that has significant implications for this debate. Both of these justifications for mandatory rules depend on the nature of investors[11] in corporations.[12] This observation is important because the nature of investors in U.S. corporations has changed dramatically since the time the securities laws were enacted, and even since the justifications for mandatory rules were put forth.

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[7] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964).

[8] Representative works in the debate on mandatory disclosure include John C. Coffee, Jr., *No Exit: Opting Out, the Contractual Theory of the Corporation and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995); Stigler, *supra* note 7; Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382 (1964) (responding to Stigler). *See also* Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81 (2007) (summarizing empirical finance contributions to this debate); Christian Leuz & Peter D. Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research* (2008), https://papers.ssrn.come/sol3/papers.cfm?abstract_id=1105398 (summarizing the debate from the accounting research perspective).

[9] Representative works in the debate on contractual freedom, among many others, include EASTERBROOK & FISCHEL, *supra* note 7; Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985). *See also* William W. Bratton, *Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180 (1992); Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006) (both giving retrospective accounts of the debate).

[10] The agency cost rationale assumes that investors cannot protect themselves from such choices ex ante. *See infra* Part I.A.2. A third rationale is economies of scale in setting arrangements. *See infra* Part II.C.6. A potential fourth rationale, that mandatory rules would expand the scope of enforcement options from those available to private parties or reduce the cost of these enforcement options, could also apply to non-mandatory rules.

[11] I will generally use the term "investors" rather than "shareholders" or "stockholders" to collectively refer to the equity investors in corporations unless further differentiation is necessary. Shareholders will necessarily be investors, but there are additional equity investors in the firm who are not technically shareholders, because they invest through intermediaries, including institutional investors and their own investors. *See* Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1236 (2008) (describing custodial ownership); Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. (forthcoming 2018) (manuscript at 5) (describing the beneficial ownership of institutional investors).

[12] *See infra* Part I.C.

Control of corporations was formerly dominated either by insiders—managers or controlling shareholders who have incentives to choose arrangements that would maximize their private benefits—or by small investors—who have no incentive to oversee directors or managers[13] to prevent such agency costs.[14] Because these investors are undiversified, they also do not have incentives to consider the effect of corporate arrangements on other corporations or those corporations' investors.[15]

Since that time, the rise of institutional investors has transformed the ownership of U.S. corporations.[16] Institutional investors, such as investment managers and pension funds, now invest the overwhelming majority of capital in U.S. corporations and have the capability to determine corporations' choice of arrangements.[17] Institutional investors have incentives to limit the agency costs of managers. Because they hold broadly diversified portfolios that include interests in many corporations, they also have incentives to consider the externalities for those other corporations.

If the main justifications for mandatory rules no longer apply, how then should corporate regulations be designed? This Article makes the case for an alternative approach, "investor ordering."[18] The SEC should set default arrangements for corporations,[19] but permit corporations to switch to alternative arrangements if their investors approve.[20] To ensure that corporations initiate value-enhancing switches, the SEC should set default arrangements to encourage managers to initiate switching. Though these prescriptions may seem modest, they would represent a significant change in the SEC's approach to rule making. Investor ordering would also have important implications for investor value, the cost of SEC regulation, and a more dynamic regulatory system.

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13 While directors and executives have different roles in the management of the corporation, in many cases, this distinction is not significant. *See*, *e.g.*, Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1835 (1989). I therefore refer to directors and executives collectively as "managers" unless differentiation is necessary.

14 *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 87 (1932).

15 *See infra* Part I.B.

16 *E.g.*, Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSP., Summer 2017, at 89, 91.

17 *See infra* Part I.C.

18 *See infra* Part II.A. (further specifying "investor ordering").

19 Investor ordering will only be possible where a corporation has a body of outside investors, so it is not appropriate for regulations that apply to offerings before a corporation has such a body of investors.

20 There are arguments for and against whether switching decisions made prior to initial public offerings (IPOs) should be approved by public shareholders post-IPO. Given the long-standing and unresolved debate on this issue, I leave it for the SEC to determine whether such approval should be required on a case-by-case basis.

The central claim of this Article is that investor ordering will have the same or greater aggregate net benefit as mandatory rules.[21] Where the default arrangement has net benefits for corporations that are greater than the costs of switching arrangements, no corporations will switch, and the aggregate net benefit of investor ordering will be the same as that of a mandatory rule. However, to the extent that a default arrangement has greater costs for any corporations than the cost of switching, those corporations would have greater net benefit with investor ordering.

This investor value case for investor ordering is dependent on a number of assumptions; to the extent these do not hold, they are arguments against investor ordering.[22] This Article considers several of these counterarguments, and explains why they are unlikely to hold. First, investor ordering may be inferior to mandatory rules if there is insufficient initiation of switching to arrangements investors prefer, as there is for many state law arrangements.[23] However, because state laws use manager-favorable defaults, switching relies on investors' ability to initiate switches, which may be limited.[24] Investor ordering would give managers significant incentives to initiate switches, resolving this concern. Second, investor ordering may be inferior to mandatory rules if institutional investors do not choose corporate arrangements that are in the interests of their own investors. While institutional investors have agency problems of their own,[25] these problems are not likely to cause them to choose arrangements that are not in the interests of their own investors. Finally, if investor ordering duplicates significant costs for corporations and investors in choosing arrangements, it may also be inferior to mandatory rules.[26] However, the limited costs involved in investor ordering decisions mean this is unlikely to be the case.

Two assumptions on which the investor value case is based *may* limit investor ordering. First, institutional investors are unlikely to internalize potential externalities that extend beyond other corporations and capital markets participants.[27] However, this limitation will be narrow, since the nature of the SEC's remit means that most SEC regulations will not have such effects. Second,

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21 *See infra* Part II.B.

22 *See infra* Part II.C.

23 *See* Michal Barzuza, *The Private Ordering Paradox in Corporate Law*, 8 HARV. BUS. L. REV. (forthcoming 2018) (manuscript at 4), https://www.ssrn.com/abstract=2930667; *see also* Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1349 (2013) ("the experience of the period from the mid-1980s to the mid-2000s does not support the contractarian expectation that management will initiate agency cost-reducing measures.").

24 *See* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 503 (2002) (recognizing "impediments to reversing a default arrangement favored by management and that such an arrangement thus might not be reversed even if the arrangement is value decreasing and the transaction costs of changing it are small.").

25 Bebchuk, Cohen & Hirst, *supra* note 16, at 90.

26 *See infra* Part II.C.6.

27 *See infra* Part II.C.4.

where institutional investors do not have a veto over choices of corporate arrangements at particular corporations, those corporations may choose sub-optimal arrangements. In particular, small companies have lower levels of institutional investment, so institutional investors may not have sufficient equity to exercise a veto.[28] The SEC should consider both of these limitations in designing regulations, and would be justified in making mandatory rules in the relatively narrow sets of circumstances where these limitations are likely to apply.

Several propositions follow from the investor value case because of two features of SEC rule making: the requirement for the SEC to undertake cost-benefit analysis and the SEC's practice of retrospective analysis.

When combined with the SEC's requirement to undertake cost-benefit analysis, the investor value case may *require* the SEC to implement investor ordering. The SEC is required to undertake cost-benefit analysis[29] of its regulations,[30] and of deregulation.[31] The D.C. Circuit has interpreted this to require the SEC to consider reasonable alternatives to a proposed regulation.[32] Investor ordering would be an obvious and reasonable alternative for most mandatory regulations, and would therefore require consideration. In the great majority of situations, where the above limitations do not apply, investor ordering will result in greater aggregate net benefits for investors than a mandatory rule. For the SEC to nevertheless implement a mandatory rule is likely to meet the D.C. Circuit's definition of "arbitrary and capricious,"[33] making the regulation susceptible to invalidation for breach of the Administrative Procedure Act.[34]

The requirement that the SEC undertake cost-benefit analysis of its rule making is a relatively recent phenomenon. The impact has been to substantially increase the costs of SEC cost-benefit analysis.[35] The merit of this change has been the subject of contentious debate among legal scholars. Critics argue that cost-benefit analysis imposes a substantial and unrealistic burden on rule making, for little gain, and should be curtailed.[36] However, there are no indications that the requirements for cost-benefit analysis are likely to diminish. On the contrary,

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[28] *See infra* Part II.C.2.

[29] Different authors have variously referred to "cost-benefit analysis" and "benefit-cost analysis." I use the term "cost-benefit analysis," as that appears to be the SEC's preferred term. *See, e.g.*, Facilitating Shareholder Director Nominations, Securities and Exchange Commission Release No. 34-60089, 74 Fed. Reg. 29,024, 29,071 (Jun. 18, 2009).

[30] *See Bus. Roundtable II* at 1148.

[31] *See* Administrative Procedure Act, 5 U.S.C. § 551(5) (2012) (defining "rule making" as including the amendment or repeal of a rule).

[32] U.S. Chamber of Commerce v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005) [hereinafter *Chamber of Commerce I*].

[33] *See Bus. Roundtable II* at 1149.

[34] *See* Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (2012).

[35] *See infra* Part III.C.1.

[36] *See, e.g.*, John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 888–89 (2015).

recent judicial developments and pending legislation would increase the requirements for SEC cost-benefit analysis.[37]

A second significant implication of investor ordering is that it would significantly reduce the cost of such SEC cost-benefit analysis.[38] The most costly part of cost-benefit analysis is determining the likely costs of a regulation. Investor ordering makes determining the cost of a regulation much more straightforward and much less costly. Where an investor ordered arrangement imposes greater cost on a corporation than the cost of switching to an alternative, the corporation will switch, and will incur only the cost of switching. Investor ordering effectively "caps" the cost to corporations of an arrangement at the cost of switching. The maximum aggregate cost of an investor ordered regulation is therefore the sum of switching costs for those corporations that would switch arrangements. Because the process for switching will be the same for different corporations and for different regulations, switching costs will not vary significantly, and will be relatively straightforward for the SEC to calculate.

Reducing the cost of cost-benefit analysis would reduce the cost of SEC rule changes. This would have obvious benefits, irrespective of whether regulation is considered desirable or undesirable. If regulation is viewed as undesirable, investor ordering would reduce the cost that SEC rule making imposes on government. Because deregulatory actions of the SEC are also subject to cost-benefit analysis requirements, investor ordering would permit greater deregulation at lower cost. If regulation is viewed as desirable, investor ordering would permit the SEC to undertake a greater level of rule making on its fixed budget. Either way, investor ordering reduces the barrier that cost-benefit analysis presents for rule changes. By reducing the cost of cost-benefit analysis without limiting its scope, investor ordering also offers a solution that sidesteps the academic debate about the merits of cost-benefit analysis.

Investor ordering would also make for a more dynamic regulatory system. Mandatory arrangements require retrospective analysis in order to determine whether the arrangement creates undue costs and should therefore be amended or repealed. The SEC conducts retrospective analysis of its regulations,[39] and the

[37] *See infra* Part III.A.3, discussing Michigan v. EPA, 135 S. Ct. 2699, 2711–12 (2015); Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 311–321, 341 (2017).

[38] *See infra* Part III.B.

[39] Retrospective analysis of independent agency regulations was recommended by Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 14, 2011). Since that time the SEC has undertaken substantial retrospective analysis of its regulations. *See* Release No. 33-10209, 81 Fed. Reg. 64,364 (Sept. 20, 2016) (listing 11 rules for review during the subsequent year); Release No. 33-9965, 80 Fed. Reg. 65,973 (Oct. 28, 2015) (listing 21 rules for review during the subsequent year); Release No. 33-9694, 79 Fed. Reg. 77,975 (Dec. 29, 2014) (listing 25 rules for review during the subsequent year); Release No. 33-9516, 79 Fed. Reg. 4,638 (Jan. 29, 2014) (listing 12 rules for review during the subsequent year); Release No. 33-9370, 77 Fed. Reg. 71,743 (Dec. 4, 2012) (listing 9 rules for review during the subsequent year); Release No. 33-9284, 76 Fed. Reg. 79,141 (Dec. 21, 2011) (listing 17 rules for review during the subsequent year).

Financial CHOICE Act would require more stringent retrospective analysis.[40] Since retrospective analysis is merely backward-looking cost-benefit analysis, it involves many of the same difficulties and costs. Investor ordering substantially reduces the need for retrospective analysis. Where a default arrangement imposes significant costs on corporations, those corporations will simply switch to an alternative arrangement. The value or cost of investor ordered regulations can therefore be evaluated by considering the number of corporations that remain bound by the arrangement. This provides a ready, automatic, and incontrovertible measure of an arrangement's value, and substantially replaces the need to undertake retrospective analysis.

To the extent retrospective analysis remains necessary, it is much easier and less costly for investor ordered regulations than for mandatory regulations. Investor ordering creates additional information regarding firms' choices of arrangements, which can be used in retrospective analysis. Variations in outcomes among corporations with different arrangements provide some evidence of the effects of those arrangements, although endogeneity concerns make these difficult to disentangle from the effects of the underlying factors that led to the switching. Investor ordering would also facilitate SEC experimentation with potential rules. Taken together, these benefits would result in a more dynamic regulatory system, with greater capacity to self-adjust towards optimal arrangements.

Collectively, these benefits make the case that the SEC should implement investor ordering by default for all categories of corporations where institutional investors have majority voting power, unless a regulation would have substantial externalities that institutional investors would not internalize. This Article offers concrete suggestions as to how the SEC should implement investor ordering, and suggests possible initial candidates for investor ordered regulation and deregulation. Switching from default arrangements should not be done by charter or bylaw amendments, but instead by a bespoke process specified in SEC regulations. Switching would require approval of outside shareholders at corporations' annual meetings. Bespoke switching would allow the SEC to fine-tune switching requirements, and to include other features that it considers desirable. These may include "sunsets" on switching decisions, or requirements for post-initial public offering (IPO) approval of switching decisions. The SEC's economic analysis could reduce corporations' decision costs by analyzing considerations that are generalizable to many corporations.

Prime candidates for investor ordered regulations are those on which there is disagreement about the value of the regulation, or suggestions that the costs of the regulation may outweigh its benefits. Potential or proposed rules that would therefore be strong initial candidates for investor ordering include proxy access, universal proxies, claw-backs, and disclosure of political spending. Switching will be more costly where the default arrangement has been in place for a long period

[40] *See* Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 316 (2017).

of time. Therefore, recent rules may have greater benefit from investor ordered deregulation than long-standing arrangements. Promising candidates for investor ordering among recent rules include internal controls,[41] conflict minerals,[42] pay ratios,[43] and say-on-pay.[44] Some long-standing regulations have recently been attacked as costly for corporations,[45] and could also be considered for deregulation through investor ordering. These include requirements for disclosure of beneficial ownership,[46] and requirements to include shareholder proposals in proxy statements.[47]

Although the focus of the Article is SEC regulation, its analysis has implications for federal legislation and state corporate law.[48] The SEC's ability to design optimal rules will be hampered by congressional mandates or prohibitions on SEC regulations. Congress could improve the likelihood of optimal rule making by refraining from such mandates or prohibitions, and thereby granting the SEC greater rule making discretion.

While state corporation laws contain a lower proportion of mandatory arrangements than SEC regulations, those mandatory arrangements that do exist may not be optimal. State law switching requirements are also unlikely to result in optimal arrangements. Switching arrangements in corporate bylaws generally does not require investor approval,[49] and switching charter provisions cannot be initiated by investors. The content of most default arrangements in state corporation laws means that managers are less likely to initiate switching. The analysis in this Article suggests that state legislatures could improve corporate arrangements by implementing investor ordering.

The remainder of this Article is structured as follows. Part I explains how the justifications for mandatory regulation are contingent on the nature of investors, and how they do not apply to corporations where choices of arrangements are controlled by institutional investors, as is now the case. Part II demonstrates the investor value case for investor ordering and considers potential limitations. Part III explains how the requirements for cost-benefit analysis, coupled with the

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[41] *See* 17 C.F.R. §§ 240.13a-15, 240.15d-15 (2017).

[42] *See id.* § 240.13p-1 (2017).

[43] *See id.* § 229.402(u) (2017).

[44] *See id.* § 240.14a-21 (2017).

[45] *See, e.g.*, Adam O. Emmerich, Theodore N. Mirvis, Eric S. Robinson & William Savitt, *Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power*, 3 HARV. BUS. L. REV. 135, 140 (2013) (calling for revision of blockholder disclosure); *see also* BUS. ROUNDTABLE, RESPONSIBLE SHAREHOLDER ENGAGEMENT & LONG-TERM VALUE CREATION: MODERNIZING THE SHAREHOLDER PROPOSAL PROCESS (2016), http://businessroundtable.org/resources/responsible-shareholder-engagement-long-term-value-creation (calling for revision of shareholder proposal rules).

[46] 17 C.F.R. §§ 240.13d-1 – 240.13d-2 (2017).

[47] *Id.* § 240.14a-8 (2017).

[48] *See infra* Part V.D.

[49] *See* Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583, 589 (2016); Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CALIF. L. REV. 8 (forthcoming 2018).

investor value case for investor ordering, likely require the SEC to implement investor ordering, and how investor ordering would reduce the cost of cost-benefit analysis. Part IV explains how investor ordering would improve retrospective analysis of regulations, and thereby create a more dynamic regulatory system. Given these benefits, Part V explains how the SEC should implement investor ordering, and describes the implications of investor ordering for state law and federal legislation.

I. The Outdated Case for Mandatory Corporate Regulations

Corporations are a blend of public law and private law. They are born out of statute, but constitute relationships among private individuals and entities. This leads to a foundational question of corporate law: how should corporate arrangements be determined? Should public law require or prohibit certain arrangements for corporations? Or should arrangements be privately ordered and chosen by the private constituents of the corporation?

This question has been the subject of voluminous scholarship, spanning the fields of law, economics, finance, and accounting. Rather than trying to recapitulate this debate, I take as given that there are valid justifications for corporate arrangements to be determined by private ordering,[50] and valid justifications for corporate arrangements to be set by mandatory regulations.[51] . These justifications are described briefly in section A.

This Article contributes to this core debate by adding the observation that the applicability of these justifications will depend on the nature of the investors in the corporations in question. This claim is developed in section B. Mandatory corporate rules are justified where the investors that choose corporate arrangements have incentives to choose arrangements that are not optimal for the corporation, or for the capital markets more generally.

However, as section C describes, the rise of institutional investors means that they now control a significant majority of the shares of U.S. corporations. Institutional investors have the power and the incentives to choose corporate arrangements that are optimal for investors in the corporation, and optimal for investors in other corporations. The rise of institutional investors therefore substantially limits the case for mandatory corporate regulation to situations where institutional investors do not control corporate arrangements or where there are potential social externalities that institutional investors are unlikely to internalize.

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[50] *E.g.*, Easterbrook & Fischel, *supra* note 7.

[51] *See, e.g.*, Bebchuk, *supra* note 13, at 1823; John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 717, 722 (1984); Bebchuk, supra note 13, at 1823; Eisenberg, *supra* note 1,1, at 1499; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89. Colum. L. Rev. 1549, 1554 (1989).

A. The Case for Mandatory Corporate Regulations

Before examining the case for mandatory regulations, it is worth considering the alternative, the case for private ordering. The case for private ordering starts from the premise that private parties are in the best position to choose their own arrangements. Different managers and different combinations of investors make up different corporations, and for each of these sets of corporate constituents there will be slightly different arrangements that are optimal.[52] These corporate constituents will understand which arrangements are optimal better than a potential regulator,[53] and will have better incentives than the regulator to choose those arrangements.[54]

The case for mandatory corporate rules counters with several reasons why the case for private ordering may not always apply:[55]

1. Externalities. Corporate arrangements have effects on other corporations, other investors, and other third parties.[56] Many of these are externalities: the corporate constituents will not take these effects into account when determining which arrangement will be privately optimal for the corporation.[57]

2. Agency Costs. The constituents determining corporate arrangements include investors and managers. Managers operate the corporation on behalf of investors. However, managers will have private incentives to take actions that are not optimal for investors.[58] In some cases it may be too difficult or costly for managers and investors to contract to prevent these actions.[59] Mandatory regulation may provide

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52 *E.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) ("No one set of terms will be best for all . . . .").

53 *E.g.*, Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law Articles and Comments*, 89 COLUM. L. REV. 1703, 1715 (1989). Dean Clark does point out that regulators may have a role in setting rules that are more likely to apply to all corporations. *See id.* at 1718.

54 Regulators may be subject to "capture" by other constituencies that would lead them to choose arrangements that are not optimal. *E.g.*, JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (Liberty Fund, 1962); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 4 (1971) (considering economic regulation).

55 *See, e.g.*, Leuz & Wysocki, *supra* note 8, at 16–21 (considering these rationales in the context of mandatory disclosure rules).

56 *See, e.g.*, Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 762 (1995); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 719, 725 (1997).

57 *See, e.g.*, Bebchuk, *supra* note 9, at 1405; John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1677 (1989) (considering corporate arrangements more generally); Coffee, supra note 51, at 723 (considering externalities from disclosure).

58 *E.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

59 *E.g.*, EASTERBROOK & FISCHEL, *supra* note 7.

a means for the parties to reach a preferable arrangement that they could not achieve themselves through bargaining.[60]

3. Economies of Scale. Without regulation, every set of corporate constituents needs to engage in costly and duplicative bargaining to establish their optimal arrangements. By mandating uniform arrangements, regulation obviates this duplication and its cost. The uniformity of these arrangements also has positive externalities for investors and others in the capital markets.[61]

B. Mandatory Corporate Regulations and the Nature of Investors

This section makes clear that the agency cost and externality justifications for mandatory regulations or private ordering are not absolute.[62] Rather, their application depends on the nature of the corporate constituents and their incentives, and, in particular, the nature of the investors in the corporation. Investors fall into several categories that have different incentives with respect to externalities and agency costs.

Investors may be insiders or outsiders. Insiders, such as corporate managers and controlling shareholders, have the ability to extract private benefits from the corporation. To the extent that an arrangement may permit agency costs, if inside investors control the choice among comparable arrangements, they will choose the arrangement that allows them the greatest private benefits. That arrangement will not be in the interests of the outside investors in the corporation.

Outside investors may hold small stakes in the corporation ("retail investors") or large stakes ("blockholders"). Given their small stakes and commensurately small influence on voting outcomes, it is not rational for retail investors to inform themselves about corporate decisions or to vote on those decisions.[63] Where retail investors control the choice of corporate arrangements, there is a significant possibility that their lack of information may lead them to choose arrangements that are against their own interests, such as arrangements that allows insiders to divert greater private benefits from the corporation.[64]

Outside blockholders may either hold their shares in the company as part of a broadly diversified portfolio of many corporations, or they may hold an undiversified interest, with a significant proportion of their assets concentrated in the corporation. Given the size of their stake, undiversified outside blockholders will have incentives to inform themselves about corporate arrangements. Where undiversified outside blockholders are responsible for choosing corporate

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[60] *See, e.g.*, Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 686–87 (2002).

[61] *See* Klausner, *supra* note 56, at 762; Kahan & Klausner, *supra* note 56, at 719, 725.

[62] The economies of scale justification for mandatory regulations is considered in Section II.C.6, *infra.*)

[63] *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 527 (1990).

[64] *See generally* Bebchuk, *supra* note 13, at 1839.

arrangements, they will choose those arrangements that are privately optimal for the investors in the corporation.[65]

Diversified blockholders largely consist of institutional investors. Institutional investors are investment intermediaries that invest on behalf of other investors, and include pension funds, mutual funds, and investment managers.[66] They hold broadly diversified portfolios that include interests in hundreds or thousands of corporations, with each corporation making up a very small share of the portfolio. When a corporate arrangement has effects on other corporations, institutional investors are also likely to be invested in those other corporations, and are therefore likely to take other effects on those corporations into account in determining which arrangements they prefer.

Whether or not mandating a particular arrangement for corporations is justified will depend on whether the arrangement may have externalities or agency costs, and whether the choice of arrangement by those corporations would otherwise be controlled by insiders, retail investors, undiversified outside blockholders, or institutional investors. Mandatory arrangements will be justified in two situations. First, if an arrangement would allow agency costs, a mandatory arrangement will be justified if insiders choose corporate arrangements, or if retail investors choose arrangements and may choose the arrangement that insiders prefer rather than the optimal arrangement. Second, if an arrangement has externalities to other corporations and their investors, a mandatory arrangement will be justified if undiversified blockholders choose arrangements, or if insiders or retail investors choose arrangements: without a mandatory arrangement, each of these types of investors would all otherwise choose arrangements that would be privately optimal for the corporation, but which would not take into account any externalities.

These conclusions are illustrated in Table 1.

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[65] This assumes that outside investors cannot protect themselves ex ante from such changes of arrangements, for example, by paying less at the IPO where they expect that such changes are likely to occur. *See, e.g.*, Easterbrook & Fischel, *supra* note 52, at 1421. If investors could perfectly protect themselves they would be indifferent regarding the choice of corporate arrangements.

[66] *See, e.g.*, Hirst, *supra* note 11, at 5.

Table 1. Justifications for Mandatory Arrangements

		Type of Investor Choosing Arrangements			
		Insiders	*Retail Investors*	*Undiversified Outside Blockholders*	*Institutional Investors*
Agency Costs	*Externalities*	Agency Costs & Externalities		Externalities	
	No Externalities	Agency Costs			
No Agency Costs	*Externalities*	Externalities			
	No Externalities				

The blank cells in Table 1 show that the above justifications for mandatory rules will *not* apply in two circumstances. Mandatory arrangements will not be justified if there are no agency costs and no externalities. In that case, no matter which type of investor chooses corporate arrangements, they will choose the optimal arrangement.[67]

Most importantly, if arrangements are chosen by institutional investors, then they will choose arrangements that are optimal for the corporation and also for the capital markets, and mandatory regulation will not be justified on the grounds of either externalities or agency costs.

C. The Nature of Investors in the Modern Corporation

When the federal securities laws were enacted, corporate share registers were dominated by either dispersed retail investors, or by inside investors.[68] As a result, mandatory rules were justified on the grounds of preventing agency costs[69] and externalities.[70]

Since that time, the nature of corporate investment has been transformed by the rise of institutional investors.[71] Retirement savings have shifted to the equity

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[67] A variation on this scenario, the claim that legal and market mechanisms effectively incentivize corporate constituents to take agency costs and externalities into account in choosing arrangements, corresponds to the position taken by some "contractarians" in the debate on contractual freedom in corporate law. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 6 (1990).

[68] *See generally* BERLE & MEANS, *supra* note 14.

[69] *See, e.g.*, Mahoney, *supra* note 8, at 1048.

[70] *See generally* ARTHUR C. PIGOU, THE ECONOMICS OF WELFARE (1920).

[71] For a discussion of the rise of institutional investors, see Bebchuk, Cohen & Hirst, *supra* note 16. Additional works discuss the rise of institutional investors. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Black, *supra* note 63; William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995); Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359 (2014); Franklin R. Edwards, R. Glenn Hubbard & Robert B. Thompson, *The*

markets, and from direct investment to investment intermediated by institutional investors.[72] The great majority of U.S. corporations now have most of their outstanding shares held by institutional investors. Figure 1(a) shows the number of U.S. corporations with different levels of institutional ownership.

Figure 1(a): Institutional Ownership of Corporations[73]

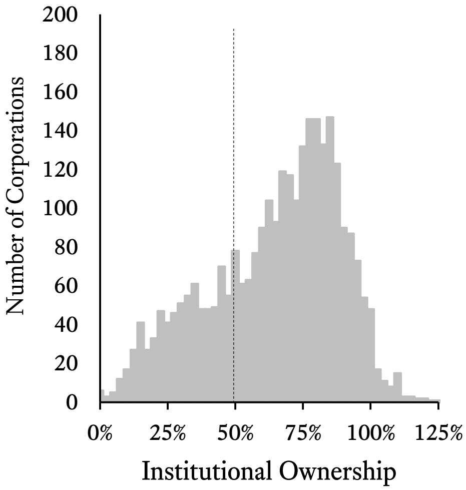
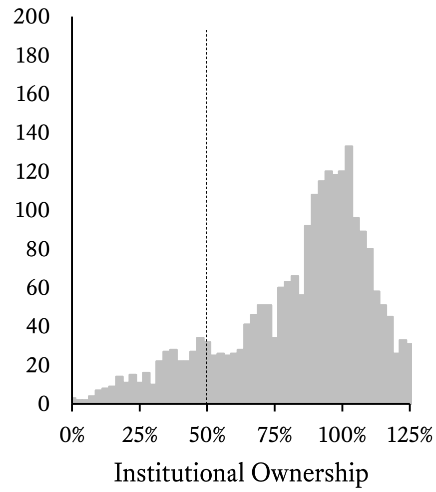


Figure 1(b). Institutional Ownership as Proportion of Shares Voted[74]



For 72% of corporations, institutional investors own more than 50% of outstanding shares. Institutional investors control less than 25% of outstanding shares for only 9% of corporations, most of which are small corporations.

The predominance of institutional investor control is even more pronounced considering that many retail investors do not vote in corporate elections.[75] As a result, there will be significantly fewer cases where institutional investors do not control a majority of the shares actually voted in corporate elections. Figure 1(b)

Growth of Institutional Stock Ownership: A Promise Unfulfilled, 13 J. APPLIED CORP. FIN. 92 (2000); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

[72] For a discussion of the main factors underlying this process, see Gilson & Gordon, *supra* note 71, at 878.

[73] Ownership data for Figure 1(a) and Figure 1(b) is as of Dec. 31, 2016, and is derived from the FactSet Ownership database (accessed August 6, 2017), which aggregates ownership of institutional investors from SEC filings. Because multiple institutional investors may have control over the same investments, there may be some double-counting and inflation of investor ownership, explaining the reported institutional ownership over 1.

[74] Voting data in Figure 1(b) is derived from FactSet SharkRepellent (accessed July 29, 2017). To permit comparison among corporations, Figure 1(b) excludes corporations with classes of shares with different voting rights.

[75] The participation rate of retail investors in corporate elections in the second half of 2016 was 28%, compared to 83% for institutional investors. PROXYPULSE, 2017 PROXY SEASON PREVIEW 3 (2017), https://www.broadridge.com/_assets/pdf/broadridge-2017-proxy-season-preview.pdf.

shows institutional ownership as a proportion of the total number of shares voted for director elections at corporations' 2016 annual meetings. For 86% of corporations, shares owned by institutional investors constitute more than 50% of the shares voted at those corporations' 2016 annual meetings. For only 4% of corporations did institutional investors control less than 25% of shares voted at corporations' 2016 annual meetings.

* * *

The implications for whether corporate arrangements should be set by mandatory rules or by private ordering are clear. Mandatory ordering will only be justified in two circumstances: First, at those corporations where institutional investors may not control the choice of corporate arrangements, which situations are likely to be the very smallest corporations. Second, those few corporate regulations that may involve externalities that institutional investors will not take into account in choosing optimal arrangements. Part II demonstrates that investor ordering will create superior outcomes in those circumstances where mandatory rules are not justified.

II. The Investor Value Case for Investor Ordering

The central claim of this Article is that, where mandatory rules are no longer justified because investors can effectively choose corporate arrangements, regulators should let them. This Part first describes how such investor ordering would function, and then demonstrates how it would result in the same or greater aggregate net benefit as would mandatory rules.

A. Investor Ordering

The discussion in Part I compared mandatory regulations to private ordering. But the nature of private ordering depends on who does the ordering, and how. The foundational debate on contractual freedom in corporate law has generally assumed that managers would effectively determine private ordering decisions.[76] This Article puts forward an alternative—investor ordering. This section sets out a series of principles that define how investor ordering would function.[77] The principles are indivisible—dispensing any principle would invalidate the case that investor ordering creates superior value. The principles for investor ordering described here build on those proposed by Lucian Bebchuk and Assaf Hamdani for

[76] *See, e.g.*, Bebchuk, *supra* note 13, at 1839.

[77] This section does not consider how these principles would be implemented into law or the practical decisions that would entail. Those questions are covered later in this Article. *See infra* Part V.

state law rules[78] and the application of those principles that several authors have subsequently proposed for particular corporate regulations.[79]

Investor ordered arrangements are privately ordered in that they have a particular arrangement as a default, but corporations are permitted to switch to an alternative arrangement. Fundamental to a rule being investor ordered is that switching decisions are approved by the outside investors of public corporations.

Investor ordering focuses on corporate arrangements—those that determine the relationships among managers and investors. For simplicity, this Part will refer to binary arrangements, although similar principles apply to arrangements that have more than two possible values.[80] For a binary arrangement, a corporation can either have the arrangement or not have the arrangement, which I refer to as having a "no-arrangement."[81]

Mandatory rules may require an arrangement or prohibit an arrangement (equivalent to requiring a no-arrangement). In contrast, investor ordered rules are permitted but not required, so corporations can choose to switch from the default. If the arrangement is the default, corporations are bound by the arrangement unless they choose to opt out, in which case they are not bound. Alternatively, if no-arrangement is the default, corporations are not bound unless they choose to opt in. The nature of opt-out and opt-in decisions thus depends on the nature of the default.[82] To avoid confusion, I use "switching" to refer to both opt-out decisions and opt-in decisions without having to specify the nature of the default.

1. Preconditions

Several preconditions for investor ordering follow from its definition. Investor ordering will only apply where the subjects of a regulation are corporations with investors. Investor ordering will not apply to the regulation of other capital market participants such as broker-dealers, investment advisors, or securities exchanges. Investor ordering will also not apply where corporations do not have a body of

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78 *See* Bebchuk & Hamdani, *supra* note 24, at 492 (describing the choice of optimal defaults); *see also* Bebchuk, *supra* note 9, at 1412 (setting out a preliminary version of this approach).

79 *See* Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 332–33 (2010) (proposing private ordering of federal proxy access regulations by investors); Brett H. McDonnell, *Setting Optimal Rules for Shareholder Proxy Access*, 43 ARIZ. ST. L.J. 67, 71 (2011) (making a similar proposal with respect to proxy access); Joshua Mitts, *A Private Ordering Solution to Blockholder Disclosure*, 35 N.C. CENT. L. REV. 203, 241 (2013) (suggesting private ordering of the SEC's blockholder disclosure rules by investors). Luca Enriques, Ron Gilson and Allessio Pacces have also suggested private ordering of takeover regulations by investors. *See* Luca Enriques, Ronald J. Gilson & Alessio M. Pacces, *The Case for an Unbiased Takeover Law (with an Application to the European Union)*, 4 HARV. BUS. L. REV. 85, 88 (2014).

80 The implementation of investor ordering for non-binary arrangements is discussed *infra* Part V.A.7.

81 Having a "no-arrangement" is the jural opposite of having an arrangement, and follows Hohfeld's use of "no-right" as the jural opposite of a right. *See* Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16, 30 (1913).

82 Opting out of an arrangement default is the opposite of opting out of a no-arrangement default, and the same as opting in to a no-arrangement default.

public equity investors. Investor ordering, therefore, does not apply to closely held corporations[83] or to corporations in the hands of their creditors.

2. Switching Arrangements

Any decision regarding whether to switch arrangements can be split into two components, initiation and approval.[84] Investor ordering permits switching to be initiated by either managers or investors, but requires investor approval for switching. In this respect it differs from "manager ordering," whereby switching decisions can be unilaterally approved by managers.

For approval of switching decisions, investor ordering requires, at a minimum,[85] the approval of a majority of votes cast by all shareholders,[86] and the approval of a majority of votes cast by outside shareholders. The latter approval requirement is akin to the concept of a "majority-of-the-minority" in Delaware corporate law.[87] It excludes insiders—directors, managers, and beneficial holders of more than 10% of the equity of the corporation[88] (since they can be assumed to have some ability to control the affairs of the corporation), as well as their immediate families and any entities they control. Requiring the approval of outside investors prevents inside investors from choosing corporate arrangements that would not be optimal for the corporation. These approvals must be made at a properly constituted meeting of shareholders.[89] Within these constraints the switching process would aim to minimize the cost of switching.

If the SEC wishes, it could also require that switching decisions made prior to an IPO be approved by public shareholders after the IPO. This possibility is discussed further in Part V.A.4. There are conceptual reasons why this may be consistent with the rationale for investor ordering, but also arguments against requiring post-IPO approval. However, the number of companies that this would

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[83] The treatment of corporate arrangements put in place before a corporation goes public is discussed in Part V.A.4.

[84] These correspond to "agenda setting" and "veto" within the political systems literature. *See, e.g.*, GEORGE TSEBELIS, VETO PLAYERS: HOW POLITICAL INSTITUTIONS WORK 2 (2002).

[85] Since this would be a minimum constraint, corporations could impose more stringent (but not less stringent) requirements for approval of switching, although imposing such rules would also require investor approval.

[86] Where the approval requirement is a majority of votes cast, the failure of retail investors to vote will not influence the outcome. For a discussion of the effects of non-voting where the vote requirement is a majority of outstanding shares, see Scott Hirst, *Frozen Charters*, 34 YALE J. REG. 91, 95–96 (2017).

[87] *See, e.g.*, Kahn v. M&F Worldwide Corp., 88 A.3d 635, 654 (Del. 2014) (holding that majority-of-the-minority approval creates a presumption that a transaction with a controller is fair to investors).

[88] This definition follows that for which disclosure is required under the Securities Exchange Act of 1934, 15 U.S.C. § 78p(a) (2012).

[89] This includes satisfaction of the corporation's quorum requirements.

apply to is very small.[90] I therefore focus instead on the switching decisions of existing corporations, which would form the overwhelming majority of corporations to which investor ordering would apply.

3. Manager-Initiation-Maximizing Defaults

In order to ensure that investors have the opportunity to consider potentially value-enhancing switches, defaults need to be set so as to maximize the chance that switching will be initiated. Managers are likely to be able to initiate switching with lower costs than investors because they control the operations of the corporation, including its proxy statement and annual meeting, and can therefore easily put forward switching proposals for approval. The regulator should thus select the default arrangements that would most encourage managers to initiate switching if it is value-enhancing.

Managers will have incentives to move from arrangements that are more restrictive of their activities (or that offer them fewer private benefits) to arrangements that are less restrictive (or offer greater private benefits). However, they will have private incentives against moving from less-manager-restrictive arrangements to more-manager-restrictive arrangements.[91] Even if such switches were value-enhancing for the corporation, managers may not initiate them. As a result, all other things being equal, the optimal default rule is likely to be the plausible arrangement that is most restrictive of managers, or least privately beneficial for managers.[92]

B. The Investor Value Case for Investor Ordering

This section sets out an informal analysis that demonstrates the proposition that, assuming that there are no potential externalities from arrangements that are not internalized by institutional investors,[93] investor ordered regulations will produce the same or greater aggregate net value for investors as would mandatory regulations.

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[90] *See, e.g.*, Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1663 (2013) (observing an average of "99 IPOs per year during 2001-2012"). The small number of IPOs compares to more than at least 3,500 public corporations every year in that period. *See* Craig Doidge, G. Andrew Karolyi, & René M. Stulz, *The U.S. Listing Gap*, 123 J. FIN. ECON. 464, 473 tbl.3 (2017).

[91] *See, e.g.*, Bebchuk & Hamdani, *supra* note 24, at 502–03.

[92] This follows the "reversible defaults approach" put forward in Bebchuk & Hamdani, *supra* note 24, at 490. An alternative criterion for defaults could be which defaults are more protective of investors, including from agency costs of managers. Investor protectiveness (vis-à-vis managers) will often be related to manager-restrictiveness. However, choosing the most investor protective default may not always maximize the likelihood that managers will initiate switching from that arrangement to a less investor-protecting arrangement, since some investor protections might also act to protect managers more than their plausible alternatives.

[93] A potential externality is a cost or benefit to another party that results from a choice, and which would be an externality if it were not taken into account ("internalized") by the parties making the choice.

To illustrate the investor value case, assume that a regulator has the power to enact a regulation that applies to corporations. The regulation will only have an effect if it is enacted, and the aggregate effect of the regulation will be the sum of the effects of the regulation on each corporation in the capital market. The regulation may be mandatory, in which case it will apply to all corporations. Alternatively, if the regulation permits private ordering, each corporation can switch from the default arrangement to no-arrangement, in which case the net benefit to the corporation from the rule will be zero, less the cost of switching.[94] Corporations will switch arrangements if the arrangement has a net cost to the corporation (i.e., the net benefit of the arrangement to the corporation is negative), and the net cost is more than the cost of opting out.

The discussion below initially assumes that there are no agency costs and no externalities to other investors; the effects of relaxing these assumptions are then discussed in Part II.B.5 and Part II.B.6, respectively. Where there are no agency costs or externalities, there will be no difference between the arrangements chosen by institutional investors and other investors, so investor ordered rules will be the same as other privately ordered rules.[95] Where there are agency costs or externalities, it is further assumed that institutional investors control the choice of corporate arrangements.

1. One Size Fits All. Consider first the situation where a particular arrangement rule has the same directional effect on all corporations in the capital market. Even if the exact net effects of an arrangement on corporations vary, if the arrangement has positive net benefits for all corporations, or net costs that are less than the cost of switching for those corporations, no corporations will switch arrangements, and an investor ordered regulation will have the same aggregate net benefit as a mandatory regulation.

To illustrate, consider a hypothetical capital market in which there are only four corporations, *A, B, C,* and *D*. Assume that an arrangement results in net benefits to {*A, B, C, D*} of {10, 20, 40, 40} compared to no-arrangement. Since the arrangement has positive net benefits for all corporations, no corporations would opt out even if they were permitted to do so, and the aggregate net benefit will be 110 whether the rule is mandatory or privately ordered.

Given that rules are made under conditions of uncertainty, the regulator may require an arrangement that it expected to be beneficial, but which turns out to be more costly for all corporations than the cost of switching arrangements. If the rule is investor ordered, each corporation will opt out of the rule. In this case, the investor ordered regulation would have greater aggregate net benefits than a mandatory rule.

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94 In this framework, a mandatory rule can be considered to be equivalent to a privately ordered rule with an infinite opt-out cost.

95 For consistency, I continue to use the term "investor ordering" to describe these private ordering decisions.

2. Heterogeneous Effects. Corporations are complex and varied, and differ in many aspects that potentially affect the impact of a corporate arrangement. As a result, a single arrangement may not have the same directional effects for all corporations.[96] In these circumstances, an investor ordered rule will have greater aggregate net benefits than a mandatory rule to the extent that the regulation results in net costs to corporations that are greater than the switching costs for those corporations.

To illustrate, consider an arrangement that results in net benefits to {*A, B, C, D*} of {-20, -10, 40, 40} compared to no-arrangement. A mandatory rule would have an aggregate net benefit of 50. But if switching were permitted and had a cost of 15, *A* would opt out, improving its outcome from -20 to -15, and the aggregate net benefit would be 55. If switching had a cost of 5, *B* would also opt out, and the aggregate net benefit of the rule would be 70.

With an investor ordered regulation, each corporation effectively has an option to switch arrangements, with the exercise price being the switching cost, and the payoff being the net cost of the chosen arrangement to the corporation.[97] The option is valuable when it is "in the money"—when an arrangement has greater net costs than the switching cost. The option has zero value when it is "out of the money"—when the net costs of the arrangement are less than the cost of opting out. Investor ordering will be valuable to the extent that it is expected to result in in-the-money options.

Investor ordering effectively caps the net cost of an arrangement to corporations at the switching cost, without affecting situations where the arrangement has positive net benefit. The lower the switching cost, the lower the downside cap on the regulation, and the greater the potential positive net benefit from private ordering. The extent to which investor ordered regulations are superior to mandatory regulations will increase with the expected aggregate net costs from an arrangement. Expected aggregate net costs will increase with the likelihood of net costs from an arrangement, and with the magnitude of the net costs. Investor ordering will therefore be more valuable where corporations are likely to have more heterogeneous effects from a particular arrangement, and where there is greater uncertainty about the effects of the arrangement on corporations.

3. Negative Aggregate Benefit Rules. Investor ordering will not just improve regulations that would have positive net benefits if mandatory, but, given sufficiently low switching costs, will create positive aggregate net benefits from rules that would have had negative aggregate net benefits if they were mandatory. For instance, if an arrangement had net benefits of {-30, -20, 10, 30}, a mandatory rule would have an aggregate net benefit of -10. However, if opting out were

[96] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 7.

[97] Consideration of investor ordering within an option framework makes clear the underlying similarity of investor ordering to the "real-option" analysis put forward by Yoon-Ho Alex Lee. *See* Yoon-Ho Alex Lee, *An Options Approach to Agency Rulemaking Essay*, 65 ADMIN. L. REV. 881, 887 (2013).

permitted and had a cost of 5, *A* and *B* would opt out, and the aggregate net benefit of the rule would be 30.

4. Agency Costs. So far, corporations have been analyzed as unitary entities. However, the interests—and therefore the decisions—of managers are not necessarily aligned with those of investors for all arrangements. Of course, if managers always act in the best interests of investors, then they will make the same choice of arrangements as investors. This might be the case if fiduciary duties, executive compensation, or other governance arrangements in place at the corporation perfectly align the interests of managers and investors. However, as discussed in Part I.A, agency costs may cause a divergence in the incentives of managers and investors, and therefore in their choices with respect to particular corporate arrangements. Certain arrangements may be more prone to agency costs than others. For instance, a regulation that imposes additional accountability requirements on managers will be costly for managers, but may benefit investors. Given potential divergence between investor interests and manager interests regarding these arrangements, investor ordered regulations will produce the same or greater aggregate net benefit compared to manager ordered regulations.[98]

To illustrate, consider an arrangement that would have benefits to the investors of {*A, B, C,* and *D*} of {-20, -10, 30, 40}, and to the managers of {*A, B, C,* and *D*} of {2, -2, -2, 2}. If the rule is privately ordered with switching costs of 5 and managers control the switching decision, *A* and *D* will opt out, but *B* and *C* will not, with an aggregate net benefit of 10. If investors control the opt-out decision, *A* and *B* will opt out, with an aggregate net benefit of 60. Where the directions of investor interests and manager interests are perfectly correlated, managers will opt out in the same cases as investors, and the results of manager ordering and investor ordering will be the same. Where the direction of manager interests and investor interests are less than perfectly correlated, management ordering will produce lower investor value than investor ordering.

In some cases, where the direction of investor interests and manager interests are negatively correlated, manager ordering may result in lower net aggregate benefit than a mandatory rule, and possibly even lower net aggregate benefit than no rule.[99] For instance, in the example above, had the regulation been mandatory, the net aggregate benefit would have been 40. If management payoffs were {2, 2, -2, -2} and the rule were management ordered, then *C* and *D* would opt out, and the net aggregate benefit would be -40.

5. Default Arrangements. So far the analysis has been confined to opting out of a particular arrangement. An investor ordered rule could also be designed to permit

[98] This analysis disregards the welfare effects on managers. A full welfare analysis would aggregate the welfare effects on managers and investors. However, in most publicly owned corporations the value invested by investors is much greater than that of managers. The effect on investors is therefore likely to be several orders of magnitude greater than the effect on managers. This would not be the case where a manager is also a significant inside investor in a corporation.

[99] *See* Bebchuk, *supra* note 13, at 1836.

opting in from a no-arrangement default. Where switching is costless, opting out of an arrangement and opting in from no-arrangement will both lead to the optimal result.[100] Consider an arrangement with benefits of {-20, 10, 10, 20}. If the arrangement is the default, and corporations can opt out with no cost, *A* will opt out, with an aggregate net benefit of 40. If there is a no-arrangement default and the arrangement can be opted into with no cost, corporations *B*, *C,* and *D* would opt in, with the same net benefits of 40. However, wherever switching is costly, or where switching does not take place with certainty when it would increase investor value, different default choices will have different outcomes.

If switching takes place with certainty when it increases investor value, the optimal rule will be the one that minimizes aggregate switching costs across all corporations. In the above example, with payoffs of {-20, 10, 10, 20}, if switching costs 5, then permitting opting out from a default arrangement is optimal, as it will result in switching costs of 5 and an aggregate net benefit of 35, rather than switching costs of 15 and an aggregate net benefit of 25 for opting in from a no-arrangement default. Alternatively, consider an arrangement with benefits of {-20, -10, 10, 20}, where opting in costs 8 and opting out costs 5. Opting out from a default arrangement would be preferable as it would result in switching costs of 10 rather than 16, and a net benefit of 20 rather than 14.

If switching takes place with certainty when it improves net benefits, both opting out from a default arrangement and opting in from a no-arrangement will result in the same or greater aggregate net benefit as a mandatory rule. However, where optimal switching is not certain, either opting out from a default arrangement or opting in from a no-default arrangement (but not both) may be inferior to a mandatory rule. Whether the investor ordered rule is superior to a mandatory rule therefore depends on the choice of the default arrangement. Consider a regulation in a market with 10 corporations, where 8 corporations of type *A* would have a net benefit of 10, and 2 corporations of type *B* would have a net benefit of -10, i.e., {10 × 8, -10 × 2}. Assume that switching has zero cost, but only takes place in 50% of the cases where it increases investor value. Opting out from a default arrangement would have an aggregate net benefit of 70, and would be superior to a mandatory rule, which would have an aggregate net benefit of 60. However, opting in from no-arrangement would have an aggregate net benefit of 40, and would be inferior to the mandatory rule. For the proposition that investor ordered rules are the same or better than mandatory rules to hold, the investor ordered rule must therefore be well-designed, and must incorporate the superior default arrangement.

6. Externalities. A corporation's arrangements may have externalities—they may affect those other than the current investors in the corporation. This would include not just investors in other corporations, but also future investors in the corporation (or in other corporations). If potential externalities are not taken into

[100] This is a simple application of the Coase Theorem. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

account (internalized) by the investors that choose corporate arrangements, they could result in an investor ordered rule being inferior to a mandatory rule.

To illustrate, consider an arrangement with net benefits to corporations {*A, B, C, D*} of {-15, -10, 10, 15}, and assume that investors in each corporation receive benefits of 5 for each *other* corporation that has the arrangement.[101] If there is a mandatory rule requiring the arrangement, in addition to the effects from their own corporation having the arrangement, the net benefits to investors in each corporation of *other* corporations having the arrangement will be {15, 15, 15, 15}, so the regulation will have an aggregate net benefit of 60. If the rule is investor ordered with opt-out costs of 5, *A* and *B* will opt out, so aggregate net benefits would be 15, plus net benefits to each corporation of other corporations being bound of {10, 10, 5, 5}, resulting in an aggregate net benefit from the regulation of 45.

C. Potential Limitations of the Investor Value Case for Investor Ordering

This section considers the potential ways in which the investor value case for investor ordering may fail, such that investor ordering may have *lower* aggregate net benefits than mandatory regulation. Investor ordering will have the same or greater aggregate net benefit than a mandatory rule with the same defaults.[102] However, optimal defaults for investor ordering will be different from optimal defaults for mandatory rules, because investor ordering defaults are chosen assuming that corporations will switch arrangements when it is optimal to do so.[103] If those corporations *do not* switch when it would be optimal to do so, an investor ordered rule may have lower aggregate net benefits than a mandatory regulation. The first four limitations therefore consider situations that may lead to sub-optimal switching: Part II.C.1 considers the possibility of sub-optimal initiation, and Part II.C.2 through Part II.C.4 consider the possibility of sub-optimal vetoes of switching decisions. Part II.C.5 and Part II.C.6 consider additional costs that might lead investor ordering to be inferior to mandatory rules.

1. Insufficient Initiation of Optimal Switching

One potential cause of insufficient switching is insufficient initiation of optimal switches. Michael Klausner and Michal Barzuza each describe evidence that, under current state law rules, corporations fail to switch arrangements to those that investors consider optimal.[104] However, that failure to switch takes place against the current backdrop of default rules that are *less* manager restrictive than the alternative. As a result, managers do not have significant incentives to initiate switching, and initiation is left to investors. As will be discussed in Part II.C.3,

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[101] A similar rationale would hold for the converse arrangement—if there are net benefits to investors in *A* if *A* had an arrangement, but net cost to investors in *B, C,* and *D* from *A* having that arrangement.

[102] This assumes that there are no significant decision costs, which is discussed in Part II.C.6.

[103] Bebchuk, *supra* note 9, at 1411.

[104] Klausner, *supra* note 23, at 1349; Barzuza, *supra* note 23, at 5.

investors have incentives to under-initiate value-enhancing switching.[105] Investor ordering therefore requires the default that will maximize initiation of switching by managers. This will generally be the plausible arrangement most restrictive of managers. With such defaults, managers will have strong incentives to initiate switching, and the problem that Professors Klausner and Barzuza observe would be remedied.

An illustration of manager initiation where there are manager-restrictive defaults can be seen in the period after the Delaware Supreme Court imposed liability on outside directors for breach of the duty of care in *Smith v. Van Gorkom*.[106] The Delaware legislature subsequently permitted corporations to opt out of such liability. At the vast majority of corporations, managers initiated charter amendments to take advantage of this provision, opting out of liability.[107]

2. Institutional Investors Not Having a Veto

If institutional investors do not have a veto right at particular corporations they will not be able to prevent any value-decreasing switches that might be initiated by managers.[108] Because investor ordering decisions require the majority approval of outside investors, the only way that institutional investors may not have a veto is if they do not control a majority of shares held by outside investors. This would be the case if retail investors and outside blockholders with positions less than 10% held a majority of the shares of the corporation.

Part I.C examined the extent to which institutional investors hold a majority of the shares in Russell 3000 corporations. Requiring approval of outside investors excludes from consideration insiders, and blockholders holding positions of more than 10% of corporations. This leaves institutional investors, retail investors, and blockholders with positions below 10%. Figure 2(a) shows the proportion of such shares held by institutional investors.

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[105] *See infra* Part II.C.3. (citing Lucian A. Bebchuk, Alma Cohen & Scott Hirst, The Under-Supply of Investor Stewardship (2017) (unpublished manuscript) (on file with the Harvard Business Law Review)).

[106] 488 A.2d 858 (Del. 1985), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009). Examples of manager-restrictive defaults are rare because manager-restrictive SEC rules are invariably mandatory and state law defaults are generally less manager-restrictive.

[107] Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) (observing that 90% of Delaware firms sampled opted out).

[108] Of course, many managers will act only in the best interests of the corporation, even if they have private incentives to the contrary, and will therefore not initiate value-reducing switches. However, some managers may initiate such switches when it is in their own interests, and some managers may mistakenly believe such switches to be in the interests of the corporation.

Figure 2(a). Institutional Control of Corporations Assuming Investor Ordering[109]

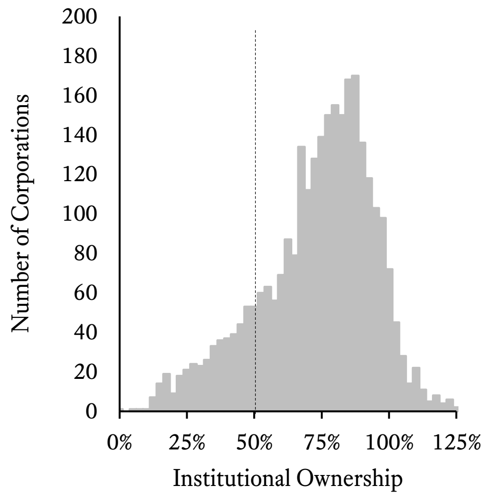

Figure 2(b). Institutional Control Assuming Investor Ordering, as Proportion of Shares Voted[110]

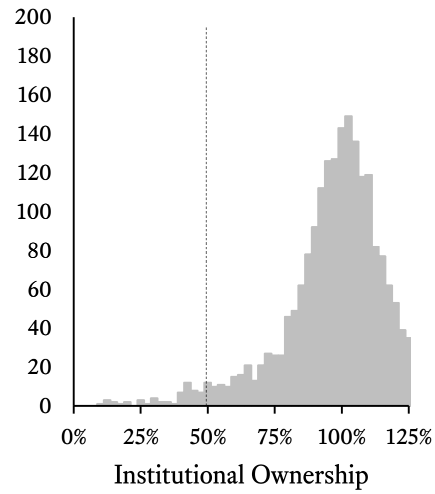

Figure 2(a) shows that institutional investors constitute a majority of shares held by outside shareholders at 84% of corporations. At those corporations, institutional investors would have a veto on choices of arrangements under investor ordering. The proportion is even more pronounced considering retail investors' limited participation in voting. Institutional investors constitute more than a majority of the outside investors that voted in annual meetings in 2016 at 97% of Russell 3000 corporations. This suggests that the number of corporations where institutional investors do not have a veto is likely to be extremely limited.

The few firms where institutional investors may not have a veto are likely to be very small firms, which have lower levels of institutional ownership. Small firms represent a tiny proportion of total capital invested in corporations—the total value of the smallest 20% of firms in the Russell 3000 is only 0.5% of the total value of firms in the index. Rather than limit the adoption of rules that would be beneficial for investors in 97% of corporations, the SEC could consider minimum size thresholds for regulations, above which regulations would be investor ordered and below which corporations would be bound by mandatory rules.

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[109] Ownership data for Figure 2(a) and Figure 2(b) is as of Dec. 31, 2016, and is derived from the FactSet Ownership database (accessed August 6, 2017), which aggregates ownership of institutional investors from SEC filings. The denominator of each figure excludes inside investors, and non-institutional holders of more than 10% of equity. Because multiple institutional investors may have control over the same investments, there may be some double counting and inflation of investor ownership, explaining the reported institutional ownership over 1.

[110] Voting data in Figure 2(b) is derived from FactSet SharkRepellent (accessed July 29, 2017). To permit comparison among corporations, Figure 2(b) excludes corporations with classes of shares with different voting rights.

3. Institutional Investors Exercising (Privately) Sub-Optimal Vetoes

If institutional investors have a veto over switching arrangements, if they systematically approve switches that are not privately optimal for the corporation, or if they fail to approve switches that are privately optimal for the corporation, then mandatory regulations may be superior to investor ordering.

Institutional investors are intermediaries that invest on behalf of other investors.[111] This creates the possibility for agency costs between the institution and their own investors. These agency costs may systematically bias the switching decisions made by institutional investors away from the switching decisions that would be optimal for the corporation. While the potential for agency costs exists with all kinds of institutional investors, it can be most clearly illustrated in the case of the investment managers that manage diversified investment funds, like mutual funds or exchange traded funds. Investment managers are also the largest institutional investors and have the greatest influence on choices of arrangements.

There are several reasons to believe that investment managers may have significant agency costs.[112] They capture only a small proportion of value increases that they create, meaning that they will have limited incentives to spend to identify and initiate value-enhancing switching.[113] Any increase in the value of companies that investment managers create will be shared with their competitors. For index funds—the largest investment managers—*all* of the value they create will be shared with others that invest in the index,[114] giving them no incentive to initiate value-enhancing switches even though those would be beneficial to the company. Even managers of actively managed investment funds will share most of any increases in value with competitors, so they will have limited incentives to initiate value-enhancing switches.[115] However, while these factors will limit the willingness of investment managers to initiate switching, they will not lead investment managers to vote against the interests of their own investors on switches that have already been initiated. Indeed, these agency costs make it more important that defaults be chosen so as to maximize the likelihood that managers will initiate value-enhancing switching.

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[111] The exact relationship between the intermediary and the beneficiaries varies with the type of institutional investor. Investment managers may purchase shares of companies on behalf of particular clients, in which case those shares will be owned by the particular client. Alternatively, investment managers may manage investment funds which pool the assets of multiple investors and use those assets to buy shares of companies, which are then owned by the investment fund. Pension funds buy and own shares of companies, but have a duty to use the proceeds of those shares for their beneficiaries.

[112] *See* Bebchuk, Cohen & Hirst, *supra* note 16, at 90.

[113] *Id.* at 90, 99

[114] *Id.*

[115] *Id.* (discussing "closet indexing"); *see also* K.J. Martijn Cremers & Antti Petajisto, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, 22 REV. FIN. STUD. 3329, 3329 (2009).

Investment managers also often offer business services to corporations, and they may believe that taking positions that corporate managers disfavor would lead corporations to reduce those services.[116] This may reduce the willingness of investment managers to oppose value-decreasing switching initiated by managers. However, this has not prevented investment managers from adopting policies and voting in favor of arrangements that managers have disfavored in the past. For instance, although managers have reasons to prefer classified boards of directors to annual elections,[117] the largest investment managers have voting policies in favor of annual elections, and routinely vote in favor of proposals to move to annual elections.[118] That such proposals receive large majorities despite management opposition[119] suggests that large investment managers are indeed willing to vote in ways that corporate managers disfavor.

4. Institutional Investors Exercising (Publicly) Sub-Optimal Vetoes

Even if institutional investors make decisions that are optimal for the corporation, mandatory regulations will be superior to investor ordering if there are significant potential externalities from changes in corporate arrangements that institutional investors do not internalize.

How might a corporation switching a particular arrangement affect investors in other corporations? The most obvious example is network externalities. If an arrangement has a network externality, the more corporations that have that arrangement, the more valuable the arrangement becomes for each corporation that has the arrangement. For instance, if a single corporation makes a particular type of disclosure, it will be expensive for other market participants to interpret that disclosure. However, the more corporations that adopt the disclosure, the easier it will be to compare corporations on that disclosure measure, and the more worthwhile it will be for others to learn how to interpret the measure.[120]

The extent to which corporate arrangements have effects on third parties depends on which third parties are included in the frame of evaluation. The SEC could evaluate corporate regulations on three successively broader criteria,[121] each

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116 Bebchuk, Cohen & Hirst, *supra* note 16, at 101.

117 *See, e.g.*, Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 891, 896–99 (2002).

118 *See* Lucian Bebchuk, Scott Hirst & June Rhee, *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157, 163 (2013).

119 *See id.* at 172.

120 A similar argument applies to interpretation of these arrangements by the courts. *See* Klausner, *supra* note 56, at 762–63.

121 For a discussion of the criteria for SEC rule making, see Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 57 ARIZ. L. REV. 85, 89–90 (2015) and Yoon-Ho Alex Lee, *SEC Rules, Stakeholder Interests, and Cost-benefit Analysis*, 10 CAP. MKTS. L.J. 311, 313 (2015), which differentiate between the impact of using investor benefit or social welfare criteria.

of which contemplates effects on successively broader groups of third parties that might suffer externalities from corporate arrangements.[122]

First, the SEC's investor protection criterion incorporates externalities on investors in other corporations and future investors in corporations. As discussed in Part I.B, diversified investors will internalize the benefits to other corporations that they also invest in. While most investment funds are broadly diversified, not all of them hold interests in all corporations.[123] However, the effect that a corporation switching its arrangements has on other corporations is likely to be similar for many other corporations, so it will not matter that the investment funds do not have interests in all of those companies.[124] The effect on the switching corporation is also likely to be much greater than the effect of the switch on any other individual corporation. As a result, any potential effect of the switch to other corporations that diversified investment managers do not hold will be very minor in comparison to the effect on the switching corporation.

It is also possible to conceive of potential externalities to future investors: either investors in the switching corporation or investors in other corporations. Such externalities could eventuate if switching arrangements move significant costs or benefits from the present to the future, or vice versa. However, institutional investors will again internalize these effects for similar reasons. The same institutional investors are likely to constitute the great majority of future investors, as they do in the present.[125] The interests of other future investors are likely to be correlated with those of institutional investors.

Second, when efficiency, competition, and capital formation are also considered, there may be externalities on other capital market participants such as financial institutions, broker-dealers, and securities exchanges. However, other market participants that have costs and benefits from the arrangement will pass on much of those effects to corporations, and therefore to investors. This will include institutional investors, who will therefore internalize those effects. In addition, most financial institutions and many other market participants are public corporations themselves, so diversified investors are likely to hold investments in them directly and will internalize any costs and benefits they face.

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[122] Prior literature has divided the potential effects into capital markets effects and real effects. *See, e.g.*, Christian Leuz & Peter D. Wysocki, *The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research*, 54 J. ACCT. RES. 525, 545 (2016). Collectively these cover the same effects as those in the first and second groups discussed here.

[123] Index funds that track broad indexes such as the Russell 3000 and the CRSP U.S. Total Market Index will have similarly broad holdings; the latter claims to include "nearly 100% of the U.S. investable equity market . . . ." *CRSP U.S. Total Market Index*, CTR. FOR RESEARCH IN SEC. PRICES, http://www.crsp.com/products/investment-products/crsp-us-total-market-index.

[124] Described formally, externality effects would need to be negatively correlated with the costs and benefits to other corporations and of a similar order of magnitude.

[125] Index funds will remain in the corporation as future investors for as long as the corporation remains part of the index. Many actively managed funds are "closet indexers," and generally follow the index weighting of many corporations, with some deviations. *See* Cremers & Petajisto, *supra* note 115, at 3332.

Finally, the SEC may consider the social welfare effects of a corporate arrangement.[126] Some corporate arrangements could have social benefits but impose costs on the business operations of corporations, or vice versa. Most of these kinds of arrangements—such as environmental regulations or workplace regulations—are not within the purview of the SEC. However, a small number of arrangements governed by the SEC do fall into this category. For example, the SEC's Conflict Minerals Rule had implementation costs for corporations, but those costs were justified on the grounds that the rule would "promote peace and security in the [Democratic Republic of the Congo]."[127]

Non-capital market social welfare effects are not likely to be internalized by institutional investors.[128] If these effects are likely to outweigh the effects of the arrangement on capital markets, then a mandatory rule could be superior to an investor ordered rule. Whether this is likely to be the case will be for the SEC to determine when deciding whether an arrangement should be mandatory or investor ordered. However, SEC regulations that benefit society at the cost of investors and capital markets are rare. Such rules are likely to fail the statutory requirement that they "promote efficiency, competition, and capital formation criteria."[129] Where such regulations have been promulgated by the SEC, it has generally been because of a congressional mandate to do so, as was the case with the SEC's Conflict Minerals Rule.[130] If the SEC were to implement such a rule without an explicit congressional mandate, the requirement to "promote efficiency, competition, and capital formation" could lead the rule to be invalidated by the D.C. Circuit.[131]

A final point to note regarding potential externalities is that, compared to mandatory regulations, investor ordered regulations may also produce positive externalities.[132] Investor ordering may produce information that can be inferred from the initiation decisions of investors and managers[133] and from the approval

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[126] The purpose of the Securities Exchange Act extends beyond investor protection to the public interest. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78b (2012) (enumerating the national public interest in regulating securities exchanges).

[127] Conflict Minerals, 77 Fed. Reg. 56,273, 56,276 (Sept. 12, 2012); *see also* Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359, 365 (D.C. Cir. 2014) (discussing the SEC's consideration of the "compelling social benefits" the rule was supposed to achieve), *overruled in part by* Am. Meat Inst. v. U.S. Dep't Agric., 760 F.3d 18 (D.C. Cir. 2014) (en banc).

[128] Institutional investors could also take into account broader social concerns that would also apply to internalize the effects of corporate arrangements on other parts of society. *See* Hirst, *supra* note 11.

[129] Securities Exchange Act of 1934, 15 U.S.C. § 77b(b) (2012); *see* discussion *infra* Part III.A.1.

[130] *See* 15 U.S.C. § 78m(p). The validity of such mandates is discussed in Part V.C.

[131] *Cf. Bus. Roundtable II* at 1148.

[132] Both investor ordered regulations and mandatory regulations may create observable information in the decisions of investors and managers regarding lobbying regulators over the content of the rule.

[133] Information about managers that can be inferred by their investment decisions may also be of value to investors in the corporation. However, this would be a direct benefit of the rule and not an externality.

decisions of investors.[134] For instance, if investors approve a switch to a particular arrangement, observers of the corporation can infer that investors believe the arrangement to be optimal for the corporation. This might allow observers to make additional inferences about the corporation that may have social benefit. For instance, investors in other corporations that they know to be similar will derive information about whether the arrangement is likely to be beneficial for their corporation. These benefits should also be taken into account in considering whether to adopt investor ordering.

5. High Switching Costs, Limiting Optimal Switches

If an investor ordered rule implemented a default that was more costly than the default that would be used for a mandatory rule, and corporations did not switch arrangements because of high switching costs, the investor ordered rule could be inferior to a mandatory rule. However, switching costs are likely to be very low for new arrangements.[135] For such arrangements, the main switching cost will be the cost of having a shareholder vote on switching arrangements. Corporations are required to conduct shareholder meetings annually. These meetings require considerable disclosure[136] and include numerous other proposals for investors to consider and vote on. To describe and consider one additional proposal that requires several pages of additional disclosure is likely to involve a very small increase in cost.

6. Duplicative Decision Costs that Outweigh the Benefits of Investor Ordering

Finally, investor ordering could be inferior to mandatory ordering if the aggregate costs of corporations switching arrangements are greater than the cost of implementing a mandatory rule, and that difference exceeds the benefit from investor ordering. This is the converse of the economies of scale justification for mandatory rules discussed in Part I.A.3. Introducing the possibility of switching means that each corporation will bear some decision costs in determining whether to initiate arrangement switching. Where switching is initiated, investors will incur additional decision costs in determining whether to approve the switch.[137] Decision costs are prior to the switching costs considered in Part II.B.1, and occur irrespective of whether the corporation actually switches arrangements.

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[134] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 97 (1989) (discussing information production as a rationale for "penalty default rules").

[135] The potential switching costs associated with deregulation—moving from an existing arrangement to a new arrangement—may be higher, as discussed in Part V.B.

[136] For instance, the 2012 proxy statement of McDonald's Corporation had 88 pages (including exhibits), of which two management proposals to amend corporate arrangements took up approximately half a page each. McDonald's Corp., Definitive Proxy Statement (Schedule 14A) 36–37 (Apr. 13, 2012).

[137] Decision costs may be lessened by managers not initiating switching decisions that they expect would have a significant chance of approval by investors, since putting forward such switches may not reflect well on the manager. This is similar to the reticence of managers to put forward charter amendments that they believe are unlikely to pass. *See, e.g.*, Hirst, *supra* note 86.

Of course, mandatory rules also involve decision costs. The regulator will bear decision costs in choosing an arrangement. Those costs have economies of scale because the regulator makes one rule for all corporations. However, groups of managers and investors will also incur decision costs in informing themselves whether a proposed mandatory arrangement is in their interests and lobbying the regulator to implement their preferred arrangement. After a mandatory rule is implemented, these groups may also incur decision costs lobbying the regulator to change the rule to their preferred arrangement.

There are reasons to believe that the decision costs for corporations and investors will not be significant. Switching decisions in different corporations will be similar, especially for corporations that are similar in aspects relevant to the arrangement. The basis for managers' decisions to initiate switching will be publicly disseminated to investors and can also be used by other corporations and investors making switching decisions. Institutional investors will learn from successive switching decisions in the many corporations in which they invest, reducing their marginal information cost for each decision. These costs will be further reduced by proxy advisors that evaluate the costs and benefits of switching and share the cost of doing so among many investors. The SEC can also decrease decision costs by producing information relevant to the switching decision as part of its economic analysis.[138] Finally, if investors believe that decision costs are likely to outweigh the benefits of switching, investors could curtail future switching decisions, for instance, by adopting a charter or bylaw amendment that imposes very stringent requirements for switching.

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Given these potential limitations of the case against investor ordering, it will fall to the SEC to determine the validity of the assumptions regarding institutional investors having a veto and the lack of externalities.[139] In addition to undertaking cost-benefit analysis regarding whether to implement or change a regulation, the SEC must also analyze whether an investor ordered rule is superior to a mandatory rule. This analysis is considered in greater depth in Part III.

III. The Cost-Benefit Analysis Case for Investor Ordering

Part II examined the first-order case for investor ordering: in normal conditions, it results in at least the same and often greater aggregate net benefits to investors than do mandatory rules. Parts III and IV consider two second-order cases for investor ordering that follow from the investor value case. This Part

[138] *See infra* Part V.A.6.

[139] Where the SEC is less certain about the existence of externalities, the expected value of those externalities will be lower, and investor ordered rules will be more likely to have greater aggregate net benefits than mandatory rules.

considers the cost-benefit analysis case for investor ordering, while Part IV considers the retrospective analysis case for investor ordering.

Cost-benefit analysis has long been a part of the regulatory process for executive agencies, including the SEC.[140] Recent judicial decisions have applied requirements for cost-benefit analysis to corporate regulations promulgated by the SEC. Section A describes cost-benefit analysis as applied to corporate regulations, its effects on corporate regulation, and the arguments concerning whether cost-benefit analysis should or should not apply to corporate regulations.

Given the investor value case for investor ordering, cost-benefit analysis has two significant implications. First, as section C explains, the D.C. Circuit's jurisprudence is likely to require the SEC to consider investor ordering as an alternative to a mandatory rule. In the majority of cases where investor ordering results in greater aggregate net benefit, it would be arbitrary and capricious for the SEC to instead implement a mandatory rule.

Second, section C explains that investor ordering reduces the cost of cost-benefit analysis for corporate regulation. Investor ordering imposes a lower bound on the potential cost of a regulation for a corporation, substantially simplifying the process of determining the cost of corporate regulations. Compared to mandatory regulations, investor ordered regulations can therefore be implemented at a lower cost to the SEC.

A. Cost-Benefit Analysis of Corporate Regulation

1. The Requirements for Cost-Benefit Analysis

The SEC's obligation to undertake cost-benefit analysis derives from four sources.[141] First, the Regulatory Flexibility Act[142] (RFA) requires agencies, including the SEC, to publish a "regulatory flexibility analysis"—essentially a cost-benefit analysis describing the impact of any proposed or final regulation on small entities.[143] Second, the Paperwork Reduction Act (PRA) requires agencies to conduct and submit to the Office of Management and Budget a review of collections of information under the regulation, which involves a de facto cost-

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[140] *See, e.g.*, Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. REG. 289, 296 (2013) (dating voluntary SEC cost-benefit analysis from the 1970s); *see also* Joshua T. White, *The Evolving Role of Economic Analysis in SEC Rulemaking*, 50 GA. L. REV. 293, 301 (2015).

[141] Although none of these requirements explicitly require the SEC to conduct a comprehensive cost-benefit analysis, the SEC's practice for many years has been to conduct such analyses. *See, e.g.*, SEC OFFICE OF INSPECTOR GEN., FOLLOW-UP REVIEW OF COST-BENEFIT ANALYSES IN SELECTED SEC DODD-FRANK ACT RULEMAKINGS 6 (2012) ("SEC Chairmen have made a commitment to Congress that the SEC will conduct cost-benefit or economic analyses in connection with its rulemaking activities.").

[142] Regulatory Flexibility Act, 5 U.S.C. § 601 (2012).

[143] *Id.* §§ 603–604.

benefit analysis.[144] Third, although the SEC is an independent agency[145] and therefore not subject to the series of Executive Orders requiring cost-benefit analyses,[146] Executive Order 13,579 recommends that independent agencies undertake cost-benefit analyses.[147] However, the most important factor of the SEC's cost-benefit analysis is the D.C. Circuit's judicial review of SEC regulation to ensure it complies with the Administrative Procedure Act and the requirements in the SEC's authorizing legislation.[148]

The Administrative Procedure Act contains several requirements for rule making by agencies. The agency must give public notice of proposed regulations or amendments,[149] including a statement of the rationale for the change and a request for comment.[150] The agency must then consider the matter and any comments. Finally, the agency must publish a statement of the basis and purpose for the rule before it can become effective.[151]

The Administrative Procedure Act also makes SEC regulations subject to judicial review.[152] As well as being reviewable for exceeding statutory authority,[153] SEC regulations can be set aside if they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[154] Persons aggrieved by most

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144 Paperwork Reduction Act, 44 U.S.C. §§ 3506–3507 (2012).

145 Rather than being an executive agency headed by a cabinet member, the SEC is headed by a commission of five, with no more than three members from any party. *See* 15 U.S.C. § 78d(a).

146 See Exec. Order No. 13,563, 76 Fed. Reg. 3821 (2011), in which President Obama reaffirmed and expanded upon President Clinton's Exec. Order No. 12,866, 58 Fed. Reg. 51735 (1993), which in turn had reaffirmed President Reagan's Exec. Order No. 12,291, 46 Fed. Reg. 13193 (1981).

147 *See* Exec. Order No. 13,579, 76 Fed. Reg. 41585, 41587 (2011) ("To the extent permitted by law, independent regulatory agencies should comply with [the cost-benefit analysis] provisions as well.").

148 In addition to judicial review, SEC rules that have been in place for 60 days or less are also subject to congressional review. *See* Administrative Procedure Act, 5 U.S.C. § 801 (2012). In February 2017, Congress used this rule to prevent the SEC's Conflict Minerals Rule from coming into effect. *See* Pub. L. No. 115-4 (2017).

149 The rules considered here are "legislative rules," through which the agency "intends to create a new law, rights or duties." Gen. Motors Corp. v. Ruckelshaus, 742 F.2d 1561, 1565 (D.C. Cir. 1984) (en banc). Legislative rules are those issued through the notice-and-comment process, as opposed to "interpretative rules." *See* Administrative Procedure Act, 5 U.S.C. § 553(b) (2012).

150 Administrative Procedure Act, 5 U.S.C. § 552 (2018).

151 *Id.* § 553.

152 *See id.* § 704 ("[F]inal agency action for which there is no other adequate remedy in a court are subject to judicial review."). As an independent agency, the SEC is not exempt from judicial review as executive agencies would be. *See* Paperwork Reduction Act, 44 U.S.C. § 3502(2) (2012). For a discussion of the implications of the differing application of judicial review to federal agencies, see Robert P. Bartlett, *The Institutional Framework for Cost-Benefit Analysis in Financial Regulation: A Tale of Four Paradigms?*, 43 J. LEGAL STUD. S379, S381 (2014).

153 Administrative Procedure Act, 5 U.S.C. § 706(2)(C) (2018) (agency action is unlawful if "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right"). *Cf.* Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837 (1983) (with differing results).

154 Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (2018). *See also Chevron*, 467 U.S. at 844 ("such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute") (footnote omitted); Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1982) (explaining that "arbitrary and capricious" includes

SEC rules can seek review in the D.C. Circuit,[155] which has become a "de facto, quasi-specialized administrative law court of last resort."[156]

The D.C. Circuit has generally not looked favorably on SEC regulations.[157] From 1990 to 2011, the D.C. Circuit reviewed seven SEC rules, and invalidated or remanded each one.[158] Most of these rules were found not to be authorized by statute.[159] However, in the three cases where the rule was authorized, the D.C. Circuit reviewed the SEC's rule making record. These cases have a particular bearing on cost-benefit analysis by the SEC.[160]

In each case, the D.C. Circuit found that the SEC regulation failed the "arbitrary or capricious" test because the SEC improperly or insufficiently considered "whether the action will promote efficiency, competition, and capital formation" as required by the SEC's authorizing statutes.[161] In *Business Roundtable*

situations where "the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise").

[155] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78y(b)(1) (2012). For rules authorized by other parts of the Exchange Act, U.S. district courts have jurisdiction. *See* 28 U.S.C. § 1331.

[156] CHRISTOPHER P. BANKS, JUDICIAL POLITICS IN THE D.C. CIRCUIT COURT xiii (1999) (explaining that the Supreme Court rarely grants certiorari for review of D.C. Circuit decisions reviewing agency rule making).

[157] Richard L. Revesz, *Cost-Benefit Analysis and the Structure of the Administrative State: The Case of Financial Services Regulation*, 34 YALE J. REG. 19 (forthcoming 2017) ("Since the early 1990s, the D.C. Circuit has treated SEC regulations with skepticism, particularly in connection with the Commission's cost-benefit analyses.").

[158] *See Bus. Roundtable II*; Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2009) (finding the SEC's consideration of the effect of a rule excluding fixed-indexed annuities from the Securities Act was arbitrary and capricious); Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007) (finding the Investment Advisers Act unambiguous in not authorizing rules exempting broker-dealers from the Act); U.S. Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006) [hereinafter *Chamber of Commerce II*] (finding that the SEC had failed to follow the notice-and-comment procedure with respect to information on which it substantially relied); *Chamber of Commerce I*; Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) [hereinafter *Bus. Roundtable I*] (finding that the Securities Exchange Act did not authorize the SEC to bar self-regulatory organizations from listing dual-class stock). *See also* Leen Al-Alami, *Business Roundtable v. SEC: Rising Judicial Mistrust and the Onset of a New Era in Judicial Review of Securities Regulation Comment*, 15 U. PA. J. BUS. L. 541 (2013) (summarizing these cases).

[159] *Fin. Planning Ass'n*, 482 F.3d 481; Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006); Teicher v. SEC, 177 F.3d 1016 (D.C. Cir. 1999); *Bus. Roundtable I*. In *Chamber of Commerce II*, 443 F.3d 890, the SEC rule was found to be authorized but was invalidated because the SEC.

[160] *Bus. Roundtable II*; *Am. Equity*, 613 F.3d 166; *Chamber of Commerce II*, 443 F.3d 890. In two further cases during this period, the D.C. Circuit remanded SEC orders on the grounds that they were not adequately supported by the SEC's analysis. *See* NetCoalition v. SEC, 615 F.3d 525 (D.C. Cir. 2010) (remanding an SEC order approving a fee charged by an exchange for its depth-of-order book, on the grounds that the SEC did not explain or support its conclusion); Timpinaro v. SEC, 2 F.3d 453 (D.C. Cir. 1993) (remanding an SEC rule prohibiting professional traders from making automated trades on the grounds that the SEC had not adequately substantiated that the costs of the order outweighed the benefits).

[161] Securities Exchange Act of 1934, 15 U.S.C. § 78c(f) (2012). These provisions were inserted by the National Securities Markets Improvement Act of 1996, 110 Stat. 3416 (codified in scattered

II, the high-water mark of the D.C. Circuit's interpretation of these requirements, the court found that the SEC's failure to "determine the likely economic consequences of [the SEC's proposed proxy access rule] and to connect those consequences to efficiency, competition, and capital formation" made the rule arbitrary and capricious.[162] The court effectively faulted the SEC's cost-benefit analysis as insufficient, concluding that the SEC had:

> inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.[163]

The D.C. Circuit's subsequent decision in *National Association of Manufacturers*[164] was more favorable to the SEC, with the court refusing to invalidate SEC rules implementing Dodd-Frank's mandate of conflict mineral disclosure on the grounds that they were arbitrary or capricious.[165] However, the decision did not ameliorate the implicit requirements contained in *Business Roundtable II* for the SEC to undertake rigorous conduct cost-benefit analysis.[166]

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sections of 15 U.S.C.), although Section 23(a)(2) of the Securities Exchange Act also requires the SEC to consider the impact that the regulation would have on competition. *See* Securities Exchange Act, 15 U.S.C. § 78w.

162 *Bus. Roundtable II* at 1148.

163 *Id.* at 1149–50. In addition, the court found that the application of the rule to investment companies was also arbitrary. *See id.* at 1150. Because of these conclusions, the court did not address the plaintiffs' argument that the rule arbitrarily rejected proposed alternatives "that would have allowed shareholders of each company to decide for that company whether to adopt a mechanism for shareholders' nominees to get access to proxy materials." *Id.*

164 748 F.3d 359 (D.C. Cir. 2014).

165 *See id.* at 369. The court did invalidate part of the rules on First Amendment grounds. *See id.* at 373.

166 The decision noted that the SEC "exhaustively analyzed the final rule's costs." *Id.* at 369. The court therefore did not have reason to consider whether the requirements for cost-benefit analysis in *Business Roundtable II* were appropriate. The decision also noted that, because of the requirements of the statute, the SEC "*had* to promulgate a disclosure rule" and was entitled to rely on Congress's conclusions regarding the benefits of the rule. *Id.* at 370.

An alternative explanation for the decision may be the change in the political composition of court. Through 2011, a majority of the D.C. Circuit judges had been appointed by Republican presidents, with Judge Douglas Ginsburg, who was appointed by President Reagan, authoring many of the important decisions invalidating SEC rules. However, in 2011, President Obama appointed a number of judges to fill the seats of Judge Ginsburg and others who had taken senior status, leading to a shift to a majority of Democrat-appointed judges. The *National Association of Manufacturers* panel also contained a majority of Democrat-appointed judges.

The *Business Roundtable II* decision has been roundly criticized[167] and has ignited a voluminous debate regarding the costs and benefits of cost-benefit analysis for financial and corporate regulation in particular.[168] The next section briefly surveys this debate and draws conclusions for investor ordering in corporate regulation.

2. The Debate About Cost-Benefit Analysis of Financial Regulation

The debate about cost-benefit analysis of financial regulation is a chapter in an older and more general debate about the value of cost-benefit analysis.[169] Proponents of cost-benefit analysis argue that it is necessary to determine the social welfare effects of regulation, and that it creates greater transparency about the reasoning underlying rules, making regulators more accountable for their decisions and improving their performance.

With respect to financial regulation, critics have argued that quantitative cost-benefit analysis is not feasible—either not possible at all,[170] or so unreliable or costly that it fails its own cost-benefit criterion.[171] These arguments have been bolstered by case-studies demonstrating the shortcomings of past quantitative analyses.[172] Critics generally conclude that requirements for cost-benefit analysis should not extend beyond qualitative analyses.

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[167] *E.g.*, James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811, 1813 (2012); Jill E. Fisch, *The Long Road Back: Business Roundtable and the Future of SEC Rulemaking*, 36 SEATTLE U. L. REV. 695, 697–98 (2013); Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law and Economics of Business Roundtable v. SEC*, 38 J. CORP. L. 101, 102 (2012); Coates, *supra* note 36, at 917–19; Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEGAL STUD. S351, S370 (2014).

[168] Financial regulation also includes many other regulated entities, such as financial institutions, broker-dealers and other market participants. However, given that the cases on the subject related to corporate regulations requiring proxy access and disclosure of conflict minerals, much of the recent debate over cost-benefit analysis in financial regulation has related to corporate regulations.

[169] For a summary of this debate, see FRANK ACKERMAN & LISA HEINZERLING, PRICELESS: ON KNOWING THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING (2004).

[170] Gordon, *supra* note 167, at S352.

[171] Coates, *supra* note 36, at 999; John H. Cochrane, *Challenges for Cost-Benefit Analysis of Financial Regulation*, 43 J. LEGAL STUD. S63, S100 (2014).

[172] Howell E. Jackson & Paul Rothstein, The Analysis of Benefits in Consumer Protection Regulations (2015) (unpublished paper), https://www.law.ox.ac.uk/sites/files/oxlaw/jackson_and_rothstein_article-_december_2015.pdf (considering consumer finance rules); Jeff Schwartz & Alexandrea Nelson, *Cost-Benefit Analysis and the Conflict Minerals Rule*, 68 ADMIN. L. REV. (2016); Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1 (2006); Joshua T. White, *Quantified Cost-Benefit Analysis at the SEC*, 2 ADMIN. L. REV. ACCORD 53 (2016) (considering conflict minerals disclosure); White, *supra* note 140 (considering credit risk retention); *see also* Coates, *supra* note 36 (considering mutual fund reforms). Professor Coates also considered Sarbanes-Oxley, Basel III, the Volcker Rule, cross-border swaps, and mortgage reforms.

Defenders of cost-benefit analysis of corporate regulations counter that quantitative analysis is possible and valuable for financial regulations, even though its results include some uncertainty,[173] and that quantitative analysis of financial regulation is not so different from the application of cost-benefit analysis in other areas.[174] To the extent there have been shortcomings in recent analyses, defenders argue, these could be overcome by improving the capacity of the institutions undertaking cost-benefit analysis,[175] a process which is already underway.[176]

A further strand in the debate relates to whether or not judicial review of cost-benefit analysis is optimal.[177] Critics of judicial review claim that it gives agencies incentives to undertake cost-benefit analyses that are overly conservative and that camouflage uncertainties.[178] One solution would be to replace judicial review with review by the Office of Information and Regulatory Affairs (OIRA), part of the Office of Management and Budget.[179] However, OIRA review of SEC rule making faces practical difficulties,[180] and replacing courts as reviewing bodies may not be possible,[181] at least not without congressional action,[182] suggesting that OIRA review should instead complement judicial review.[183]

As it stands, the debate offers no clear conclusions about whether quantitative cost-benefit analysis of financial regulation is worthwhile, whether it is even possible, or how it could be improved. Policy makers have yet to follow the recommendations of those criticizing cost-benefit analysis, and have instead engrained cost-benefit analysis further into the regulatory process.

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173 *See, e.g.*, Eric A. Posner & E. Glen Weyl, *Benefit-Cost Paradigms in Financial Regulation*, 43 J. LEGAL STUD. S1, S16 (2014) (responding to the criticisms put forward by Professor Coates).

174 *See* Revesz, *supra* note 157, at 14 (comparing cost-benefit analysis by financial regulators to the Environmental Protection Agency); Cass R. Sunstein, *Financial Regulation and Cost-Benefit Analysis*, 124 YALE L. J. F. 263, 270 (2015) (arguing that shortcomings in cost-benefit analysis of financial regulation can be overcome by break-even analysis).

175 *See* Revesz, *supra* note 157, at 44.

176 *See* Kraus & Raso, *supra* note 140, at 325; Bruce R. Kraus, *Economists in the Room at the SEC*, 124 YALE L. J. F. 280, 296 (2015).

177 *See* Bartlett, *supra* note 152, at S400; Coates, *supra* note 36, at 912 (criticizing judicial review); Robert J. Jackson, Jr., *Comment: Cost-Benefit Analysis and the Courts*, 78 LAW & CONTEMP. PROBS. 55, 63 (2015) (suggesting limitations on judicial review); Posner & Weyl, *supra* note 173, at S30 (considering executive review in lieu of judicial review); Sunstein, *supra* note 174, at 267.

178 *See* Coates, *supra* note 36, at 902; Schwartz & Nelson, *supra* note 172, at 6.

179 *See* Bartlett, *supra* note 152, at S400; Ryan Bubb, *Comment: The OIRA Model for Institutionalizing CBA of Financial Regulation*, 78 LAW & CONTEMP. PROBS. 47, 51 (2015). For a discussion and history of OIRA, see Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260 (2006).

180 *See* Kraus & Raso, *supra* note 140, at 336 (arguing that OIRA would not be effective for overseeing independent agencies given their multi-member constitution). *But see* Revesz, *supra* note 157, at 40 (arguing that judicial review of independent agencies suffers from the same problem).

181 *See* Revesz, *supra* note 157, at 47.

182 *See* Jackson, *supra* note 177, at 63.

183 *See, e.g.*, Revesz, *supra* note 157, at 49 (arguing that courts should give greater deference to rule making that had been reviewed by OIRA).

3. *The Future of Cost-Benefit Analysis*

Indeed, recent judicial and congressional developments suggest that cost-benefit analysis will likely become more important. The U.S. Supreme Court's 2015 decision in *Michigan v. Environmental Protection Agency* will likely further enshrine the importance of cost-benefit analysis for SEC rules.[184] Justice Scalia's opinion reads the term "appropriate and necessary" as requiring analysis of the costs of an environmental protection regulation.[185] As Professor Revesz has pointed out, this term appears frequently in the SEC's organic statutes.[186] The Financial CHOICE Act bill approved by the House of Representatives includes stringent requirements for rule making by financial agencies, including requirements for quantitative cost-benefit analysis, and judicial and congressional review of regulatory actions.[187]

B. *The Implications of Cost-Benefit Analysis for Investor Ordering*

The first-order benefits of investor ordering described in Part II will almost certainly require that the SEC *consider* investor ordering for corporate regulations as part of its cost-benefit analysis, and may *require* investor ordering for corporate regulations.

The SEC is required to consider reasonable alternatives to its proposed regulation.[188] That investor ordering will, in most cases, result in the same or greater aggregate net benefit as a mandatory rule suggests that it represents a reasonable alternative.[189] In addition, the SEC is also obligated to consider investor protection, and the effects of the rules on efficiency, competition, and capital formation,[190] which the D.C. Circuit has interpreted to include the cost of regulations. As discussed in Part II.B, investor ordering is likely to reduce the cost of regulations, and thereby affect efficiency, competition, and capital formation. The SEC will therefore be required to consider investor ordering as an alternative to a mandatory rule, and failure to do so is likely to provide grounds for invalidating the regulation as arbitrary and capricious.

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184 135 U.S. 2699 (2015).

185 *See id.* at 2711.

186 Revesz, *supra* note 157, at 4.

187 Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 312 (2017). Many of these provisions were derived from previously bills, including Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (2011); SEC Regulatory Accountability Act of 2011, H.R. 2308 112th Cong. (2011); and Independent Agency Regulatory Analysis Act of 2012, S. 3468 112th Cong. (2012). Although these bills have not yet been enacted, they demonstrate the legislative aspirations of a powerful group of law makers.

188 *See, e.g.*, *Chamber of Commerce I* ("The disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it.") (quoting Laclede Gas Co. v. FERC, 873 F.2d 1494, 1498 (D.C. Cir. 1989). *See also* Fisch, *supra* note 167, at 717.

189 Investor ordering could also be raised as an alternative in comment letters responding to the proposal, strengthening the obligation for the SEC to consider it. *See Laclede Gas Co.*, 873 F.2d at 1498 (requiring FERC to consider reasonable alternatives suggested in comment letters).

190 *See Bus. Roundtable II* at 1148.

Given the investor value case for investor ordering, investor ordering will produce greater aggregate net benefits than a mandatory rule for rules that do not involve significant potential externalities that institutional investors would not internalize, and for corporations where institutional investors exercise power over the choice of arrangements. If the SEC's economic analysis does not demonstrate substantial evidence that these limitations apply, then investor ordering is likely to result in greater aggregate net benefits than a mandatory rule. Implementing a mandatory rule where it would be inferior to a reasonable alternative is therefore likely to be arbitrary and capricious, rendering the regulation susceptible to invalidation by the D.C. Circuit.[191]

This discussion suggests that the burden of the SEC's cost-benefit analysis should shift to concluding whether there are clear reasons why investor ordering would *not* produce greater aggregate net benefits than a mandatory regulation. In the absence of such a finding, the SEC should implement its regulations using investor ordering.

C. The Advantage of Investor Ordering for Cost-Benefit Analysis

The major second-order benefit of investor ordering is that it significantly reduces the substantial cost of cost-benefit analysis and, consequently, the cost of making regulations, or amending or repealing them.

1. The Cost of Cost-Benefit Analysis

The effect of requiring cost-benefit analysis has been to substantially increase the cost of the SEC's rule making process.[192] The decision in *Business Roundtable II* and the threat of judicial review invalidating future rules have caused the SEC to increase the resources it devotes to cost-benefit analysis. If the requirements for cost-benefit analysis become more stringent these costs may increase further.

Even prior to the *Business Roundtable II* decision, the SEC devoted substantial resources to cost-benefit analysis. The SEC estimated that preparation and analysis of the proxy access rule that was the subject of the *Business Roundtable II* litigation required at least 22,000 staff hours over two years, at an approximate cost of $2.2 million.[193] By comparison, the entire 2010 budget of the SEC Division of Risk,

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191 Note that the Financial CHOICE Act would generally prohibit rule making if the SEC concluded that the quantified costs are greater than the quantified benefits. *See* H.R. 10, 115th Cong. § 312(b)(4)(A) (2017).

192 Donna M. Nagy, *The Costs of Mandatory Cost-Benefit Analysis in SEC Rulemaking*, 57 ARIZ. L. REV. 129, 149 (2015) (describing the different types of costs of cost-benefit analysis); *see also* White, *supra* note 140, at 309 (quantifying the costs of the SEC's economics division).

193 Letter from Mary L. Schapiro, Chairman, SEC, to Scott Garrett, Representative, U.S. House of Representatives (Aug. 5, 2011), http://www.law.du.edu/documents/corporate-governance/sec-and-governance/SEC-letter%208-5-11.pdf; *see also* Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward a Framework of Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983, 1988 (2013); Rachel A. Benedict, *Judicial Review of SEC Rules: Managing the Costs of Cost-Benefit Analysis Note*, 97 MINN. L. REV. 278, 278 (2012); Anthony W. Mongone, *Business Roundtable: A New Level*

Strategy and Financial Innovation, which was then responsible for economic analysis, was $20 million.[194]

Since the *Business Roundtable II* decision, the costs of cost-benefit analysis have increased substantially. Following the decision, the SEC undertook a comprehensive review of its economic analyses.[195] The result was a memorandum setting out new guidelines for SEC economic analysis.[196] The memorandum adopted many of OIRA's approaches to cost-benefit analysis.[197] To increase its capacity to undertake the more rigorous economic analysis described in the memorandum, the SEC undertook substantial internal reorganization and an expansion of the department responsible for these analyses.[198] The Division of Risk, Strategy, and Financial Innovation was reconstituted as the Department of Economic and Risk Analysis (DERA). DERA has since hired a substantial number of economists,[199] and SEC budget requests for DERA have grown significantly more than any other SEC department.[200] The increased resources devoted to economic analysis can be expected to have increased the detail that has gone into SEC proposed rules and regulations.

The costs of SEC rule making include not just direct costs, but the expected costs of future litigation. To the extent that *Business Roundtable II* has increased the likelihood of challenges to rule making, the expected cost of litigation has also risen.

These costs present a substantial impediment to rule making. SEC rule changes can be considered as a tradeoff between increasing investor protection and increasing the ease of capital formation. Higher costs for rule changes mean that the SEC can do less of either for the same cost. The SEC can make either fewer rule changes for the same cost, or the same number of rule changes for greater cost. If the SEC's budget remains fixed, or grows less than commensurate to the costs of rule making, this will reduce the SEC's ability to undertake rule making. While this may be seen as a benefit by those who believe SEC regulations to be undesirable, it will also limit the SEC's ability to deregulate. Investor ordering provides a solution to these problems.

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of Judicial Scrutiny and Its Implications in a Post-Dodd-Frank World Note, 2012 COLUM. BUS. L. REV. 746, 794 (2012); Nagy, *supra* note 192, at 131.

194 SEC, IN BRIEF: FY 2012 CONGRESSIONAL JUSTIFICATION (2011). Of course, a substantial proportion of the costs involved in the preparation of the proxy access release derived from other SEC departments, including the Division of Corporate Finance and the Office of the General Counsel.

195 This was prompted in part by a review by the SEC's Office of the Inspector General. SEC OFFICE OF INSPECTOR GEN., *supra* note 141.

196 SEC, CURRENT GUIDANCE ON ECONOMIC ANALYSIS IN SEC RULEMAKING (2012).

197 Circular A-4, Regulatory Analysis, 68 Fed. Reg. 58,366 (Oct. 9, 2003).

198 Kraus & Raso, *supra* note 140, at 326; White, *supra* note 140, at 307.

199 Kraus & Raso, *supra* note 140, at 326; White, *supra* note 140, at 307.

200 White, *supra* note 140, at 309.

2. Investor Ordering and Cost-Benefit Analysis

As illustrated in Part II, in most conditions, investor ordered rules will provide greater aggregate net benefit because they cap the cost of a regulation for particular corporations at the cost of switching arrangements. The maximum aggregate cost of the regulation can be calculated as the sum of the switching costs for those corporations where investors are likely to switch arrangements. This means that cost-benefit analysis of investor ordered regulations is considerably simpler than that of mandatory regulations. Rather than estimating the exact cost to corporations of the regulation, the SEC can instead calculate the maximum cost to corporations of opting-out of the regulation.

Under the system of investor ordering described in Part II.A, the main switching cost for a new corporate regulation will be the cost of putting forward switching proposals for approval at annual meetings and of shareholders deciding whether to approve those proposals. The costs associated with shareholder voting on proposals at annual meetings are familiar to the SEC from its long experience with proxy rules and the hundreds of thousands of annual meetings that have been conducted subject to those rules.

This process, and therefore the cost of switching associated with it, is unlikely to vary significantly across corporations or across different corporate regulations. This means that the analysis of opt-out costs could essentially be replicated and refined from regulation to regulation. Once corporations had considered switching from the initial investor ordered regulation, the costs of such switching would be a strong estimator of the cost of switching from subsequent investor ordered regulations. As further investor ordered regulations were implemented, the cost of switching could be established with considerable accuracy. That is, the marginal cost to the SEC of establishing the cost of successive regulations would approach zero as the number of investor ordered regulations increased. Over time, cost-benefit analysis of investor ordered regulations would evolve into a consideration of the benefits of the regulation.[201]

Simplifying the SEC's analysis of the costs of a regulation significantly reduces the greatest burden on the SEC in cost-benefit analysis and one of the major vectors of attacks against SEC regulations. The costs of a regulation are generally more identifiable than benefits likely to result from the regulation. The RFA and the PRA include explicit requirements that the SEC consider the costs of regulations.[202] The SEC therefore undertakes exhaustive consideration of the potential costs of a

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[201] The effect of this approach would be particularly pronounced for negative aggregate net benefit arrangements. If investor ordered, such arrangements would be of positive net aggregate benefit even if they only benefit a small number of corporations. For these rules, the SEC would only need to show that the rule is likely to be substantially beneficial for investors in a small number of corporations.

[202] Administrative Procedure Act, 5 U.S.C. §§ 603–604 (2012); Paperwork Reduction Act, 44 U.S.C. §§ 3506-3507.

regulation, which comprise a significant proportion of the cost-benefit analyses undertaken by the SEC.[203]

No matter how comprehensive the SEC's analysis of costs, there will always be some potential costs that the SEC fails to include. Plaintiffs wishing to challenge SEC rules bear the burden of showing that the SEC has failed to consider certain factors. It may often be easier for plaintiffs to identify additional costs that the SEC has not considered than to suggest that the SEC has overstated the benefits of a regulation. This is compounded by the fact that plaintiffs seeking to challenge SEC regulations have generally represented corporate interests, which—given their constituency—have informational advantages in identifying the costs to corporations from the regulation. The plaintiffs in *Business Roundtable II* and *National Association of Manufacturers* focused on the SEC's failure to fully estimate the potential costs of corporate regulations.[204] The SEC's focus on an exhaustive discussion of costs has been in part an attempt to forestall future attacks on such grounds. However, given the impossibility of identifying all such costs, a court could still find this incomplete. In these circumstances, limiting the set of factors involved in establishing the costs of the regulation is especially valuable.

Investor ordered regulations also provide a simpler framework for establishing the benefits of a regulation. Rather than "guesstimating" the potential benefits of the rule,[205] the SEC can determine whether investors are likely to switch from the default arrangement. That investors do not expect to switch is evidence that the default arrangement is likely to be of aggregate net benefit to investors. Given the realities of institutional investor ownership, whether corporations switch will be determined by a relatively small number of institutional investors.[206] It would be inexpensive for the SEC to determine the beliefs of these investors regarding the effects of the regulation on their portfolio companies. The SEC is already required to solicit the views of market participants as part of the notice-and-comment process, and many of these investors, or their representative organizations, submit comments in response to proposed regulations.[207] Alternatively, the SEC could take a more proactive approach, surveying whether institutional investors favor the

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[203] For instance, in the SEC's final Conflict Minerals Rule, the SEC's economic analysis of the potential benefits of the rule comprised of 836 words, while its discussions of the costs comprised 3,653 words. This is in addition to 6,643 words discussing comments related to costs of the rule, compared to 1,048 words discussing comments relating to benefits of the rule. *See* Conflict Minerals, 77 Fed. Reg. 56,274 (Sept. 12, 2012).

[204] *See* Nat'l Ass'n of Mfrs. v. SEC, 748 F.3d 359, 369 (D.C. Cir. 2014); *Bus. Roundtable II* at 1149.

[205] *See* Coates, *supra* note 36, at 887.

[206] *See supra* Part I.C.

[207] For instance, on the SEC's 2016 Universal Proxy proposal the SEC received comment letters from the Investment Company Institute, representing investment managers, and the Council of Institutional Investors, representing asset owners. Comments were also received from groups generally representing corporate managers, including the U.S. Chamber of Commerce, the Business Roundtable, the Society for Corporate Governance, and the National Association of Corporate Directors. *See Comments on Proposed Rule: Universal Proxies*, SEC (Feb. 13, 2018), https://www.sec.gov/comments/s7-24-16/s72416.htm.

arrangement for particular types of portfolio companies.[208] While switching decisions will necessarily differ for each corporate regulation, the framework for establishing investors' views about the net benefits of an arrangement and their likely switching behavior could be substantially reused from regulation to regulation, reducing the cost of establishing the benefits of regulations.

Lower-cost cost-benefit analysis would have significant implications for SEC rule making. The SEC could implement the same number of regulations at a lower cost. Alternatively, working within a fixed budget, the SEC could implement more regulations. This analysis also allows an end-run around the debate over cost-benefit analysis of financial regulations. Implementing investor ordered rules makes the stakes of that debate significantly lower without limiting the scope of cost-benefit analysis.

IV. The Retrospective Analysis Case for Investor Ordering

The growth in emphasis on cost-benefit analysis of financial regulation has been accompanied by a focus on retrospective analysis of regulations. Retrospective analysis involves cost-benefit analysis of existing regulations. Where regulations are found to be sub-optimal, retrospective analysis provides a basis for their improvement, or—if they are not fixable—for their repeal. Executive Order 13,579 recommends greater retrospective review of SEC rule making.[209] Retrospective analysis has been strongly advocated by certain commentators.[210] As a result, the SEC has undertaken retrospective analyses of many of its regulations. The draft Financial CHOICE Act would mandate detailed retrospective analysis of new and existing SEC regulations.[211]

Compared to mandatory regulations, investor ordering has four significant benefits for retrospective analysis. As discussed in section A, the modification or repeal of regulations is less necessary for investor ordered regulations, because most corporations will opt out of value-decreasing arrangements. As section B describes, whether corporations have switched arrangements provides an automatic and timely measure of the value of the arrangement. Section C explains that, to the extent it remains necessary, retrospective analysis is much easier and less costly for investor ordered regulations because investor ordering permits observation of variations in outcomes of different arrangements. Finally, section D

208 Some of these institutions may not respond to a survey if the SEC makes their responses public, as has been the SEC's practice for written comments it receives regarding proposed rule makings. *See* Fisch, *supra* note 167, at 717. The SEC may therefore receive better information if it conducts its survey prior to the notice period, or if the survey is conducted by a third party that is not required to disclose the identity of the participants. Alternatively, views could be solicited as part of in-person interviews.

209 Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 11, 2011).

210 *See, e.g.*, Cass R. Sunstein, *The Regulatory Lookback*, 94 B.U. L. Rev. 579, 589–91 (2014).

211 *See* Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 315–316 (2017) (requiring a regulatory impact analysis within five years of each new rule making regulation, and retrospective review of regulations every five years).

describes how the low cost and ease of evaluation of investor ordered regulations facilitate effective regulatory experimentation.

A. The Reduced Need to Modify Investor Ordered Regulations

Retrospective analysis and modification of mandatory arrangements are necessary because they are, by their nature, invariant. The regulator's choice of arrangements may have been sub-optimal at the time it was made, or may have become so because of changes in circumstances. In extreme cases, mandatory regulations could have negative net aggregate benefits. In a system of mandatory rules, the only remedy is regulatory action to amend or repeal the regulation, which requires retrospective analysis to identify, and new cost-benefit analysis to implement.[212] Mandatory rules therefore require continuous manual reevaluation and readjustment.

Given the costs of cost-benefit analysis and regulatory change, this ongoing retrospective evaluation and adjustment is costly, possibly even more so than for initial regulations. Many parties will have made investment and other decisions predicated on the existing regulation, and will therefore prefer to maintain the status quo. Any readjustment by the regulator will require balancing the effects on different parties, and managing their lobbying behavior regarding the regulation. Given the SEC's resource constraints, retrospective analysis and adjustment cannot be carried out as frequently as would be necessary to adapt regulations to continually changing circumstances, so mandatory regulations will always lag behind what is optimal. Mandatory rules also lead to regulatory "cruft,"[213] detritus in the corpus of regulations, as outdated and sub-optimal regulations continue in effect and accumulate over time.

In contrast, investor ordered rules are dynamic in their application. Investor ordered regulations that have negative net aggregate benefits are substantially self-repealing. If investors in a particular corporation believe a default arrangement to be costly, either when it is implemented or as the corporation's circumstances change, then the corporation can switch to an alternative arrangement. Even if the regulator eventually adjusts the default arrangement so it no longer applies to those corporations, investor ordering would save the cost that would have been incurred by those corporations during the lag until the regulation is adjusted. This obviates the most pressing need for retrospective analysis of the rule at no additional cost to the regulator: there is no longer an urgent need to identify and remedy costly regulations because corporations and investors will themselves avoid most of the costs of those regulations.

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[212] *See* Administrative Procedure Act, 5 U.S.C. § 551(5) (2012).

[213] "Cruft" is computer jargon meaning "[e]xcess; superfluous junk; use esp. of redundant or superseded code." DAVID LETZLER, THE CRUFT OF FICTION: MEGA-NOVELS AND THE SCIENCE OF PAYING ATTENTION 5 (2017) (citing ERIC S. RAYMOND, THE NEW HACKER'S DICTIONARY 135 (3d ed. 1996)).

B. Automatic and Observable Assessment of Investor Ordered Regulations

The proportion of corporations that continue to be bound by an arrangement (those that have not switched from the default arrangement), provides an automatic, observable, timely, and incontrovertible metric for the value of the regulation. In contrast, for mandatory regulations, the value of the regulation is not apparent without retrospective analysis, which is costly, infrequent, and contestable.

The observability of the proportion-bound metric has the effect of legitimizing arrangements that continue to apply to large numbers of corporations and raising doubts about the value of those arrangements that do not. Mandatory regulations are routinely criticized for imposing costs on corporations. Evaluating the validity of these criticisms often requires detailed analysis, if it is possible at all. Where investor ordered arrangements continue to be widely in force, they are inoculated against such criticism. Conversely, where a large number of corporations have opted out of a default arrangement, that arrangement will be rapidly and rightfully called into question, providing a signal to the regulator that the arrangement should be reevaluated and revised.

Of course, the usefulness of the proportion-bound metric assumes corporations correctly choose whether to switch arrangements. The metric does not indicate whether investors benefit from the arrangement, but only whether investors *expect* to benefit from the arrangement. However, since investors can update their views on the appropriate arrangement and choose a new arrangement if their previous choice proves incorrect, investor expectations are likely to approach the actual effect of the regulation over time. As described in Part II.C.6, this process will be accelerated by investors observing the switching decisions of other corporations and the consequences of those decisions.

Investor ordering will not eliminate the usefulness of retrospective analysis entirely. Some degree of retrospective analysis will continue to be warranted for investor ordered rules because investors may not always choose optimal arrangements, and because the extent to which they have or have not done so may not be obvious. The non-zero cost of switching means that there is always a possibility that some corporations for which an arrangement is costly will choose not to switch because switching is costlier than the arrangement itself. Switching may be under-initiated if investor ordered rules are not designed with optimal default arrangements. Switching arrangements also takes time, and corporations for which an arrangement is costly will continue to incur costs until they switch arrangements. As a result, some degree of retrospective analysis and adjustment will continue to be necessary for investor ordered regulation. However, investor ordering will make such retrospective analysis less costly and more accurate than retrospective analysis of mandatory regulations.

C. Improved Retrospective Analysis Given Investor Ordering

Information produced by investor ordered regulations makes their retrospective evaluation considerably easier and less costly than that of mandatory regulations, which create no such information. As well as permitting the observation of the aggregate proportion of corporations that prefer to switch arrangements, investor ordered regulations create variation in arrangements, and the differing outcomes for different arrangements provide insight into the effects of the arrangements.

If some corporations have switched arrangements,[214] the different performance outcomes of those corporations and those with the default arrangement can be observed. Where corporations switched arrangements sometime after the rule came into effect, the different effects of the old arrangement and the new arrangement on those corporations can also be observed.[215]

The endogeneity of corporate switching decisions means that determining the effects of arrangements will be difficult, but it may not be impossible. Decisions of corporations to switch arrangements will be related to factors affecting those particular corporations. It will be difficult to parse whether the difference in outcomes for corporations that have switched arrangements is due to the arrangement or to the underlying factors that caused the corporation to switch arrangements (or not switch arrangements). However, there may be exogenous differences in arrangements caused by factors unrelated to the nature of the corporation that can be exploited to identify the effects of the arrangement.

The switching decisions of individual corporations also provide useful information to regulators undertaking retrospective analysis.[216] The reasons that managers give for initiating switches will be publicly available, as will be the reasons proxy advisors give for recommending for or against approval. These can be evaluated by the SEC as part of its retrospective analysis. Where arrangements are not binary, regulators can also observe which alternative arrangement switching corporations chose to adopt.[217] The prevalence of each type of arrangement, and the determinants of the choice of arrangement, will be useful to the regulator in evaluating alternatives to the regulation.

In contrast to investor ordering, retrospective analysis of mandatory rules is difficult. Mandatory rules generate very little information. Under a mandatory rule there is no cross-sectional variation in arrangements among corporations, and almost no variation over time. The only variation produced by a mandatory rule

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[214] This would not apply if either no corporations or all corporations have opted out of the rule. However, the latter possibility is theoretical at best, given the unlikelihood that the SEC would adopt a rule that would have negative aggregate benefit for investors in *all* corporations.

[215] This would not apply where corporations switched to alternative arrangements from the time the regulation came into effect.

[216] See Part II.C.6 for a discussion of the information content of switching.

[217] The possibility of multiple alternative arrangements is discussed below. *See infra* Part V.A.7.

that can be used for retrospective analysis is variation upon the rule's implementation.[218] In the typical design of mandatory corporate regulations, all the corporations that will be bound by the rule become bound by the rule at the same time. This makes it very difficult to separate the effects of the regulation on corporations from the effects of unrelated changes over time. As a result, retrospective analysis is no easier than initial cost-benefit analysis: both involve comparing the current state of the capital markets to a hypothetical counterfactual. For prospective analysis, the counterfactual is the capital markets if the rule were to be implemented. For retrospective analysis, the counterfactual is the capital markets if the rule had not been implemented. Investor ordering, therefore, offers significant benefits in facilitating retrospective analysis to the extent that analysis remains necessary.

D. Lower-Cost Regulatory Experimentation

A number of scholars have suggested that regulators adopt experimental rules to assess the effects of a potential regulation before it is implemented across the board.[219] Investor ordering reduces the need for experimentation. To the extent that experimentation remains useful, investor ordered experiments would involve lower costs and would overcome many of the difficulties with mandatory experiments, albeit with some loss of fidelity for scholarship.

Proponents of regulatory experimentation have suggested that mandatory rules be modified to produce variation in the application of the rules that would make retrospective analysis more straightforward, and that small-scale experiments should be conducted to determine whether larger-scale regulation is warranted.[220] The Financial CHOICE Act would require the SEC to consider such regulatory experimentation.[221] For corporations, an experimental rule could mandate different arrangements for different corporations,[222] or different corporations could become subject to arrangements at different times.[223]

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[218] The possibility of regulation-mandated variation for experimental purposes is considered later. *See infra* Part IV.D.

[219] *E.g.*, Michael Abramowicz, Ian Ayres & Yair Listokin, *Randomizing Law*, 159 U. PA. L. REV. 929 (2011); Zachary J. Gubler, *Experimental Rules*, 55 B.C. L. REV. 129 (2014); Lee, *supra* note 97; Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation Symposium: Financial Regulatory Reform in the Wake of the Dodd-Frank Act*, 97 CORNELL L. REV. 1267 (2012).

[220] *See, e.g.*, Cox & Baucom, *supra* note 167, at 1842; Whitehead, *supra* note 219, at 1298–99.

[221] Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 312(a)(6) (2017) (requiring any SEC regulation that did not involve a pilot program to explain why a pilot program is not appropriate).

[222] For example, in 2005, the SEC relaxed Rule 10a-1 (the so-called "Uptick Rule") with respect to a proportion of Russell 3000 index constituent stocks. *See* Cox & Baucom, *supra* note 167, at 1843. Since May 2016, the SEC has also been conducting a pilot study of increased quoting and trading increments for small capitalization stocks. *See* Joint Industry Plans, Exchange Act Release No. 74,892, 111 SEC Docket 2239 (May 6, 2015).

[223] Delayed implementation for smaller corporations has been used for a number of regulations. *E.g.*, Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption From Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, Exchange Act Release No. 50,754, 84 SEC Docket 945 (Nov. 30, 2004) (delaying the implementation of reports on internal controls for

The proportion-bound metric that investor ordering produces provides a clear indicator for the effect of a regulation, reducing the need for experimental analysis to determine the effect of a regulation. A variation on investor ordering also provides a much less costly "pilot" process for new regulation. Rather than setting restrictive defaults that maximize manager initiation, regulators could set minimal defaults. While this would substantially reduce the likelihood of manager initiation, and therefore of switching, it would also reduce the potential cost of the regulation. However, if there is *any* switching—for instance, investor-initiated switching—this would create information about the rule at very low cost. That information could then be used to determine whether changing the rule to a more restrictive default would be worthwhile.

The validity of inferences of regulatory value from switching decisions depends on the critical assumption that investors make optimal switching decisions. To the extent that this is not believed to be true, experimental analysis may still be valuable. Experimental analysis may also inform investor decisions about which arrangement to choose.

To the extent experimentation is considered worthwhile, it could be implemented for investor ordering as well as for mandatory regulation by varying default arrangements. This would have advantages and disadvantages compared to experimentation with mandatory rules. On one hand, experimentation with mandatory rules would have epistemic advantages over experimentation with investor ordered rules, as corporations switching from the default would reintroduce endogeneity concerns, making it more difficult to isolate the effect of the arrangement.

On the other hand, experimental rules present significant problems for the SEC, which would be ameliorated by investor ordering. Mandating arrangements would only be useful if the SEC expected the arrangements to have some effect on outcomes for corporations. Mandating an arrangement for some corporations while prohibiting it for others would therefore advantage some corporations and their investors over others. The most valuable variation from an epistemic point of view would require treating similar corporations differently. However, by its very nature, such treatment would be arbitrary and capricious, and therefore susceptible to judicial invalidation.

Investor ordering would also have benefits in broadening the scope of potential experimentation. If the SEC expected an arrangement to have negative aggregate net benefits, mandating such an arrangement—even for experimental purposes—would likely have negative effects on all corporations subject to the arrangement. Undertaking such an experiment would be of limited value: if the SEC's expectations prove accurate, the SEC will not implement the rule. However,

small corporations); Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, Securities Act Release No. 8934, Exchange Act Release No. 58,028, 93 SEC Docket 1436 (July 2, 2008) (delaying internal control attestation for smaller corporations).

aggregate negative net benefit rules can be value-enhancing if investor ordered, and could be implemented at full-scale or on an experimental basis.

The choice of mandatory experimental rules over investor ordered experimental rules therefore involves a tradeoff between limiting endogeneity—and therefore producing clearer evidence of the effects of arrangements—against mandating sub-optimal arrangements for particular corporations based on random selection. Corporate law scholars—myself included—are predisposed to value the clear understanding of the effects of arrangements. However, for regulators, and for the corporations and investors affected by their regulations, such understanding is merely a tool for determining the optimal arrangements for corporations. The social value of such understanding is therefore less than the value of achieving its ultimate objective, and having corporations choose optimal arrangements themselves.

* * *

By offering the possibility of experimentation, automatic repeal of ineffective regulations, greater feedback about the effects of rules, and lower-cost experimentation, investor ordered rules could create a dynamic system for corporate rules. In this respect, they would offer many of the benefits praised by advocates of state competition,[224] which—advocates claim—creates a dynamic process that results in optimal arrangements for corporations.[225] By incorporating investor choice, investor ordered regulations would directly result in the maximization of investor value.

V. Implementing Investor Ordering

The discussion above demonstrates that investor ordering will have considerable benefits for most regulations, and may be required by law. This Part considers the practical matter of how investor ordering should be implemented in corporate regulation by the SEC, and offers concrete recommendations for which new regulations and existing regulations may be appropriate initial candidates for investor ordering. It then extends the implications of investor ordering to federal legislation and state corporate law. The recommendations offered below should not be thought of as complete, but rather as initial principles; they could evolve and

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[224] *See, e.g.*, Roberta Romano, The Genius of American Corporate Law (1993); Easterbrook & Fischel, *supra* note 52; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977).

[225] There has been considerable debate about whether state competition creates rules that are optimal for investors, or only for managers. *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L.J. 663 (1974). In contrast to state competition, investor ordering by the SEC would permit the benefits of greater dynamism while maintaining a central regulator to ensure that the process does not go awry.

improve iteratively as the SEC implements investor ordered regulations and observes their consequences.

A. Implementing Investor Ordering in Corporate Regulations

1. Investor Ordering as the Default for SEC Regulation

The discussion above makes clear that investor ordering of corporate regulations will be superior to mandatory rules, other than where there are significant potential externalities that are not internalized by institutional investors. Investor ordering should therefore be the SEC's default approach for new corporate regulations where there is a body of equity investors that can undertake investor ordering.[226] The SEC's rule making process should focus on determining whether there is a significant likelihood of externalities that institutional investors will not internalize or other factors that would outweigh the benefits of investor ordering. Only if that determination is satisfied should a rule be mandatory.

This approach provides a straightforward framework for judicial review of SEC rule making to determine whether the SEC's choice between mandatory rules or investor ordered rules was arbitrary and capricious. Such a framework would reduce the cost of judicial review of SEC rule making, both to the courts and for the SEC, and allow the SEC greater certainty regarding whether regulations would survive judicial review.

2. Designing Switching Requirements

The SEC's design of investor ordered regulations should incorporate the principles set out in Part II.A: either managers or investors could initiate switching, and switching should require the approval of a majority of votes cast by outside investors.

These principles mean that switching should not be conditioned on state law mechanisms, such as a change to the charter or the bylaws of a corporation. Those mechanisms have their own process rules established by state law, which cannot be easily adapted to these optimal specifications. For instance, charter amendments cannot be initiated by shareholders, and have majority requirements of all outstanding shares, rather than votes cast, or of outside shareholders. Bylaws can generally be amended by directors without investor approval.[227] In addition, explicit references to state law may sit uncomfortably in federal regulations.

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[226] The choice of the default approach to regulation can be understood as a meta-discussion, suggesting the altering rules for altering rules. *Cf.* Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2074–75 (2012).

[227] *See generally* Fisch, *supra* note 49. Directors can even amend bylaw provisions that have been included by a shareholder vote, as was the case in October 2014 when Bank of America directors removed a provision from the corporation's bylaws separating the roles of Chairman and Chief Executive Officer of the corporation. *See* Christina Rexrode & Dan Fitzpatrick, *Investors Chide Bank of America on Combining Chairman-CEO Roles*, WALL ST. J., (Oct. 30, 2014),

The SEC should therefore design its own bespoke switching arrangements, which could be incorporated into particular regulations. For example, a bespoke switching provision could be drafted as follows:

> Unless a resolution expressly electing not to be bound by this Rule has been approved by shareholders representing (a) a majority of the voting power of a registrant voting at the annual meeting of the registrant, and (b) a majority of such voting power excluding securities held by any director, officer, or person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security of the registrant, ...[228]

Most parsimoniously, the SEC could draft a standing rule that permitted switching, which could be incorporated by reference into corporate regulations. Such a rule would be well placed among other existing SEC proxy regulations that affect shareholder meetings.[229]

Bylaws and charters create a register of the choices of arrangements that corporations have made. Since the bespoke switching arrangement would not make use of bylaws or charters, it would require another method for maintaining such a register of the default arrangements a corporation had switched out of. Such a register could appropriately be located among the required corporate governance disclosure in the corporation's annual report on Form 10-K.[230]

The SEC could clarify by way of staff guidance what kind of resolution would be considered necessary for switching. Ideally, individual resolutions of corporations would not require particular language, and any resolution that is clearly intended to opt out of or opt into a regulation would be considered effective. While the question of whether particular resolutions satisfied this test would be justiciable, adjudication is unlikely to be necessary, as investors would not approve provisions that did not unambiguously opt out of the rule.[231]

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http://www.wsj.com/articles/some-investors-chafe-at-bank-of-america-combining-chairman-ceo-roles-1414698418.

[228] This language assumes the SEC implements manager restricting defaults. If the SEC did decide that less-manager-restricting (i.e., opt-in) rules were appropriate in particular circumstances, similar language would apply *mutatis mutandis*, with the first part of the provision replaced by "If a resolution expressly electing to be bound by this Rule has been approved . . . ."

[229] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78n (2012).

[230] *See* 17 C.F.R. § 249.310 (2017).

[231] By way of comparison, the charter language of Delaware corporations opting out of § 102(b)(7) has generally either tracked the statutory language or broadly eliminated liability (e.g., "to the fullest extent permissible by law"). *See* Blake Rohrbacher, *§ 4.13 Limitation of Liability*, *in* R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations (3d ed. 2017). Despite the extensiveness of his discussion of § 102(b)(7), Rohrbacher does not cite any cases where a Delaware court required particular wording for amendments purporting to opt out of § 102(b)(7).

These arrangements would also permit shareholders to initiate switching decisions by putting forward shareholder proposals for inclusion in the company proxy pursuant to Rule 14a-8.[232]

If switching decisions could be bundled into a single proposal with other arrangements, managers might abuse such bundling to influence investor voting on arrangements. For instance, consider a resolution that is favored by managers but which investors do not believe to be in their best interest. Managers could "bundle" the resolution with a "sweetener"—make it contingent on some benefit to investors. A sufficient sweetener might lead investors to support the bundle, even though they did not believe the resolution itself to be in their best interest.[233] The SEC has previously dealt with this concern by adopting anti-bundling rules into Rule 14a-4, which would also apply to proposals for switching arrangements.[234]

As illustrated in the example provision above, the rule could make use of existing regulatory concepts to cover insiders who are current managers or directors, and others who can influence control over the corporation.[235]

If the SEC wished, it could also permit investors to opt out of the requirement that investors approve switching. That is, if investors believed that the cost of approving switching exceeded the expected cost of value-decreasing switching that managers might prefer, investors could permit managers to make switching decisions without investor approval. This would effectively change investor ordering to manager ordering. Investors could also put in place alternative switching requirements that they believe to be optimal.

3. Switching Back

Investors should also have the possibility of switching back to the default arrangement—or switching to another arrangement—in the event that their initial switching decisions prove to be sub-optimal, or where circumstances change to make the substituted arrangement no longer optimal. Switching decisions should,

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[232] Under these arrangements, Rule 14a-8 proposals would not face the difficulties involved in submitting bylaw amendments through the Rule 14a-8 process. *See* Bebchuk & Hirst, *supra* note 79, at 341.

[233] *See, e.g.*, Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549, 1552 (2010) (discussing bundling of arrangements generally); Gordon, *supra* note 51, at 1577 (discussing "sweeteners").

[234] *See* 17 C.F.R. § 240.14a-4(a)(3) (requiring the form of proxy to "identify . . . each separate matter to be acted upon"); *id.* § 240.14a-4(b)(1) (requiring means to approve, disapprove or abstain with respect to "each separate matter"); *see also* Greenlight Capital, L.P. v. Apple, Inc., No. 13 CIV. 900 RJS, 2013 WL 646547 (S.D.N.Y. Feb. 22, 2013) (interpreting these provisions with respect to bundled charter amendments); Julian Ellis, *The "Common Practice" of Bundling: Fact or Fiction?*, 91 DENV. U. L. REV. ONLINE 105 (2014) (discussing the anti-bundling rule and its interpretation).

[235] Securities Exchange Act of 1934, 15 U.S.C. § 78p (2012), *implemented in* 17 C.F.R. §§ 240.16a-1–240.16a-13 (requiring disclosure of changes of beneficial ownership by directors, officers, and principal stockholders).

therefore, be reversible by the same process as applied to the initial switching.[236] This could be achieved by adding the following clause to the language proposed in the previous section:

> and such shareholders have not subsequently approved a resolution expressly reversing such prior resolution, . . .

Given that initial defaults will generally be manager-restricting, switching back to those arrangements would likely be initiated by managers less often than would be optimal. Under-initiation of switching back could be overcome by incorporating a sunset provision into initial switching decisions.[237] Initial switching decisions would lapse after a period of time—five years, for instance— and the corporation would once again be bound by the default arrangement, unless investors once again opted out of the rule.[238] This could be achieved by revising the language above from "have not subsequently approved a resolution" to "have not, *within the last five years*, approved a resolution." Where repeated sunset periods have passed, and corporations that switched arrangements have not decided to switch back, sunset provisions may impose net costs. The SEC could observe such a circumstance in its retrospective analysis of the rule, and could thereafter relax or remove the sunset requirement.

4. Approval of Pre-IPO Switching

Before corporations become public they are controlled by insiders, including founders, managers, and undiversified blockholders, such as venture capital funds and private equity funds.[239] If the value effects of corporate arrangements are accurately incorporated into the IPO price, insiders will have incentives to make optimal switching decisions. However, if this is not the case, insiders may not choose the arrangements that public investors would consider optimal.[240] There is therefore an argument that investor ordering should require arrangements to be approved by investors *after* the corporation becomes public, when the corporation has developed a mature public shareholder base that includes institutional

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[236] *Cf.* Bebchuk & Hirst, *supra* note 79, at 357 (proposing that shareholders have the ability to reverse earlier opt-out decisions regarding proxy access).

[237] *See id.* at 357 n.113 (proposing a sunset as an alternative for ensuring that shareholders continue to support opt-outs).

[238] This is comparable to the SEC's say-on-frequency rule, whereby every six years, investors must elect whether to require a say-on-pay vote on executive compensation at one-, two-, or three-year intervals. *See* Securities Exchange Act, 15 U.S.C. § 78n–1(a)(2).

[239] If such investors have a sufficiently large stake to influence control over the corporation they may also be considered insiders under the definition in Part I.B.

[240] Whether or not these investors have an incentive to choose optimal arrangements depends on whether the IPO market accurately incorporates the value of those arrangements into the IPO price. This has long been a source of considerable debate. *Cf.* Barzuza, *supra* note 23; Klausner, *supra* note 23 (discussing evidence that corporate arrangements chosen before IPOs do not reflect the preferences of public investors).

investors.[241] Whether or not insiders would choose the optimal arrangements, outside investors will choose arrangements that are optimal for ongoing investors in the corporation, and will internalize more of the effects of the arrangements on the capital markets. However, if insiders cannot irrevocably choose the arrangements that they prefer, they may avoid going public. This is a debate that that has been active for at least thirty years.[242] My proposal does not take a position on either side of this debate. Rather, the SEC should determine whether pre-IPO switching decisions with respect to particular arrangements should require post-IPO approval. In reality, because of the very small number of IPOs each year, the significance of pre-IPO switching is likely to be limited.[243]

5. Choosing Default Rules

As described in Part II.A.4, the optimality of investor ordering depends on the SEC choosing default rules that are most likely to cause managers to initiate switching. The optimal default will generally be the plausible arrangement most restrictive of, or least privately beneficial to, managers. It will often be clear from the SEC's economic analysis which plausible rule is most restrictive of managers or otherwise most likely to cause managers to initiate switching. This could be confirmed by considering the desires expressed with respect to particular arrangements by representatives of management during the notice-and-comment period.[244]

In limited circumstances the SEC may determine that another default may be preferable because it would be more likely to lead to the optimal set of corporations being bound by the arrangement. Negative aggregate net benefit rules and experimental rules may be better designed with the status quo arrangement as the default, even though this may be less likely to result in initiation of switching. However, the lower the costs of switching, the less frequent should be exceptions to the default of manager-initiation-maximizing defaults.

6. Reducing Switching Costs and Decision Costs

SEC regulations should be designed to reduce switching costs as much as possible. The lower the cost of switching arrangements, the greater the aggregate net benefit that will result from investor ordering. Switching by voting at annual

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[241] For a similar proposal with respect to dual-class share arrangements, see Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017).

[242] *See, e.g.*, Lucian A. Bebchuk, *Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law* (Harvard Law Sch. Program in Law and Econ., Discussion Paper No. 46, 1988).

[243] *See, e.g.*, Gao, Ritter & Zhu, *supra* note 90, at 1663 (observing an average of "99 IPOs per year during 2001-2012"). The small number of IPOs compares to more than at least 3,500 public corporations every year in that period. *See* Doidge, Karolyi, & Stulz, *supra* note 90, at 473 tbl.3.

[244] This would include letters submitted by managers of individual corporations, as well as letters submitted by trade groups that represent managers and corporations, like the Business Roundtable, the U.S. Chamber of Commerce, and corporate law firms that generally represent corporations. *See, e.g.*, *supra* note 207.

meetings is likely to require little marginal direct cost; adding an additional proposal to the agenda of an annual meeting will not add significantly to the costs of the meeting or to the costs of voting.

The main additional costs from investor ordering are likely to be the decision costs of managers and investors informing themselves about optimal arrangements. As discussed in Part II.C.6, to the extent that many different investors and corporations are generating this information themselves, this will be duplicative. The SEC can reduce information costs by undertaking the generalizable part of this analysis themselves in their economic analysis of the regulation, which becomes publicly available. The SEC can suggest the factors likely to determine the differing costs and benefits for different corporations.[245] All that would remain would be for managers and investors to determine the extent to which these costs and benefits applied to their corporations.

Proxy advisors further assist investors in reducing decision costs. By producing information that is useful to investors, and sharing the cost of that information among many investors, they prevent the costly duplication of information production by investors. The value of proxy advisors for investor ordering militates against restrictions on proxy advisors of the kind contained in the Financial CHOICE Act bill,[246] which would make their production of information more difficult or more costly.

7. Multiple Alternative Arrangements

So far investor ordering has been discussed as a binary choice between having an arrangement and not having the arrangement. In practice investors may prefer to have some but not all of the effects of the arrangement. Managers or investors who initiate switching are likely to propose alternative arrangements with such effects in order to induce investors to vote to switch arrangements.[247] Corporations can maintain some network externality benefits by fixing upon one of a small "menu" of arrangements.[248] The SEC can facilitate such a process by proposing a menu of alternative arrangements in its rule making. The SEC's economic analysis is required to consider alternatives,[249] and such a requirement may be further

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245 *See* Clark, *supra* note 53, at 1718 (suggesting that the SEC may have superior understanding of matters of general application to corporations).

246 Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 482 (2017) (creating onerous requirements for registration of proxy advisory firms and conditions for their activities).

247 Such bundling of arrangements might create distortions by permitting managers to add sweeteners. *See* Bebchuk & Kamar, *supra* note 233; Gordon, *supra* note 51, at 1577–78.

248 *Cf.* Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3 (2006); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. EMPIRICAL LEGAL STUD. 279 (2009).

249 *See* SEC, *supra* note 196, at 8 (stating that SEC releases should "identify and discuss reasonable potential alternatives to the approach in the proposed rule").

enshrined in law by the Financial CHOICE Act.[250] By fully articulating alternative arrangements, the SEC can provide focal point arrangements that corporations could fix upon, thereby increasing the value of network externalities from the rule.[251]

B. Potential Investor Ordered Regulation and Deregulation

1. Potential New Investor Ordered Regulations

This Article has focused on the proposition that investor ordering is superior to mandatory rules. However, the process of regulation and deregulation requires the SEC to answer a different question: would a new rule of either variety be superior to the existing rule? This section combines the two questions and considers potential subjects for new investor ordered regulations.

In considering initial subjects for investor ordering, the SEC should initially look for fire where there is smoke. That is, the SEC should consider topics whose costs and benefits have been the source of contention. There are a number of potential subjects for regulation that have been the subject of such contentious debate, particularly regarding the cost of potential regulation. Many of these potential regulations have strong support from investors, but there is uncertainty regarding the potential costs the regulation would create for corporations and their investors. Other arrangements have limited support from investors but strong support from other constituencies. Both categories would appear to be particularly good candidates for investor ordered regulation, which would let investors themselves determine whether the benefit of the regulation outweighed the costs. Promising examples among proposed or potential rules include proxy access,[252] universal proxies,[253] claw-backs, and disclosure of political spending by corporations.[254]

2. Potential Investor Ordered Deregulation

The benefits of investor ordering also apply to SEC rule changes to deregulate existing mandatory rules. Moving from mandatory regulations to investor ordered regulations will result in no additional costs to corporations affected by the

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250 *See* H.R. 10 § 312(a)(6) (requiring "an identification and assessment of all available alternatives to the regulation").

251 A similar point is made by Chief Justice Strine of the Delaware Supreme Court, and Vice Chancellor Laster of the Delaware Court of Chancery in arguing for a standard set of fiduciary defaults for alternative entities. *See* Leo E. Jr. Strine & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* ROBERT W. HILLMAN & MARK J. LOEWENSTEIN, RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS & ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11, 13 (2015).

252 Authors have called for investor ordered rules on proxy access. *See* Bebchuk & Hirst, *supra* note 79, at 356–58; McDonnell, *supra* note 79, at 71.

253 *See* Scott Hirst, *Universal Proxies*, 35 YALE J. REG. (forthcoming 2018) (calling for investor ordering of universal proxies).

254 *Cf.* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 947 (2013) (arguing for mandatory SEC regulation of corporate political spending disclosure).

regulations. Such moves will also have aggregate net benefits, if there are no potential externalities that would not be internalized by institutional investors. Of course, deregulation will also involve direct costs for the SEC, including the cost of cost-benefit analysis. The SEC must therefore determine whether the aggregate net benefit from moving from a mandatory rule to investor ordering will be greater than the direct cost of deregulation. This will depend on the extent to which investors will switch from the default arrangement and their net benefits from switching.

The extent of switching by corporations may be lower for investor ordered deregulation than for new investor ordered regulations, since switching costs will be higher. Given that a mandatory rule may have been in place for some time, corporations and investors are likely to have invested in systems predicated on the mandated arrangement. Replacing these with new systems will increase switching costs.

For the large body of SEC rules about which investors and managers have not expressed dissatisfaction—where there is no smoke—there is likely to be limited benefit to switching. Such limited benefit may be too small to overcome these switching costs and may not merit the direct costs of SEC deregulation. Rules that fall into this category are likely to include the requirement that corporations disclose annual, quarterly, and periodic reports;[255] and prohibitions on fraud, misleading and deceptive conduct,[256] and insider trading.[257]

However, a number of existing mandatory rules have attracted considerable criticism. Especially for the more recent of these rules, there may be sufficient cause to consider deregulation by investor ordering. Such rules include conflict minerals,[258] pay ratios,[259] disclosure of internal control requirements,[260] and say-on-pay.[261] Some long-standing regulations have also recently been attacked as

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[255] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78m (2012); *id.* § 78o(d); 17 C.F.R. §§ 240.13a-1– 240.13a-20, 240.15d-1–240.15d-20 (2017).

[256] *See* 17 C.F.R. § 240.10b-5 (2017).

[257] *See id.* §§ 240.10b5-1–240.10b5-2 (2017). There has been considerable discussion of the possibility of opting out of insider trading rules. *E.g.*, Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 324 (2002); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866 (1983); David D. Haddock & Jonathan R. Macey, *Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1451 (1986).

[258] *See* 17 C.F.R. § 240.13p-1 (2017). The rule is currently under reconsideration by the SEC. *See* Press Release, Michael S. Piwowar, Acting Chairman, SEC, Reconsideration of Conflict Minerals Rule Implementation (Jan. 31, 2017), https://www.sec.gov/news/statement/reconsideration-of-conflict-minerals-rule-implementation.html.

[259] *See* 17 C.F.R. § 229.402u (2017). The rule is currently under reconsideration by the SEC. *See* Press Release, Michael S. Piwowar, Acting Chairman, SEC, Reconsideration of Pay Ratio Rule Implementation (Feb. 6, 2017), https://www.sec.gov/news/statement/reconsideration-of-pay-ratio-rule-implementation.html.

[260] 17 C.F.R. § 240.13a-15 (2017).

[261] Securities Exchange Act of 1934, 15 U.S.C. § 78n–1 (2012). Notwithstanding recent criticism, for example Leo E. Strine, *Securing Our Nation's Economic Future: A Sensible, Nonpartisan Agenda to Increase Long-Term Investment and Job Creation in the United States*, Soc. Sci. Res. Network, (2015)

costly for corporations,[262] and could also be considered for deregulation through investor ordering. These include requirement for disclosure of beneficial interests[263] and requirements to include shareholder proposals in proxy statements.[264]

The SEC may also face external pressure—or a congressional requirement—to deregulate particular rules. Given such pressure or requirement, the above analysis makes clear that moving to investor ordered rules would have greater aggregate net benefit than moving to manager ordered rules. If the SEC chooses to deregulate a particular rule, or if Congress requires it to do so, then the same D.C. Circuit jurisprudence discussed in Part III.A is likely to require the SEC to consider investor ordering as an alternative. If the proposed deregulation is expected to result in less aggregate net benefit than an investor ordered alternative, it is likely to be considered arbitrary and capricious, and could therefore be invalidated.

C. Investor Ordering and Federal Legislation

A further implication of the greater aggregate net benefit of investor ordering regards the SEC's leeway to promulgate regulations. For many corporate regulations, legislative provisions leave little discretion for the SEC to design optimal rules. Legislation either incorporates rules directly[265] or requires the SEC to implement rules with certain effects.[266] Recent appropriations bills and the Financial CHOICE Act[267] go further in prohibiting the SEC from taking certain actions. Because Congress does not undertake any formal cost-benefit analysis regarding these requirements, they are likely to be less well considered than rules designed by the SEC with its comprehensive cost-benefit analysis.[268]

There would also appear to be some hypocrisy in a congressional requirement for the SEC to undertake greater cost-benefit analysis. Congress does not itself

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(calling for triennial or quadrennial say-on-pay votes), there appears to be broad investor support for annual say-on-pay votes, for example John Roe, *U.S. Proxy Season Half-Time Update*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 31, 2017), https://corpgov.law.harvard.edu/2017/05/31/u-s-proxy-season-half-time-update/ (showing 92% of votes through May 26, 2017 favored annual elections).

262 *See, e.g.*, BUS. ROUNDTABLE, *supra* note 45, at 6 (calling for revision of shareholder proposal rules); Emmerich, Mirvis, Robinson & Savitt, *supra* note 45, at 140 (calling for revision of blockholder disclosure).

263 *See* 17 C.F.R. §§ 240.13d-1–240.13d-2 (2017); *see also* Mitts, *supra* note 79, at 244 (arguing for private ordering of blockholder disclosure by shareholder bylaw amendments).

264 *See* 17 C.F.R. § 240.14a-8 (2017).

265 *See, e.g.*, Securities Exchange Act, 15 U.S.C. § 78n–1 (requiring advisory votes on executive compensation).

266 *See, e.g.*, *id.* § 78n–2 (requiring the SEC to issue rules requiring corporations to disclose why they have the same person or different persons acting as chairman and chief executive officer).

267 *See, e.g.*, Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 845 (2017) (prohibiting the SEC from requiring corporations and other proponents to use a single proxy card).

268 There is some irony in the Financial CHOICE Act requiring considerably greater cost-benefit analysis by the SEC, while failing to undertake any cost-benefit analysis on its own extensive requirements, including the requirement for cost-benefit analysis.

undertake *any* formal cost-benefit analysis, including any cost-benefit analysis of requiring SEC cost-benefit analysis. By requiring the SEC to implement certain regulations, Congress also reduces the permissible scope of the very cost-benefit analysis that congressional legislation requires of the SEC.[269]

These considerations mean that congressional mandates reduce the likelihood that the SEC can implement value-enhancing rules. In order to maximize investor value and social welfare, Congress should permit the SEC greater discretion to implement regulations and should not require or prohibit particular arrangements or regulatory designs.

D. Investor Ordering and State Corporate Law

While the focus of this Article is corporate regulations, the analysis of investor ordering also suggests a number of conclusions for state corporate law.[270] First, state corporate law rules—whether established by legislatures or courts—generally do not involve any formal cost-benefit analysis. This suggests that their design may not incorporate optimal switching rules or default arrangements. Second, while the majority of state law rules are privately ordered, a number are mandatory.[271] As the framework presented in this Article makes clear, these could be sub-optimal compared to investor ordered rules. Third, even though the majority of state corporate law rules are privately ordered, they do not fit the optimal switching arrangements for investor ordering set out above.[272] A number of state corporate laws can be varied in the bylaws of a corporation, which can often be amended by directors without shareholder action.[273] However, in most cases charter amendments are required to switch from default corporate law rules. While these require investor approval, they can only be initiated by the directors of the corporation.[274] Moreover, in controlled corporations there is no requirement that switches be approved by outside investors. In addition, where switching decisions are approved by investors, voting requirements for approval are generally some proportion of shares outstanding,[275] making it more likely that retail voters would be pivotal in votes to approve switching decisions made once a corporation is public. Finally, state law defaults are often less restrictive of managers than the plausible alternatives, making it less likely that managers will initiate switching to such alternative arrangements.[276]

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[269] *See, e.g.*, Conflict Minerals, 77 Fed. Reg. 56,274, 56,350 (Sept. 12, 2012) (providing limited analysis of the benefits of the SEC's Conflict Minerals rule because it had been required by Congress).

[270] *See* Bebchuk & Hamdani, *supra* note 24 (discussing the desirable design of investor ordering in state corporate law).

[271] *See, e.g.*, Gordon, *supra* note 51, at 1553 (listing the "striking number of mandatory norms" in Delaware corporate law).

[272] *See supra* Part II.A.2.

[273] *See* Fisch, *supra* note 49.

[274] *E.g.*, General Corporation Law, DEL. CODE ANN. tit. 8, § 242(b)(1) (2017).

[275] *See* Hirst, *supra* note 86, at 99–100.

[276] *See* Barzuza, *supra* note 23; Klausner, *supra* note 23; *see also* discussion *supra* Part II.C.1.

For these reasons, state law rules are likely to be sub-optimal and could be improved by implementing investor ordering. This would require amending a number of state law rules, such as: requiring that switching decisions be made in the charter rather than the bylaws of the corporation or restricting manager amendment of certain bylaw arrangements;[277] permitting investor initiation of charter amendments;[278] and amending defaults to be manager-restricting.

Conclusion

The rise of institutional investors provides an answer to the foundational debate about whether corporate arrangements should be mandatory or enabling: they should be investor ordered. For the great majority of regulations at the great majority of corporations, investor ordering will result in the same or greater aggregate net benefit to investors. SEC regulations regarding corporate arrangements have heretofore invariably been mandatory. Future SEC corporate regulations should be investor ordered by default. In many cases, future corporate regulations will be *required* to be investor ordered; were the SEC to implement a mandatory regulation when investor ordering would offer greater aggregate net benefits, the regulation would be subject to invalidation as "arbitrary and capricious." Implementing investor ordering will not only bring about greater aggregate net benefits for investors, and therefore greater social welfare, but will also reduce the cost of rule making for the SEC and lead to a more dynamic regulatory system.

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277 *See* Fisch, *supra* note 49, at 36 (advocating greater judicial oversight of board-adopted bylaws).

278 *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 865 (2005).