The SEC's New Proxy Access Proposals

by John Finley, Avrohom Kess and LeAnn Leutner

In June, after a decade of modest attempts to change proxy ballot access, the U.S. Securities and Exchange Commission proposed a radical shakeup in how shareholders can place director names on company proxy ballots. Are the SEC's proxy proposals the reform needed to rebuild investor confidence—or are they too much, too fast?

The U.S. Securities and Exchange Commission, in its latest foray into the contentious issue of stockholder proxy access, in June proposed a rule that would require most public companies to include stockholder nominees for director in company proxy materials. The only major exception would be for stockholders seeking to gain more than a limited number of seats on the board or change control of the company.

The SEC also proposed an amendment to the stockholder proposal rules that would preclude companies from relying on the "election exclusion" to omit proxy proposals regarding director nomination procedures or disclosures about stockholder nominees.

The SEC says proxy access will fight an "erosion of investor confidence." However, there are sharply different views about whether the changes further the best interests of investors.

In proposing these rules, the SEC noted the need for stronger proxy democracy to combat the "erosion of investor confidence" and heightened concerns about board accountability, particularly in light of the current economic crisis. The SEC cites a number of other policy arguments, including the concerns of foreign investors and the lack of director accountability creating a competitive issue for U.S. companies.

The public comment process and media debates about these proposed rules have highlighted sharply differing views about what, if any, changes to the proxy rules would further the best interests of stockholders and the national economy. The SEC views proxy access as an effective way to boost stockholder participation in director nominationsso that the proxy process better replicates the rights that a stockholder would have in person at an annual meeting.

These proposals strengthen stockholder access to a much greater degree than past SEC proposals. Due to the complexity and importance of the issues involved, however, there are serious reservations as to whether the SEC can adopt thoughtful and comprehensive reforms to the proxy rules in time for the 2010 proxy season.

The SEC's proposed rules are the latest episode in the continuing saga surrounding stockholder access to company proxies. In October 2003, the SEC proposed a rule that would have made access available to stockholders upon the occurrence of certain issuer-related triggers.

The 2003 Proposal would have required stockholders to meet certain eligibility requirements, including owning more than five percent of a company's stock for at least two years at the time of a director nomination. The 2003 Proposal permitted stockholder nominations only upon certain triggering events (material percentage of withhold votes or majority support for proxy access) that suggested lack of board responsiveness to stockholder concerns. After attracting approximately 17,000 letters to the SEC in support or opposition, the 2003 Proposal was abandoned in 2004 because the commissioners were unable to reach a consensus.

In July 2007, the SEC proposed two competing

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rules relating to stockholder proposals. The first rule (the *Exclusion Proposal*) codified the SEC's historical view that Rule 14a-8(i)(8) of the Securities Exchange Act allows companies to exclude stockholder proposals that may result in contested director elections, including proxy access proposals.

The second rule (the *Access Proposal*) would have required companies to include stockholder proposals for bylaw amendments regarding director nomination procedures. The stockholder making such a proposal would have needed to beneficially own more than five percent of the company's stock, and have held the stock for at least one year.

The SEC received approximately 34,000 letters supporting or opposing these proposals. In November 2007, the SEC adopted the Exclusion Proposal. However, after the resignation of SEC Commissioner Roel C. Campos, then-SEC Chairman Christopher Cox thought it unlikely that he could garner a majority vote to adopt the Access Proposal, but he promised to revisit the matter in the future.

Unlike the 2003 Proposal, the new Rule 14a-11 would not require any triggering events that suggest lack of board responsiveness to stockholders.

The 2009 SEC proposals cover two areas:

☐ *Proposed Rule 14a-11* under the Exchange Act would, under certain circumstances, require companies (including registered investment companies) to include stockholder nominees for director in company proxy materials. Unlike the 2003 Proposal, the new Rule 14a-11 would not require any triggering events that suggest lack of board responsiveness to stockholders.

Investors seeking to nominate directors under Rule 14a-11 would need to meet certain eligibility criteria regarding length and percentage of stock ownership. Specifically, the nominating stockholder would be required to have beneficially owned shares in the company for at least one year in an amount equal to at least:

- One percent of the company's securities for large accelerated filers and registered investment companies with net assets of $700 million or more.
- Three percent of securities for accelerated filers and investment companies with net assets of between $75 million and $700 million.
- Five percent of company securities for non-accelerated filers and investment companies with assets of less than $75 million.

Rule 14a-11 would not be available to stockholders seeking to gain more than a limited number of seats on a board of directors or change control of a company. The maximum number of nominees a company would be required to include under the rule would be either one or 25 percent of the board, whichever is greater. A company with more than one eligible stockholder would be required to include up to the maximum number of nominees on a "first-come, first-served" basis in the order the notices of nominations are received.

Any nominating stockholder using Rule 14a-11 would be required to submit to the issuer and the SEC a Schedule 14N, and would be subject to liability for any false or misleading statements. The Schedule 14N would be required to include:

- A representation that the nominee meets the objective criteria for independence from the company set forth by a national securities exchange or national securities association (if the company is subject to such rules).
- A representation that neither the nominee nor the nominating stockholder has an agreement with the company regarding the nomination.
- A statement that the nominating stockholder or each member of the nominating group intends to own the requisite amount of securities through the date of the stockholder meeting.
- Disclosure on the nature and extent of the relationships between the nominating stockholder(s) or the nominee, and the company or any affiliate of the company.

In addition, a Schedule 14N could include an optional statement, not to exceed 500 words, to appear in the company's proxy statement in support of the stockholder nominee(s). An amendment to Schedule 14N would need to be filed promptly

upon any material change in the initial filing, and a final Schedule 14N amendment would be required within 10 days after the company's announcement of election results to state the stockholder or group's intention regarding continued ownership of the company's securities.

☐ *Proposed amendment to Rule 14a-8(i)(8)* under the Exchange Act provides that a company must include a stockholder's proposal and supporting statement in its proxy materials if the stockholder satisfies certain eligibility and procedural requirements, and the proposal is not excludable on specified substantive grounds. Although the election exclusion pursuant to Rule 14a-8(i)(8) had historically provided a basis for excluding proxy access proposals, the SEC's proposed change to Rule 14a-8(i)(8) would, under certain circumstances, require a company to include in its proxy materials a stockholder proposal that would amend company documents regarding nomination procedures. The proposal could not, however, conflict with proposed Rule 14a-11 unless the proposal made proxy access easier than the SEC's rules.

The new Rule 14a-11 would trigger more dramatic changes than the previous SEC proxy access proposals.

☐ *Discussion.* Proposed Rule 14a-11 would trigger more dramatic changes than previous proxy access proposals by the SEC. The 2003 Proposal would have required a company to include nominees only after a triggering event suggesting lack of responsiveness by that company to stockholder concerns. The current proposal has no such triggering event requirement. It would instead compel the inclusion of any qualifying director nominee proffered by eligible stockholders.

The 2003 Proposal also set a minimum stock ownership threshold of five percent, with a minimum holding period of two years. The new proposed rule features a tiered ownership threshold that starts as low as one percent for large accelerated filers and requires only a one-year holding period. Any number of stockholders would be able to form a group and aggregate their holdings to satisfy the Rule 14a-11 ownership threshold.

One of the most significant features of Rule 14a-11 is that the proposed rule would not permit companies to opt out of Rule 14a-11. The SEC has, however, asked whether company governing documents should be allowed to prohibit or limit the inclusion of stockholder director nominees.

In that connection, the release asks whether Rule 14a-11 should provide that a company's governing documents may render the rule inapplicable only if company stockholders approve a provision addressing the inclusion of stockholder nominees in company proxy materials (as contrasted to the board implementing such a provision without stockholder approval). Given that the purpose of Rule 14a-11 is to enhance stockholder rights, many have noted the irony if stockholders cannot exercise the rights to modify or avoid entirely proxy access.

Those in favor of proxy access see the election of directors as a self-sustaining process of the board determining its members with little input from stockholders. They fear the lack of competition for directors makes directors effectively unaccountable to stockholders. The related belief is that stockholder-nominated directors would make boards more accountable to stockholders and improve corporate governance.

Opponents fear that the proposed rules risk turning every corporate election into a costly and disruptive contest, and discouraging qualified director candidates from appearing on a company's slate of nominees. They also note that the potential for withhold or similar campaigns is ignored by those pushing proxy access.

Opponents further argue that proxy access will damage the board cohesiveness necessary for effective oversight. Moreover, the downside of increasing the likelihood of director removal is that it may actually exacerbate the short-term management focus which the SEC is attempting to discourage, and which many observers blame for current economic ills.

Opponents also worry that the flip side of rosy visions of robust stockholder democracy will be self-

ishly empowered special-interest stockholders. Such stockholders would now be free to pursue narrow agendas that destroy overall long-term enterprise value. Finally, opponents question whether the accountability of boards (rather than easy money or lax regulations) can be fairly linked to the current financial crisis, as the SEC implies.

A dizzying array of unresolved questions surrounds proposed Rule 14a-11. These include the nearly 500 questions posed by the SEC in the proposing release. For example, the proposal does not fully address how the directors who are elected pursuant to the proxy access proposal will be treated in the following year. If the board renominates them, should additional directors be able to seek election pursuant to proxy access?

The new proposal also fails to discuss how economic incentives that nominating stockholders or groups may have through derivative securities would be taken into account. For example, Rule 14a-11 appears to permit a nomination by a nominating stockholder that has an entirely hedged financial exposure in the company, or that could even profit from decreases in the company's stock price.

Other issues relating to the proposed rule include how the notice requirements would fit with the company's own advance-notice rules for director nominations, the effect on proxy access if a traditional proxy contest commenced after a stockholder-nominated director was included in company proxy materials and the consequences if a stockholder fails to hold the required amount of shares through the annual meeting.

In conclusion, due to the complexity of the issues involved, we doubt that the SEC will be able to adopt any form of direct proxy access in a thoughtful manner in time for the 2010 proxy season. A more realistic and measured approach might be to first amend Rule 14a-8(i)(8) as proposed, and then assess its effects and the need for any further reform. The SEC should use its resources in a comprehensive and deliberate manner to gather empirical data and perspectives based on the experiences of participants in the proxy process following the amendment of Rule 14a-8(i)(8).

The SEC could then develop an approach to access that helps further its objectives without undermining efficient and effective governance of the companies it regulates. In the meantime, companies and their stockholders could privately correct the deficiencies in the proxy process that the SEC has identified. This is similar to the incremental movement toward majority rather than plurality voting for director elections that is taking place, particularly among large-cap companies, in the absence of SEC action.

Modifications to the established structure for corporate elections must be carefully calibrated to promote better corporate governance and enhanced participation for all stockholders. Hasty changes adopted for the sake of immediate "reform" in uncertain times could bring unintended consequences. These could diminish the general welfare of stockholders and other corporate constituencies that the proposed rules seek to benefit. In fact, they may exacerbate the problems that the SEC's proposed rules are seeking to remedy. ■