Lessons from the 2015 Proxy Access Front

In her regular column on corporate governance issues, Holly Gregory discusses recent developments in proxy access.

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Efforts by shareholders to directly influence corporate decision-making are intensifying, as demonstrated by the significant increase over the past three years in financially focused shareholder activism and the more recent efforts by large institutional shareholders to encourage directors to "engage" more directly.

Through the collective efforts of large institutional investors, including public and private pension funds, shareholders at a number of companies are likely within the next several years to gain the power to nominate a proportion of the board without undertaking the expense of a proxy solicitation. By obtaining proxy access (the ability to include shareholder nominees in the company's own proxy materials) activists and other shareholders will have an additional weapon in their arsenal to influence board decisions.

While proxy access has been the subject of shareholder proposals for several years, 2015 appears to be a turning point, with a significant increase in:

- Shareholder proxy access proposals.
- The negotiation and voluntary adoption of proxy access.

Proxy access initiatives have had limited levels of success in prior years. However, shareholder support increased last year as proponents began to focus on the 3% ownership threshold and three-year holding requirement first promoted by the SEC.

This year, with a major initiative from public pension funds led by New York City Comptroller Scott M. Stringer and with encouragement from major investors, such as TIAA-CREF and their industry group, the Council of Institutional Investors (CII), proxy access is taking hold. Adding to the momentum is the SEC's removal for the 2015 proxy season of a key defense in the form of no-action relief in situations in which a company intends to put forward its own competing proposal. Proxy advisor policies that discourage other efforts to defend against proxy access proposals add to the impetus (see *Box, Proxy Advisor Policies*).

The broad-based shareholder campaign for proxy access on a company-by-company basis, and the apparent momentum developing among targeted companies and other leading companies to respond by taking action to adopt proxy access, is reminiscent of the campaign several years ago for companies to replace plurality voting with majority voting in the election of directors. Both issues relate to the ability of shareholders to influence the composition of the board, and both campaigns show the power of concerted efforts at private ordering.

This article discusses:

- The SEC's attempt in 2010 to create a market-wide proxy access rule, which set the stage for later developments in this area.
- The recent uptick in shareholder proposals seeking proxy access.
- Institutional investor support for proxy access.
- Changes in how companies defend against shareholder proxy access proposals based on SEC proxy rules.
- The emerging approaches of companies taking action on proxy access.
- The potential impact that proxy access may have on corporate governance.

THE SEC'S 2010 PROXY ACCESS RULE

The SEC has unsuccessfully sought the adoption of a market-wide proxy access rule for decades. In 2010, the SEC adopted a proxy access rule (Exchange Act Rule 14a-11) that would have given shareholders the ability to nominate candidates through the company's proxy materials if they (or a group) held 3% of the company's shares for at least three years. Rule 14a-11 was adopted shortly after Section 971 of the Dodd-Frank Act clarified the SEC's authority to promulgate it. The SEC issued final rules facilitating shareholder director nominations on August 25, 2010 and these rules were scheduled to become effective on November 15, 2010.

However, in September 2010, Business Roundtable and US Chamber of Commerce challenged Rule 14a-11. In 2011, the US Court of Appeals for the District of Columbia Circuit vacated Rule 14a-11 on the grounds that the SEC had acted "arbitrarily and capriciously" in promulgating the rule and for failing to adequately assess its economic impact. The SEC did not appeal the court's decision. (*Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011)*.)

Search DC Circuit Strikes Down SEC Proxy Access Rule 14a-11 for more on *Business Roundtable v. SEC*.

SHAREHOLDER PROPOSALS SEEKING PROXY ACCESS

Under Delaware law, proxy access is an appropriate topic for shareholder action (see *8 Del. C. § 112* (providing for private ordering proxy access under state law)). When the SEC adopted Rule 14a-11 in 2010 it also lifted a prohibition on shareholder proposals that related to proxy access and other director election mechanisms. In the commentary to the SEC's proposed Rule 14a-11, some corporate commentators expressed the view that the matter should be left to shareholders and companies to decide on a company-by-company basis through private ordering.

The private ordering effort is now in full swing. Shareholder proposals seeking proxy access are the defining feature of the 2015 proxy season, with approximately 100 companies receiving proposals requesting that the board amend the by-laws to allow large, long-standing shareholders (or groups of smaller shareholders) to nominate directors to the board and include those nominees in the company's own proxy statement and related materials.

The New York City Pension Funds, with approximately $160 billion under management, accounted for the majority of proxy access proposals in the 2015 proxy season. In November 2014, Comptroller Stringer announced the "Boardroom Accountability Project," targeting 75 companies with non-binding proxy access shareholder proposals. The proposals request that the board adopt a by-law to give shareholders who meet a threshold of owning 3% of the company for three or more years the right to list their director candidates, representing up to 25% of the board, on the company's ballot. According to Comptroller Stringer, the targeted companies were selected due to concerns about the following three priority issues:

- Climate change.
- Board diversity.
- Excessive executive compensation.

INSTITUTIONAL INVESTOR SUPPORT FOR PROXY ACCESS

CII, an industry group for large institutional investors, has long supported proxy access, favoring a broad-based SEC rule imposing proxy access. Absent such a rule, Section 3.2 of CII's *Policies on Corporate Governance* states that companies should provide access to management proxy materials for an investor or a group of investors that have held in the aggregate at least 3% of the company's voting stock for at least two years to nominate less than a majority of directors up for election.

The California Public Employees' Retirement System (CalPERS) also continues to favor a regulatory mandate. According to CalPERS, proxy access "is a fundamental shareowner right to nominate director candidates who can be considered on a level playing field with board or management candidates." CalPERS has indicated in its list of priority regulatory reform issues

that the SEC should revisit its attempt to impose proxy access on all companies through renewed rulemaking, addressing as necessary the concerns raised in *Business Roundtable v. SEC*. (*CalPERS Priorities for the U.S. Securities and Exchange Commission*.)

In February 2015, TIAA-CREF, with approximately $851 billion under management, wrote to the 100 largest portfolio companies in which it invests encouraging them to adopt proxy access at the 3% for three-year threshold. TIAA-CREF believes that this will make boards more accountable and companies more profitable.

TIAA-CREF joins Vanguard Group Inc. and BlackRock Inc. in backing proxy access reform. Vanguard Group recently adopted a new policy stating that it will generally support changes to allow investor groups with 5% of shares to nominate directors. BlackRock has stated that it supports proxy access, but will review proposals "on a case-by-case basis." (*Reuters, Exclusive: TIAA-CREF joins 'proxy access' push with letter to top holdings, Mar. 12, 2015*.)

Proxy access proposals framed to track the SEC's vacated Rule 14a-11 have a fair likelihood of receiving a majority of votes cast. Of the proxy access proposals that went to vote in 2014, fewer than half received a majority of the votes cast in favor, with average support of approximately 37%. However, support was uniformly high for proposals (such as Comptroller Stringer's proposals) that relied on a 3% for three-year threshold. All of the proposals that received a majority of votes cast were based on this requirement.

DEFENDING AGAINST SHAREHOLDER PROPOSALS

Under the SEC's proxy rules, companies may exclude a shareholder proxy access proposal from company proxy materials if it fails to meet the requirements of Exchange Act Rule 14a-8, and companies may seek approval of the SEC staff to exclude a proposal through the "no-action relief" process provided for in the rules. While there are a number of potential grounds on which a shareholder proposal may be excluded, two that are relied on by companies when they have taken or are considering taking action, are that the proposal:

- Directly conflicts with a management proposal under Exchange Act Rule 14a-8(i)(9).
- Has already been substantially implemented under Exchange Act Rule 14a-8(i)(10).

However, for the 2015 proxy season the SEC has removed the ability of companies to seek no-action relief on the grounds of a direct conflict with a management proposal.

DIRECTLY CONFLICTING PROPOSALS

In early December 2014, the SEC Division of Corporation Finance granted no-action relief to Whole Foods Market, Inc., essentially agreeing that Whole Foods could exclude a 3%, three-year proxy access proposal in light of the company's stated intention to put forward a management proposal for proxy access at a 9%, five-year threshold based on the direct conflict between the two proposals. When Whole Foods filed its preliminary proxy statement with the SEC, it reduced the ownership threshold in its management proposal from 9% to 5%.

Given the grant of no-action relief to Whole Foods, it was broadly expected that other companies would counter shareholder proxy access proposals by putting forward management proxy access proposals with higher minimum ownership thresholds, invoking Rule 14a-8(i)(9) to obtain no-action relief. However, following the grant of no-action relief to Whole Foods, James McRitchie, the proponent of the Whole Foods proposal, appealed the grant to the full Commission and a letter writing campaign by incensed shareholders followed.

In January 2015, the SEC reversed course. In an unusual development, SEC Chair Mary Jo White directed the SEC staff to review Rule 14a-8(i)(9) as a basis for exclusion. Following Chair White's direction, the Division of Corporation Finance announced that it would express no views on the application of Rule 14a-8(i)(9) for the remainder of the 2015 proxy season. The SEC further announced that pending the review it would stop granting no-action relief under Rule 14a-8(i)(9) and withdrew relief granted to Whole Foods regarding its planned exclusion. In light of the SEC's statement, Whole Foods postponed its 2015 annual meeting, which was originally scheduled for March 10, 2015, until September 15, 2015.

Search SEC Division of Corporation Finance Suspends No-action Relief This Proxy Season on Conflicting Shareholder Proposals for more on this development.

Business Roundtable and other commentators have expressed concern that the SEC's approach forces companies faced with a shareholder proxy access proposal that are considering a management proposal to either:

- Include the shareholder proposal in the proxy materials even though it will compete with the similar management proposal and possibly lead to confusion.
- Omit the shareholder proposal, creating a heightened risk of litigation and negative targeting by certain pension funds and proxy advisors.

SUBSTANTIALLY IMPLEMENTED PROPOSALS

A tactic that is still available to companies under SEC proxy rules is to adopt proxy access by-laws and then seek to omit a shareholder proposal for proxy access on the grounds that it has been "substantially implemented" under Rule 14a-8(i)(10).

The SEC granted General Electric Company no-action relief allowing it to exclude a proxy access shareholder proposal on these grounds. The shareholder proposal had sought holding thresholds of 3% for three years, for up to 20% of the board's seats. General Electric adopted a proposal with the same 3% for three-year threshold for up to 20% of seats, but limited to 20 the number of shareholders in the group that constitutes the 3% holding.

EMERGING APPROACHES TO PROXY ACCESS

According to Institutional Shareholder Services Inc. (ISS), the vast majority of governance proposals in 2015 address proxy

Proxy Advisor Policies

Both ISS and Glass, Lewis & Co. (Glass Lewis) generally favor the ability of significant, long-term shareholders to directly nominate director candidates though the company's proxy materials.

ISS

ISS will generally recommend in favor of both shareholder and management proposals for proxy access with the following features:

- An ownership threshold of not more than 3% of the voting power.
- A holding period of no longer than three years of continuous ownership for each member of the nominating group.
- Minimal or no limits on the number of shareholders that may form the nominating group.
- A cap on the number of available proxy access seats of 25%.

(*ISS, 2015 Benchmark U.S. Proxy Voting Policies, FAQ on Selected Topics, Feb. 19, 2015.*)

ISS will review any additional restrictions on the right of proxy access for reasonableness. Where a company includes both a management proposal along with a shareholder proposal, ISS will compare them in relation to the guidance above.

ISS will also generally recommend a vote against one or more directors if a company omits from its ballot a properly submitted shareholder proposal, if the company has not obtained:

- A grant of no-action relief from the SEC.
- A US district court ruling that exclusion is appropriate.
- The proponent's voluntary withdrawal of the proposal.

GLASS LEWIS

According to Glass Lewis, it will review on a case-by-case basis shareholder proxy access proposals and the company's response, including whether the company offers its own proposal in place of, or in addition to, the shareholder proposal. Glass Lewis will consider:

- Company size.
- Board independence and diversity of skills, experience, background and tenure.
- The shareholder proponent and the rationale for the proposal.
- The percentage of ownership requested and the holding period requirement.
- The shareholder base in both percentage of ownership and type of shareholder.
- Board and management responsiveness, as evidenced by progressive shareholder rights policies and reaction to shareholder proposals.
- Company performance and steps taken to improve poor performance.
- Existence of anti-takeover protections or other entrenchment devices.
- Opportunities for shareholder action (such as the ability to act by written consent or the right to call a special meeting).

(*Glass Lewis & Co., Proxy Paper Guidelines, 2015 Proxy Season, Shareholder Initiatives.*)

Search Glass Lewis Announces Views on Recent Proxy Access Developments for more on the approach that Glass Lewis has adopted for the 2015 proxy season.

access. ISS has identified 102 resolutions seeking a proxy access right, which is nearly four times as many proposals compared to last year's filings. Further, resolutions on proxy access constitute more than 40% of all governance proposals and represent 13% of the approximately 780 resolutions filed for the 2015 season. ISS reports that it is:

- Aware of 34 companies that have adopted or committed to adopt proxy access. Of these companies, 21 have adopted or committed to adopt a proxy access provision in 2015.
- Tracking 58 proxy access proposals on proxy ballots of which:
  - 53 are shareholder proposals; and
  - five are board proposals (in four out of these five proposals, investors will vote on both a shareholder proposal and a board proposal).

(*ISS, Governance Insights, 2015 Shareholder Proposal Forecast, Apr. 10, 2015.*)

IMPACT ON GOVERNANCE

It remains to be seen what impact proxy access will have on corporate governance. At companies where proxy access is adopted, boards and management may become more focused on the quality of shareholder relations, communications and engagement, in an effort to avoid the imposition of one or more proxy access directors.

One of the benefits of the board self-determination that occurs absent a proxy contest or proxy access situation is the ability of the board to ensure that its composition is aligned with its view of what the company needs for effective oversight. This is not a simple matter given the mosaic of skill sets, experience and diversity that is needed on a board.

An elected proxy access director will owe the same fiduciary duties as the other directors, though some may view proxy access directors as potentially having an allegiance to the

Additional By-law Considerations for Director Nominees

In addition to by-laws addressing the ownership and holding periods, and the percentage of seats and numbers of shareholders who can make up the ownership group, companies should consider by-law provisions addressing director nominee eligibility requirements. For example, a by-law could provide that a director nominee will:

- Be independent.
- Represent that he or she does not have a control intent.
- Agree to retain shares through the meeting date.
- Be ineligible to be a shareholder proxy access nominee in the future for a period of time (for example, two years) if he or she:
  - withdraws from, or becomes ineligible or unavailable for, election at the meeting; or
  - does not receive at least 25% of the votes cast at the meeting.

nominating shareholder's interests. Depending on the circumstances, however, there may be a greater risk that the proxy access director is viewed by the rest of the board as an outsider or even an adversary.

Search Fiduciary Duties of the Board of Directors for more on the fiduciary duties of the board, including a discussion of the core duties of care and loyalty.

Concerns about how proxy access may impact board dynamics include:

- **Board fragmentation.** The board may become dominated by factions that are aligned with particular segments of the shareholding body rather than the shareholding body as a whole.
- **Board dysfunction.** Distrust among directors may develop and lead to board dysfunction with an associated negative impact on the quality of board oversight.

Concerns about how proxy access may impact a company in general include:

- **A higher risk of legal challenges.** Disagreement among directors may lead to a greater risk of legal challenges, including challenges in contexts that lack business judgment rule protection, subjecting transactions to heightened standards of review.
- **Joint shareholder action.** Special interest shareholders could coordinate to increase their representation on the board without the shareholding body at large understanding the potential for joint action.
- **Increased costs and distractions.** Proxy access can lead to increased costs and distractions without delivering improvements in company or board performance.

PRACTICAL CONSIDERATIONS

Notwithstanding these concerns, it appears inevitable that proxy access will soon play a larger role in governance at some companies as a result of private ordering. There is no indication that the SEC will revisit a broadly applicable rule.

In response to questions from US House of Representatives Democrats during a congressional hearing, SEC Chair White testified on March 24, 2015 that the SEC will not adopt a proxy access rule, but will observe the ongoing efforts of private ordering to encourage companies to adopt proxy access on a company-by-company basis. Chair White pointed to the success of the current shareholder proposal process and indicated that the SEC is very closely monitoring the process to see the direction it takes.

Counsel should follow developments in this area and keep the board generally apprised. It appears fairly inevitable that proxy access will become common among S&P 500 companies in the next several years, assuming that institutional investors continue to campaign through shareholder proposals and the threat of shareholder proposals. If faced with a proxy access proposal, counsel should be prepared to help the board and management consider the full range of options available given the company's circumstances.

One of these options is to proactively adopt proxy access to set the terms upon which proxy access is imposed (such as ownership threshold, holding period, limits on the number of seats at issue, limits on the number of shareholders who can combine to meet the threshold, nominee requirements and shareholder and nominee disclosure requirements) and head off a shareholder proposal or provide the ability to assert substantial implementation in a bid for no-action relief. Notably, the 3% for three-year threshold for at least 20% to 25% of board seats has become the standard, and variation from this will risk disfavor with shareholders.

Additionally, if a shareholder proxy access proposal is received, a company could:

- Quickly adopt proxy access on terms set by the company and assert substantial implementation.
- Submit a management proposal with terms more favorable to the company and also include the shareholder proposal in the proxy materials.
- Include the shareholder proposal in the proxy materials.
- Attempt to negotiate a settlement providing that the company will adopt or recommend that shareholders adopt proxy access the following year or potentially negotiate some other resolution.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.