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Look Who Crashed the 2015 Proxy Season! Proxy Access, SEC Uncertainty and Related Issues

The rise of shareholder activism in the realm of corporate governance has increasingly focused on board performance and the right of shareholders to replace those directors who are perceived to underperform. One proposed approach to facilitate the replacement of underperforming directors is to give shareholders direct access to the company's proxy materials, including permitting the inclusion of a shareholder-proposed director nominee (or slate of nominees) and a statement in support thereof in the company's proxy statement (which such approach is more commonly referred to as "proxy access"). Although current U.S. securities regulations do not grant shareholders access to company proxy materials, proxy access may be available to shareholders by way of a company's organizational documents (e.g., articles of incorporation, bylaws or corporate governance guidelines), as permitted by state corporate law.[1]

While proxy access did not garner significant attention over the past two proxy seasons, it is one of the most notable early developments of the 2015 proxy season. It has been reported that shareholders have submitted an estimated 100 proxy access proposals to U.S. companies, a considerable number of which will be voted upon by shareholders over the next several months.[2] Proxy access will very likely be one of the most contentious corporate governance issues this proxy season.

This corporate governance update (1) provides general information concerning proxy access (including a synopsis of arguments for and against), (2) summarizes the proxy access position of several of the largest asset managers and public pension funds, select proxy advisory firms and certain corporate governance advocates and (3) presents other related proxy access considerations to facilitate boardroom and C-suite discussion, including issues to consider during the current proxy season and elements of a potential proxy access bylaw.

Proxy Access, SEC Uncertainty and Related Issues

Background. Proxy access generally provides shareholders that meet certain requirements (such as minimum stock ownership thresholds) the opportunity to nominate directors to a company's board and include those nominees in the company's proxy materials without going through a typical proxy contest. The Securities and Exchange Commission ("SEC") initially proposed a proxy access rule in 2003 and again in 2007.[3] A final rule, authorized under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), was adopted by the SEC in August 2010.[4] That rule, which became effective in November 2010, required companies to include shareholder director nominees in proxy materials under certain circumstances, the most important of which mandated that the shareholder (or shareholder group) nominating the director candidate hold at least 3% of the voting power of a company's securities for at least three years. In July 2011, the SEC's proxy access rule was vacated by the U.S. Court of Appeals for the District of Columbia Circuit.[5] Over the past several years, however, the 3%/3-year ownership thresholds (which would have applied under the SEC's mandatory proxy access rule) have become the unofficial standards by which proxy access threshold provisions (and subsequently, proxy access proposals) are typically evaluated.

Arguments in Support of and Against. There are conflicting views as to whether or not proxy access promotes better corporate governance. Arguments in support of and against companies providing their shareholders with proxy access include the following:

In Support of	Against
▪ provides shareholders (as owners of the company) with the right to nominate their own representatives ▪ promotes greater director accountability to shareholders ▪ makes it significantly easier (and less costly) to present to shareholders meaningful choices regarding board composition ▪ current alternatives to effectuate change in composition of board (e.g., via proxy contests) are not practical (as they are too costly and procedures are too cumbersome) ▪ fosters competition for board seats, which may lead companies to nominate directors who are better qualified and more independent ▪ a shareholder activist trend is developing; therefore, companies may voluntarily adopt proxy access bylaws to avoid a public relations backlash and pre-empt activists, which in turn may conserve company resources (i.e., time, money, management resources) ▪ makes it easier (and less political) for boards to replace underperforming directors (as directors are increasingly expressing dissatisfaction with their fellow directors)[6]	▪ leads to the nomination of special interest directors with agendas favoring minority shareholder positions ▪ increases corporate and shareholder short-termism ▪ bypasses the company's nominating committee, which (1) is in the best position to evaluate the board's current skills and qualifications and future needs and (2) could diminish the board's fiduciary role and ability to protect interests of all shareholders ▪ impairs the ability of public companies to attract and retain quality directors ▪ leads to further politicization of the boardroom, which could weaken the effectiveness of the board, interfere with company management, be disruptive to the corporate governance process and adversely affect long-term shareholder value ▪ implementing such a policy is resource intensive ▪ there is conflicting research as to whether proxy access would positively affect corporate performance and long-term shareholder value[7]

Past and Current Proxy Seasons; Related SEC Action. In recent years, proxy access (unlike other corporate governance topics, such as the separation of the CEO/chair positions, the declassification of boards and the ability of shareholders to act by written consent) has not been the focus of shareholder activists' initiatives. The following chart details the proxy access shareholder proposals received by Russell 3000 companies over the past three proxy seasons:[8]

Proxy Access Shareholder Proposals	2014	2013	2012
Filed	17	12	14
Voted Upon	13	11	7
Average Shareholder Support	39%	32%	38%
# Receiving More Than 50% Support	5	3	n/a

As mentioned, however, 2015 may be the turning point for proxy access as an estimated 100 shareholder proposals relating thereto have been submitted to U.S. companies so far this proxy season. The New York City Comptroller alone, on behalf of the city's pension funds, has filed 75 proxy access shareholder proposals.[9]

In previous years, companies receiving proxy access shareholder proposals with the 3%/3-year stock ownership thresholds have often sought and received SEC no-action relief, relying on Rule 14a-8(i)(9) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to exclude the shareholder proposal from proxy materials in favor of a management proposal containing more restrictive thresholds (e.g., 5%/5-year thresholds).[10] On January 16, 2015, however, SEC Chair Mary Jo White instructed SEC staff to review and report on this rule (due to questions that had arisen concerning its proper scope and application).[11] In light of Chair White's directive, the SEC's Division of Corporation Finance announced that it would not express any views on the application of Rule 14a-8(i)(9) during the 2015 proxy season and subsequently reversed a December 2014 no-action letter granting relief to Whole Foods Market, Inc. (which initially stated that Whole Foods could exclude a proxy access shareholder proposal due to its direct conflict with a management proposal being submitted on the same topic).[12] Consequently, companies will not be able to rely on SEC Rule 14a-8(i)(9) no-action relief to exclude proxy access (or other) shareholder proposals from their proxy statements this proxy season.

Positions of Certain Institutional Investors, Proxy Advisory Firms and Corporate Governance Advocates on Proxy Access

Although boards and management need to implement corporate governance practices that are best for their company and will generate long-term value for their shareholders, it is important they stay abreast of developments in connection with the proxy access policies of (1) their company's largest institutional investors, (2) proxy advisory firms (given their influence on the proxy voting process) and (3) other corporate governance advocates. A selected summary of those policies follows:

Institutional Investors – Asset Managers. The current proxy access position of each of the country's top five asset managers is as follows:[13]

- BlackRock, Inc. ("BlackRock"):
  - reviews proxy access proposals on a case-by-case basis
  - believes that long-term shareholders should have the opportunity, when necessary and under reasonable conditions, to nominate individuals to stand for election to the board, provided that proxy access mechanisms should assure shareholders that the mechanism will not be subject to abuse by short-term investors, investors without a substantial investment in the company or investors seeking to take control of the board[14]
- State Street Global Advisors ("SSgA"):
  - considers proxy access proposals on a case-by-case basis
  - evaluates the company's specific circumstances, the impact of the proposal on the target company and its potential effect on shareholder value (considerations include, but are not limited to, the ownership thresholds and holding duration proposed in the resolution, the binding nature of the proposal, the number of directors that shareholders may be able to nominate each year, company performance, company governance structure, shareholder rights and board performance)[15]
- The Vanguard Group, Inc. ("Vanguard"):
  - reviews proxy access proposals on a case-by-case basis
  - most likely supports proxy access provisions that provide a shareholder (or group of shareholders) representing 5% of a company's outstanding shares held for at least three years with the right to nominate directors for up to 20% of the seats on the board, but may support different thresholds based on a company's other governance provisions and other relevant factors[16]
- Allianz Asset Management AG ("Allianz"):
  - states that shareholders should be able to nominate director candidates for the board[17]
- FMR LLC ("Fidelity Investments"):
  - generally votes "against" proposals to adopt proxy access[18]

Institutional Investors – Public Pension Funds. The current proxy access position of several of the country's largest public pension funds is as follows:[19]

- California Public Employees' Retirement System ("CalPERS"):
  - mentions that shareholders should have effective access to the director nomination process and that companies should provide access to management proxy materials for a long-term investor (or group of long-term investors) owning in aggregate at least 3% of a company's voting stock for at least two years, to nominate less than a majority of the directors[20]
  - finds proxy access very important for board accountability; if boards do not respond constructively to proxy access (and shareholder proposals relating thereto), CalPERS will "take [its] votes to the boardroom"[21]
- California State Teachers' Retirement System ("CalSTRS"):
  - asserts that proxy access proposals are to receive a favorable vote[22]
  - states that if a company decides to not include in its proxy materials a shareholder's proxy access proposal that was submitted, CalSTRS plans to "take action against directors"[23]

- New York State Common Retirement Fund ("NYSCRF"):
  - supports proxy access proposals (as proxy access is a cost-effective tool to increase shareholders' ability to hold boards accountable)[24]
- Florida State Board of Administration ("SBA"):
  - generally votes "for" proxy access proposals noting that proposals which require an investor (or group of investors) to own a meaningful percentage of the company's voting stock (generally defined as greater than 1%) for meaningful periods of time (generally defined as greater than one year) are favored; however, a 3% ownership and a three-year holding period is a reasonable benchmark against which individual shareholder proposals may be compared
  - may vote "against" proposals that contain burdensome or otherwise restrictive requirements (such as ownership or holding thresholds set at impractical levels)[25]

Proxy Advisory Firms. The current proxy access position of the two prominent proxy advisory firms is as follows:

- ISS:
  - supports proxy access as an important shareholder right
  - takes a case-by-case approach in evaluating proxy access proposals and does not set forth specific access parameters; however, among other factors, takes into account company-specific factors and proposal-specific factors (including the percentage and duration ownership thresholds proposed in the resolution, the maximum proportion of directors that shareholders may nominate each year and the method of determining which nominations should appear on the ballot if multiple shareholders submit nominations)[26]
- Glass, Lewis & Co., LLC ("Glass Lewis"):
  - generally supports affording shareholders the right to nominate director candidates to management's proxy
  - considers several factors when evaluating on a case-by-case approach whether to support proxy access proposals (including the company's performance and overall governance profile; the board's independence, leadership, responsiveness to shareholders and oversight; the opportunities for shareholders to effect change, such as by way of calling a special meeting; and the number/type/nature of the shareholders above the proposed threshold, as well as the nature of the proponent)[27]

Corporate Governance Advocates. The current proxy access position of each of the following corporate governance advocates is as follows:

- Council of Institutional Investors ("CII") (advocating on behalf of shareholders):
  - believes that companies should provide access to management's proxy materials for a long-term investor (or group of long-term investors) owning in aggregate at least 3% of a company's voting stock for a minimum of two years to nominate less than a majority of the directors[28]
- The Business Roundtable ("BRT") (advocating on behalf of management):
  - asserts that proxy access imposes unnecessary costs, allows special interest groups to disrupt corporations' focus on long-term sustainable growth, forces retail shareholders to support special interest campaigns by union and state pension funds, and diverts the energies of directors and managers from other business of the corporation[29]

Considerations for Companies

To facilitate proxy access discussion in boardrooms and C-suites, companies may consider the following:

- **2015 Proxy Season.** There is no one-size-fits-all response for companies receiving a proxy access shareholder proposal. If a company receives such proposal, it may consider including management's own proxy access proposal in the company's proxy materials and (1) excluding the competing shareholder proposal unilaterally, (2) excluding the competing shareholder proposal after seeking declaratory relief from a court and (3) including the competing proxy access shareholder proposal and having shareholders vote on both proposals. In determining its response, a company should conduct a facts-and-circumstances analysis of each proposal. This should include, but not be limited to, the parameters set forth in the proposal, its potential impact on the company, its likelihood of success if submitted to a shareholder vote, the likely vote

recommendations of proxy advisory firms, and the potential risks and costs of litigation if the shareholder proposal is excluded from proxy materials.[30]

- **Elements of a Proxy Access Bylaw.** If a board concludes that it is in the best interests of the company and its shareholders to adopt proxy access as part of its corporate governance practices, elements for the board to consider as part of a proposed access bylaw include, but are not limited to:
  - *ownership and holding period requirements* — establish the minimum stock ownership and holding period thresholds necessary to nominate a director
  - *aggregation* — identify whether shareholders would be permitted to aggregate their stock with the stock of other shareholders to meet the minimum stock ownership threshold
  - *number of nominees* — describe the number and/or percentage of directors that shareholders may nominate
  - *representations* — include the various representations that nominating shareholders would be required to make, including those relating to (1) director nominee independence (that the nominee meets company, state law and stock exchange independence standards), (2) certain relationships between the nominee, the nominating shareholder (or group), and the company and its management, and (3) whether the nominating shareholder (or group) intends to own its shares through the date of the annual (or special) meeting, and that it is not attempting to effectuate a change of control or to gain more than a limited number of seats on the board[31]
- **Peer and Industry Reviews.** Companies should determine and continue to monitor whether their proxy access practices are aligned with peer companies and the industry in which they operate (as outliers may become the target of activist shareholder campaigns, be identified by institutional investors as an entity with potentially problematic corporate governance practices, and/or be susceptible to director "withhold" or "against" vote recommendations by proxy advisory firms). Companies should also monitor 2015 proxy access proposals received by peers and others in their industry, if any, and gauge shareholder support relating thereto (e.g., review and analyze shareholder voting results on both management and shareholder proxy access proposals).
- **Governance Documents and Processes.** Companies should consider how their governance documents and processes would be affected by proxy access and whether any changes would be necessary to implement such access. For example, amendments to a company's director nomination policy and/or nominating committee's charter may be necessary to reflect any additional procedures that are developed for vetting shareholder nominees. In addition, advance notice and other bylaws provisions relating to director qualifications may warrant a re-examination to see how they will interact with proxy access provisions and any best practices that may emerge.
- **Annual Meeting Timeline.** Companies may also need to review (and modify, as necessary) their annual meeting preparation timelines to account for proxy access or a potential election contest. If there is a shareholder proxy access nomination, issues may arise regarding the eligibility of the nominating shareholder and companies may need to address a disputed nominee. In these circumstances, a company may need to prepare for a contested election and may require the assistance of a proxy solicitor.
- **Enhanced Shareholder Communications.** Companies should prepare for the possibility of a future shareholder proxy access initiative. Accordingly, it is increasingly important for companies to be aware of shareholder concerns and to maintain good communications, particularly with institutional shareholders. Constructive engagement on traditional matters such as financial performance and corporate strategy, as well as on nontraditional matters such as executive compensation and governance practices may head off shareholder proxy access efforts as well as build support for a board's director nominees. Additional actions relating to shareholders should include (1) monitoring the company's shareholder base and trading activities (e.g., Schedule 13G filings) and (2) maintaining current profiles of the company's institutional investors and gathering information on the background and specific investment strategies pursued by these investors, including prior investment decisions, history of activism, time horizons and performance targets.
- **Director Confidentiality Policy.** Companies should continue to be mindful of the general prohibition under Regulation FD regarding communicating material nonpublic information during discussions with shareholders involving potential corporate governance changes. Companies should consider implementing a

comprehensive director confidentiality policy that would not only cover traditional "insider information" issues, but also establish rules for maintaining confidentiality of all boardroom discussions, including those relating to proxy access.

- **SEC Actions.** Companies should continue to monitor SEC actions concerning any future proxy access rulemaking and Rule 14a-8(i)(9) actions. Such information may provide companies with valuable guidance and inform their policy and actions relating to proxy access.

How Chapman Can Help

Chapman and Cutler attorneys provide corporate and business counseling to a wide range of clients, both publicly and privately held entities, with a focus on financial services institutions, utilities, investment advisors, insurance companies, manufacturers, distributors, wholesalers, retailers, contractors, transportation companies, professional service providers, pension funds and not-for-profit entities. Chapman and Cutler maintains a dedicated Corporate Counseling Practice Group with the necessary skills and experience to counsel on the issues presented in this corporate governance update. If you would like to discuss any of the issues contained in this update or other legal, regulatory, compliance or corporate governance-related issues facing your institution, please contact an attorney in our Corporate Counseling Practice Group.

1 For example, in 2009, Delaware amended its general corporation law to add a new section that allows (but does not require) Delaware corporations to adopt bylaws that give shareholders the right to include in the corporation's proxy materials shareholders' nominees for election of directors, subject to such lawful procedures and conditions as the corporation's bylaws may impose, such as establishing minimum ownership requirements (including duration of ownership) for the nominating shareholder and certain other information disclosure requirements. Delaware General Corporation Law, Section 112.

2 *Glass Lewis' Views on Proxy Access Developments*, Glass Lewis, Bob McCormick (January 28, 2015).

3 SEC Release No. 34-48626 (October 14, 2003) and Release No. 34-56161 (July 27, 2007).

4 Section 971 of Dodd-Frank states that the SEC may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the SEC determines are in the interests of shareholders and for the protection of investors. See also SEC Release Nos. 33-9136, 34-62764 (August 25, 2010).

5 The Court held, among others, that the SEC was arbitrary and capricious in adopting the rule. *Business Roundtable and Chamber of Commerce of the United States of America v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011). As of the date of this publication, the SEC has not subsequently proposed or adopted a new proxy access rule.

6 In 2014, 36% of surveyed directors reported that another member of the board should be replaced, up from 31% in 2012 (a 16% increase in just two years). *Trends Shaping Governance and the Board of the Future, PwC's 2014 Annual Corporate Directors Survey*, PricewaterhouseCoopers LLP (October 7, 2014).

7 See e.g., *Proxy Access in the United States: Revisiting the Proposed SEC Rule*, CFA Institute (August 2014) (concluding that proxy access has the potential to enhance board performance and raise overall U.S. market capitalization by as much as $140.3 billion with little cost or disruption to companies and the markets as a whole). However, see e.g., *Shareholders in the Boardroom: Wealth Effects of the SEC's Proposal to Facilitate Director Nominations*, JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, Ali C. Akyol, Wei Fen Lim and Patrick Verwijmeren (October 2012) (finding that increasing shareholder rights, specifically by facilitating director nominations by shareholders, may be detrimental to shareholder wealth).

8 *Proxy Voting Analytics (2010-2014)*, The Conference Board (November 2014).

9 The Comptroller's proxy access campaign (referred to as The Boardroom Accountability Project) requests that a board adopt and present for shareholder approval a proxy access bylaw that affords shareholders who meet the 3%/3-year stock ownership thresholds the right to include their director candidates, representing up to 25% of the board, in the company's proxy materials. Companies receiving the Comptroller's proposals were selected based on "three priority issues" (relating to climate change, board diversity and CEO pay) and consisted of 55 S&P 500 and 20 Russell 3000 companies. For additional information on The Boardroom Accountability Project, see the Comptroller's website, *available at* http://comptroller.nyc.gov/boardroom-accountability/.

10 Rule 14a-8(i)(9) permits exclusion of a shareholder proposal when there is a direct conflict with a management proposal on the same topic.

11 *Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals*, SEC, Chair Mary Jo White (January 16, 2015).

12 *Announcement of the Division of Corporation Finance Related to Exchange Act Rule 14a-8(i)(9) for Current Proxy Season*, SEC (January 16, 2015). See also *Letter to Whole Foods Market, Inc.*, SEC, David R. Fredrickson (January 16, 2015).

13 *BlackRock Is America's Top Money Manager of 2014*, INSTITUTIONAL INVESTOR (July 8, 2014).

14 *Proxy Voting Guidelines for U.S. Securities*, BlackRock (April 2014).

15 *Proxy Voting and Engagement Guidelines–U.S.*, SSgA (March 2014).

16 *Vanguard's Proxy Voting Guidelines*, Vanguard (2015).

17 *Corporate Governance Guidelines and Proxy Voting Policy*, Allianz Global Investors (2015).

18 *Corporate Governance and Proxy Guidelines: Fidelity Funds' Proxy Voting Guidelines (November 2014)* and *Fidelity Sector Portfolios' Proxy Voting Guidelines (December 2014)*, Fidelity Investments (2015).

19 *Pensions & Investments/Towers Watson 300 Analysis Year End 2013*, Towers Watson (September 2014).

20 *Global Principles of Accountable Corporate Governance*, CalPERS (May 19, 2014).

21 *Shareholders Threaten Boards Over "Proxy Access,"* USA TODAY, Kaja Whitehouse (January 27, 2015).

22 *Corporate Governance Principles*, CalSTRS (November 2, 2011).

23 *Shareholders Threaten Boards Over "Proxy Access,"* Kaja Whitehouse, *supra* note 21.

24 *Proxy Voting Guidelines*, NYSCRF (January 2011).

25 *2015 Corporate Governance & Proxy Voting Guidelines*, SBA (2015).

26 *United States Concise Proxy Voting Guidelines: 2015 Benchmark Policy Recommendations (Effective for Meetings on or after February 1, 2015)*, ISS (January 7, 2015).

27 *Proxy Paper Guidelines 2015 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice (United States)*, Glass Lewis (November 6, 2014) and *Glass Lewis' Views on Proxy Access Developments*, Bob McCormick, *supra* note 2.

28 *Corporate Governance Policies*, CII (October 1, 2014).

29 *Proxy Access Legal Challenge: Issue Backgrounder*, BRT (September 29, 2010).

30 As discussed, companies hoping to exclude a shareholder proposal on the basis of a direct conflict with a management proposal on proxy access will not have the benefit of the SEC's Rule 14a-8 no-action process during the 2015 proxy season. Note, however, that companies are not required to obtain SEC no-action relief to exclude a shareholder proposal, but need only notify the SEC of the company's intent to exclude the proposal and its reasons for doing so before it files its definitive proxy statement (as such relief reflects only the SEC's informal views and does not adjudicate the merits of a company's position with respect to the proposal, which only a court can do). Accordingly, the SEC's discretionary determination not to recommend or take enforcement action does not preclude a shareholder from pursuing any rights the shareholder may have against the company in court should management omit the proposal from the company's proxy materials.

31 Companies should be prepared to provide their rationale as to how and why the various parameters of the proxy access bylaw were established.

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