

Proxy Access At The Tipping Point

by Holly Gregory

What happens when the shareholders of most U.S. corporations gain the power to nominate their own slates for board elections? We are about to find out. By the end of 2016, just over half of America's largest corporations had shareholder proxy access policies in place. The following report examines what this quiet revolution in activist power over the board will mean for proxy season 2017.

In late December 2016, proxy access reached the tipping point in terms of adoption by large companies—just over 50 percent of S&P 500 companies have now adopted proxy access. Through the collective efforts of large institutional investors, including public and private pension funds, and other shareholder proponents, shareholders are increasingly gaining the power to nominate a portion 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), shareholders will have yet another tool to influence board decisions.

The movement toward proxy access began to build in 2015. This trend continued in 2016, and is continuing into 2017.

While proxy access has been the subject of shareholder proposals for several years, 2015 was a watershed year, following the private ordering pattern of majority voting in uncontested director elections. Many companies received proposals for their 2015 annual meetings requesting that the board amend the bylaws to allow large, long-standing shareholders (or groups of shareholders) to nominate directors and include those nominees in the company's own proxy statement and related materials. This trend continued in 2016, and is continuing into 2017.

Proxy access initiatives had limited levels of success

prior to 2015. However, shareholder support started to increase in 2014 as proponents began to focus on the three percent for three years ownership requirement adopted by the SEC in its 2010 rulemaking efforts.

This is a broad-based shareholder campaign for proxy access on a company-by-company basis. The momentum continues to accelerate among targeted companies and other leading companies to adopt proxy access (with or without first receiving a shareholder proposal). It is reminiscent of the campaign several years ago for companies to replace plurality voting with majority voting in the uncontested 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.

□ **The SEC's 2010 proxy access rule.** The SEC has unsuccessfully sought to adopt 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 a shareholder (or a group of shareholders) held three percent of the company's shares for at least three years.

Under the rule, a nominating shareholder (or group of shareholders, with no limit on the size of the group) could nominate one proxy access director, or 25 percent of the board, whichever is greater. Rule 14a-11 was adopted shortly after Section 971 of the Dodd-Frank Act confirmed the SEC's authority to promulgate a proxy access rule.

The SEC issued final rules mandating proxy access in August 2010, which were scheduled to become effective in November 2010. In addition, the SEC also amended Exchange Act Rule 14a-8(i)(8) to allow shareholder proposals relating to proxy access and certain other director election mechanisms.

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Two Busy Years

Proxy Access Adoptions Since January 2015

	Prevalence of Selected Alternatives	Shareholder Viewpoints*	Proxy Advisory Firm Policies and Council of Institutional Investors (CII) Position
Ownership Threshold and Duration	<ul style="list-style-type: none"> • 3% for 3 years — 339/342 (99%); included in SEC vacated rule • 5% for 3 years — 3/342 (1%) 	<ul style="list-style-type: none"> • Nearly all favor 3% • Shareholder proposals more likely if company adopts at 5% 	<ul style="list-style-type: none"> • ISS and Glass Lewis support 3% • CII supports 3% and views 5% as “troublesome”
Proxy Access Nominee Limit (Maximum percent of Board)	<ul style="list-style-type: none"> • Greater of 2 or 20% — 228/342 (67%) • 20% cap — 68/342 (20%) • Greater of 2 or 25% — 23/342 (7%) • 25% cap — 23/342 (7%); included in SEC vacated rule 	<ul style="list-style-type: none"> • Most favor 20%–25% 	<ul style="list-style-type: none"> • ISS and Glass Lewis support 25% • If adopted after majority-supported shareholder proposal, ISS may issue negative vote recommendations against directors if less than 20% • CII favors ability to nominate at least 2 candidates
Nominating Group Size Limit	<ul style="list-style-type: none"> • No limit — 8/342 (2%); included in SEC vacated rule • 50 — 1/342 (<1%) • 30 — 2/342 (1%) • 25 — 13/342 (4%) • 20 — 311/342 (91%) • 15 — 3/342 (1%) • 10 — 3/342 (1%) • 5 — 1/342 (<1%) 	<ul style="list-style-type: none"> • General consensus that limit of 20 is reasonable • Possibility of shareholder proposals seeking removal of limits or specifying a particular nominating group size (e.g., 40 or 50) 	<ul style="list-style-type: none"> • ISS favors minimal or no limits • If adopted after majority-supported shareholder proposal, ISS may issue negative vote recommendations against directors if less than 20 • CII views <i>any</i> limit as “troublesome”
* Derived from publicly available voting policies as well as preferences expressed through engagement and voting results.			

In September 2010, Business Roundtable and the U.S. Chamber of Commerce challenged the validity of Rule 14a-11. In 2011, the U.S. 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 failing to adequately assess its economic impact.

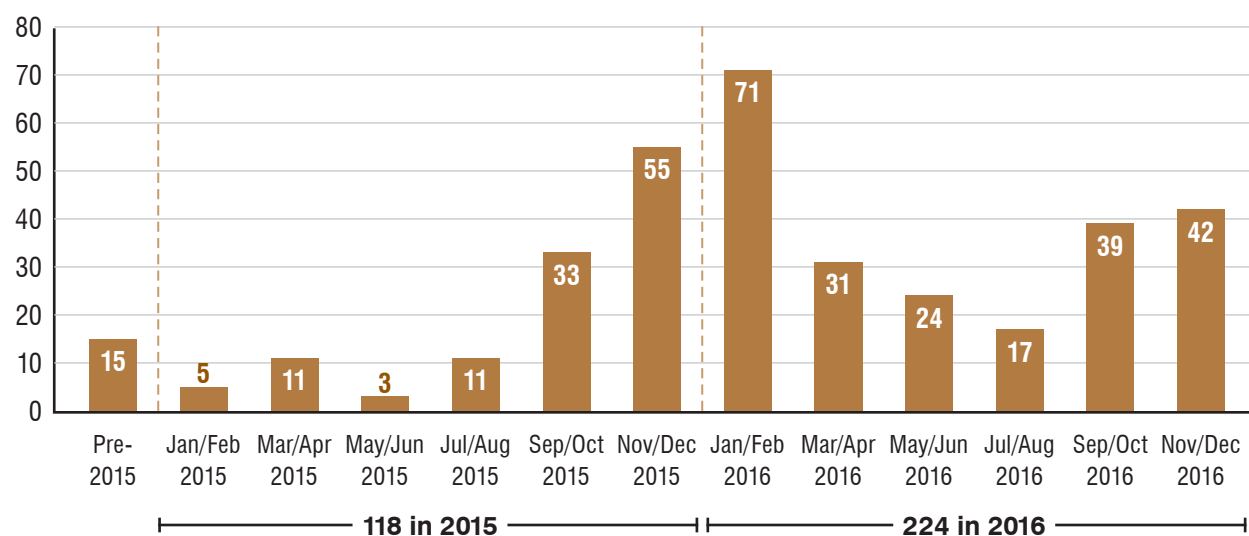
The SEC did not appeal the court’s decision and has not re-proposed any proxy access rule since. However, the amendment to Rule 14a-8 became effective in September 2011, thereby opening the door to shareholder proposals seeking proxy access.

□ ***Uptick in shareholder proxy access proposals.*** Fifteen companies adopted proxy access prior to 2015, including a few large companies, such as Hewlett-Packard Company (now known as HP Inc.), The Western Union Company and Verizon Communications Inc. Each adopted proxy access after receiving a shareholder proposal on the topic, as well as some companies that have since gone private.

In addition, proxy access with a five percent for two years ownership threshold has been mandatory for companies incorporated in North Dakota since 2008. We are aware of one public company that reincorpo-

A Rolling Tide

Pace Of Proxy Access Adoptions



rated to North Dakota from Delaware several years ago with the stated purpose of taking advantage of this and other “shareholder-friendly” provisions. To date, no shareholder has included a director nominee in the proxy materials of a U.S. company pursuant to a proxy access right.

The private ordering effort is now in full swing. Shareholder proposals seeking proxy access were the defining feature of the 2015 and 2016 proxy seasons, and we expect them to be prevalent in the 2017 proxy season. One hundred fifteen shareholder proxy access proposals were submitted for the 2015 proxy season, which was more than four times the number submitted for the 2014 proxy season. Based on the success of private ordering efforts in 2015, more than 200 shareholder proxy access proposals were submitted for the 2016 proxy season, well surpassing prior-year levels.

The New York City Pension Funds, with approximately \$160 billion under management, accounted for the majority of the proxy access proposals submitted for the 2015 proxy season. In November 2014, Comptroller Scott Stringer announced the “Boardroom Accountability Project,” targeting 75 companies with non-binding shareholder proxy access proposals.

The proposals request that the board adopt, and

present for shareholder approval, a bylaw to give shareholders who meet a threshold of owning three percent of the company’s stock for three or more years the right to include their director candidates, representing up to 25 percent of the board.

On January 11, 2016, the New York City Pension Funds expanded the Boardroom Accountability Project by submitting proxy access proposals at 72 companies for 2016. Thirty-six that had received proxy access proposals in 2015 were targeted again for 2016 because they had not yet adopted proxy access at a three percent ownership threshold.

As of December 31, 2016, 97 of 110 companies targeted by the New York City Pension Funds for 2015 and 2016 have adopted proxy access.

Another 36 companies were newly targeted for 2016, with a focus on the Fund’s largest portfolio companies, coal-intensive utilities and companies selected due to concerns about board diversity and excessive CEO pay.

The form of proxy access proposal submitted for the 2016 proxy season did not differ substantively from the template submitted for the 2015 proxy

season except that it no longer specifically sought shareholder approval of proxy access bylaws. The form of proposal for the 2017 proxy season was revised to indicate that the number of proxy access nominees shall not exceed the larger of two or 25 percent of the board.

As of December 31, 2016, 97 of the 110 companies targeted by the New York City Pension Funds for 2015 and 2016 have adopted proxy access.

Proxy access is supported by many institutional investors, including the following:

- *BlackRock*—reviews proxy access proposals on a case-by-case basis, and generally supports them. The proposals should not be “overly restrictive or onerous” and “provide assurances 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.”

- *California Public Employees’ Retirement System (CalPERS)*—indicated that proxy access was one of its strategic priorities for the 2015 proxy season and supported proxy access proposals at 100 companies in 2015. In February 2016, CalPERS announced that proxy access would continue to be a strategic priority in 2016, and that it continues to support shareholder proposals at the three percent for three years threshold and will issue adverse votes against director nominees at companies where proxy access proposals passed in 2015 and that implemented provisions that restrict or limit the use of proxy access. Finally, CalPERS updated its Global Governance Guidelines in March 2016 to recommend that companies adopt proxy access at the three percent for three years threshold to nominate up to 25 percent of the board.

- *California State Teachers’ Retirement System (CalSTRS)*—supports proxy access at the three percent for three years threshold, capped at a minority of board seats.

- *State Street Global Advisors*—reviews proxy access proposals on a case-by-case basis evaluating the company’s specific circumstances and the proposal’s potential effect on shareholder value. State Street takes into account “the ownership thresholds and holding duration proposed in the resolution, the binding nature of the proposal, the number of direc-

tors that shareholders may be able to nominate each year, company governance structure, shareholder rights and board performance.”

- *TIAA (formerly TIAA-CREF)*—wrote to the 100 largest companies in which it invests in February 2015, encouraging them to adopt proxy access at the three percent for three years threshold. In addition, TIAA submitted proxy access proposals at some companies for the 2016 proxy season.

- *T. Rowe Price*—supports proxy access proposals at the three percent for three years threshold, and opposes “significant impediments” to a proponent’s ability to aggregate holdings with other shareholders to qualify for proxy access. For the 2016 proxy season, T. Rowe Price added to its Proxy Voting Policies that it will generally recommend votes against shareholder proposals to amend existing proxy access bylaws if the company’s bylaw meets the three percent for three years threshold and does not impede aggregation.

- *United Brotherhood of Carpenters*—sent letters to 50 companies in late 2015 seeking a proxy access right in the event that the board refuses to accept the resignation of an incumbent director who fails to receive majority support. The letters were sent to companies with a majority voting standard and a director resignation policy and that had shareholder proxy access proposals on the ballots for their 2015 annual meetings, whether or not those proposals received majority support.

- *Vanguard*—announced in February 2016 that it amended its proxy voting guidelines to decrease the ownership threshold for likely support from five percent to three percent. Vanguard stated that the policy change was informed by engagement over the past year and “the critical mass of access adoption at the three percent ownership level by an increasingly wide range of companies.” Vanguard now generally support proposals at the three percent for three years threshold, capped at 20 percent of board seats.

- *Fidelity*—updated its proxy voting guidelines in January 2017 to no longer vote against proxy access proposals but will consider them on a case-by-case basis and generally support proposals at the three percent for three years threshold, capped at 20 percent of board seats.

Investors Speak On Proxy Access

Why They Support And Oppose Proposals

Factors increasing shareholder support	Factors decreasing shareholder support
Company did not adopt proxy access prior to the meeting	Company adopted proxy access prior to the meeting: significantly lower support if previously adopted at 3% ownership threshold
No competing management proxy access proposal on the ballot	Competing management proxy access proposal on the ballot
Less insider ownership	Greater degree of insider ownership
More shareholders that vote in line with proxy advisory firm recommendations	Less shareholders that vote in line with proxy advisory firm recommendations
Less voting retail shareholders	More voting retail shareholders
Combative tone of corporate disclosure around proxy access concept	More conciliatory/open tone of corporate disclosure around proxy access concept
Concerns relating to corporate performance, shareholder rights and/or compensation	Lack of concern relating to corporate performance, shareholder rights and/or compensation

Shareholders have also started filing “fix-it” proposals at companies which adopted proxy access rules not to investors’ liking.

□ **Emergence of “fix-it” proposals.** Following the flood of shareholder proposals asking companies to adopt proxy access, shareholder proponents began submitting proposals in 2016 requesting that companies make specific revisions to their existing proxy access bylaws. These so-called “fix-it” proposals were voted on at only eight companies in 2016.

The proposals passed at two companies (in each case where the proponent requested a reduction of the ownership threshold from five percent to three percent, among other amendments) and average shareholder support was approximately 44 percent (compared to shareholder proposals to adopt proxy access which have received average support of 51 percent).

While they are typically non-binding, a few fix-it proposals have been binding, none of which were approved by shareholders. The initial variety of fix-it proposals requested some combination of the following amendments:

- The ownership threshold would be three percent.
- The number of proxy access nominees would be the greater of 25 percent or two directors (or, at some companies, 25 percent).
- Loaned shares would count toward the ownership threshold so long as they are recallable.
- There would be no limit on the size of the nominating group.
- There would be no restriction on the re-nomination of a proxy access nominee based on the number or percentage of votes received in a prior election.
- There would be no requirement to hold shares after the annual meeting (e.g., for one year) or to express any intention to do so.
- The board would not have the power to amend the proxy access bylaw.
- The board would defer decisions about the suitability of shareholder nominees to a shareholder vote.

Based on recent SEC staff determinations, some shareholder proponents are refining their shareholder proxy access proposals or fix-it proposals to limit them to a single issue. This makes it less likely for a

company to be able to exclude them on the basis of substantial implementation. For example, some proponents are asking companies to adopt proxy access or amend their proxy access bylaws with a specific limit on the size of the nominating group (40 or 50).

□ **Potential impact on corporate governance.** It remains to be seen what impact proxy access will have on corporate governance. At companies where access has been adopted, boards and management may become more focused on the quality of shareholder relations, communications and engagement, in an effort to avoid a contested election against one or more proxy access nominees.

There are benefits in the board self-determination that occurs without a proxy contest or proxy access situation. The board can better 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 skills, experience and diversity that is needed on a board.

There may be a greater risk that the proxy access director will be viewed by the rest of the board as an outsider, or even an adversary.

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

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 shareholders, rather than the shareholding body as a whole.

□ **Board dysfunction.** Distrust among directors may develop, and lead to board dysfunction a 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. These include challenges on issues 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.

□ **Potential withdrawal of existing directors.** Incumbent directors may choose to resign rather than serve alongside a particular proxy access director.

Proxy access will inevitably soon play a larger role in corporate governance as a result of private ordering.

□ **Practical considerations.** Notwithstanding the concerns noted above, proxy access will inevitably soon play a larger role in corporate governance as a result of private ordering. Companies have several alternatives when considering whether and when to adopt proxy access.

Companies with a majority-supported shareholder access proposal should consider proxy advisor policies when implementing proxy access. Specifically, weigh the likelihood of negative vote recommendations against directors if the board has “failed to act” on a majority-supported shareholder proposal.

We expect that some companies will continue to follow a “wait-and-see” approach, particularly if they have not previously received a shareholder proxy access proposal. However, the trend towards adopting proxy access without receipt of a shareholder proposal continues to accelerate.

Some companies may choose to pre-emptively adopt a proxy access bylaw by board action. This can be done by requesting shareholder approval of a bylaw (or charter) amendment at the next annual meeting, in either case with or without a prior public

commitment to adopt proxy access.

This may help position the company as an early adopter of governance best practices, particularly if no shareholder proposal has been received. Depending on the specific provisions, this may also minimize the likelihood of receiving a future shareholder proxy access proposal. A company taking this approach should ensure that it can justify any proxy access provision with thresholds that differ from the following terms which have become standard: three percent for three years for up to 20 percent of the board (at least two directors) with a group size limit of 20.

Consider adopting proxy access on your own terms, rather than putting the proposal up for a vote.

If faced with a shareholder 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. A proxy access proposal with a three percent for three years ownership threshold is likely to receive majority shareholder support at a company that has not previously adopted proxy access.

Therefore, consider adopting proxy access on your own terms, rather than putting the proposal up for a vote. Doing so may enable a company to negotiate a withdrawal from the proponent. Alternatively, in light of the SEC's grants of no-action relief on the basis of "substantial implementation," a company will likely be able to exclude the shareholder proposal so long as the company's proxy access bylaw tracks the proposal's three percent for three years ownership threshold. This may not be the case, though, if the

proposal seeks a single specific provision that the company has not implemented (such as a nominating group size of 40 or 50).

Companies that have already adopted proxy access on standard terms should bear in mind that shareholders increasingly submit proposals seeking to modify the terms of their proxy access bylaws. The ability to have such proposals withdrawn or excluded is far less certain for shareholder proposals seeking adoption of proxy access.

As companies are considering these alternatives, they should:

- Follow developments in this area and keep the nominating and corporate governance committee and the full board generally apprised.
- Know the preferences of their shareholder base (as shown in proxy voting policies and other public statements, and voting history on proxy access proposals), and engage with shareholders on proxy access.
- Keep abreast of proxy advisory firm policies and guidance relating to proxy access.
- Stay apprised of the key parameters and other terms companies use when adopting proxy access.
- Be aware of the SEC staff's position on requests to exclude shareholder proxy access proposals and "fix-it" proposals seeking to amend proxy access bylaws.
- Review the "advance notice" and "director qualification" provisions in their bylaws, and consider whether such provisions may align with a proxy access provision if implemented. In addition, companies that have cumulative voting in place may wish to consider eliminating (or requiring suspension of) cumulative voting if a proxy access nominee is included in the company's proxy materials. ■

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