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Hot Issues Alerts – Law Firms

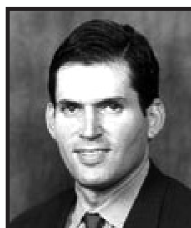
Proxy Access Looms: Understanding It And Its Challenges

*The Editor Interviews **Alon Y. Kapen**, Partner, Farrell Fritz, P.C.*

Editor: What is the SEC proposing with respect to proxy access for director nominations and bylaw proposals from shareholders?

Kapen: In a nutshell, the SEC is proposing two reforms. First, a new Exchange Act Rule 14a-11 will permit shareholders owning a specific percentage of a company's shares for a one-year period to nominate up to 25 percent of the company's board of directors and to solicit proxies in favor of those nominees using the company's proxy statement. The nominating shareholders would have to provide certain disclosures regarding the nominees and certify that they are not seeking to "change control" of the company. The new rule would establish a floor for shareholder proxy access that could not be undercut by state law or a company's bylaws. So, a company can amend its bylaws to make proxy access easier, but it couldn't make it more difficult for shareholders.

The second proposal is a repeal of the so-called election exclusion under Rule 14a-8(i)(8). That proposal would mean that companies generally would no longer be able to exclude from company proxy materials shareholder proposals dealing with the director nomination process unless the shareholder proposal conflicts with the SEC's proposal on shareholder access. In other words, the shareholder proposal process could not be a means to eliminate or restrict rights provided by proposed Rule 14a-11.


Alon Y. Kapen

Editor: What are the eligibility requirements for shareholders and their nominees to gain proxy access?

Kapen: There are four basic eligibility requirements. They are ownership, holding period, purpose and independence.

As to ownership, there is a tiered ownership structure. The specified thresholds are: one percent for large accelerated filers (companies with net assets of $700 million or more), three percent for accelerated filers (net assets of $75 million or more but less than $700 million) and five percent for non-accelerated filers (net assets of less than $75 million).

As to holding period, the nominating shareholder must have held the shares continuously for at least one year, and the shareholder must intend to hold those shares through the date of the shareholders' meeting.

As to purpose, the nominating shareholder must certify that the shares are not held for the purpose of effecting a change in control or to gain more than a limited number of board seats.

As to independence, the nominee would have to satisfy the objective independence requirements of the relevant stock exchanges. Interestingly enough, he would not need to comply with an exchange's subjective independence requirements or any company-specific independence criteria. There are no proposed restrictions on any relationship between the nominating shareholder and his nominees.

Editor: What is the rationale for these requirements?

Kapen: To understand the rationale for these eligibility requirements you can go straight to the release. The Commission's stated purpose in making the proposals is to remove impediments that it believes the federal proxy rules create to shareholders exercising their rights to nominate and elect directors. At the same time, the Commission recognized competing concerns that need to be taken into account, like the potential cost and disruption to the company of a proxy access process, especially if there were no eligibility requirements.

So, to balance those interests, the Commission made shareholder access subject to eligibility requirements. In terms of rationale for the holding period requirement, the SEC believes that long-term shareholders are more likely to have interests that are better aligned with other shareholders and are less likely to use 14a-11 solely for short-term gain. Nevertheless, the SEC is proposing only a one-year holding period rather than the two-year requirement that it proposed in 2003 despite the fact that the majority of commenters in 2003 actually supported a two-year holding period. I should point out that the so-called Shareholder Bill of Rights Act of 2009 proposed in the Senate would require a two-year holding period, so the two proposals would need to be reconciled. I would add, though, that the one-year requirement is consistent with the existing holding period for shareholders submitting proposals under Rule 14a-8.

In terms of rationale for the minimum

Alon Y. Kapen is a Partner in the corporate department of Farrell Fritz, P.C., concentrating in corporate securities transactions and regulation and mergers and acquisitions.

Please email the interviewee at akapen@farrellfritz.com with questions about this interview.

ownership requirement, the Commission made clear that it believes it is important that any shareholder or group that intends to promote a candidate by piggybacking on the company's proxy materials continue to have a significant economic interest in the company. So, the SEC is requiring that a nominating shareholder provide a statement as to that shareholder's intent to continue to hold the requisite amount of shares through the date of the meeting to demonstrate a commitment to both the nominee and the election process. Finally, the tiered beneficial ownership threshold that I just mentioned is an effort to address the possibility that certain companies could be impacted disproportionately based on their size.

Editor: What is the SEC's rationale for wanting to go forward with shareholder access at a time when so many other things are going on?

Kapen: The SEC has concluded that the federal proxy rules actually pose impediments to, rather than facilitate, shareholder democracy. In most cases, directors nominate the slate of candidates, and then the company sends information to shareholders in its proxy materials so that they have information to vote their shares. But, because shareholders rarely have any input into management's slate of candidates, they are not always able to vote for the person they believe is the most qualified. Although shareholders are generally allowed to nominate candidates from the floor of an annual meeting, the problem is that by then it's too late to be meaningful because the proxy votes will have already been cast. Consequently, shareholders who are serious about pursuing their own candidates are forced to pursue a proxy fight in which they mail out their own proxy statements and proxy cards, a very expensive process.

The SEC believes that its authority to regulate the proxy process includes a mandate to simulate an in-person meeting of shareholders. Insofar as shareholders are geographically dispersed, and most do not attend the meeting, the proxy process is intended to simulate an actual in-person meeting. The SEC believes that its proposed proxy access rules will better simulate an in-person shareholders' meeting and provide shareholders with a meaningful mechanism to exercise their state law rights to nominate and elect directors.

This is the Commission's third attempt at proxy access reform in the last six years, the first two being in 2003 and 2007, when the SEC was bombarded with negative comment letters and chose not to adopt the proposals. What makes adoption more likely this time around is pretty much a perfect storm. We had an election in 2008, which gave us a Democrat White House and a Democratically controlled Congress. We also have a majority of pro-proxy access commissioners at the SEC. And throw in the mix a financial crisis of historical proportions and $10 trillion of investor losses, which has a way of inviting reform.

Editor: Would the proposed rules make directors more responsive to the shareholders or more sensitive to risk factors like those that precipitated the current financial crisis?

Kapen: That depends on where you sit on the two sides of the proxy-access debate. Those who oppose proxy access will say that proxy access will only encourage directors and management to continue to focus on short-term results, the very type of behavior that contributed mightily to the financial and economic crisis. Nevertheless, the SEC believes that proxy access would give shareholders a meaningful mechanism to influence board nominations and voting and thus incentivize directors to be more responsive to shareholders.

Editor: We get to the critical question of whether the SEC has authority to do this in any event.

Kapen: That is going to be a major issue and it is unclear how it will play out. Many anticipate that the SEC will be criticized and possibly sued for exceeding its authority under Section 14 of the Exchange Act. The release is full of references to the effect that shareholder access would not be allowed in particular instances if state law or the company's bylaws prohibit shareholder nomination of directors. I'm not aware of any state law that prohibits shareholder nominations, so this is probably an attempt by the SEC to sanitize its proposal in anticipation of challenges that it had exceeded its authority. I should mention that the SEC hasn't had a great track record in federal court the last few years in defending against challenges to its rule-making authority. It's likely that the final rules will have additional and perhaps even more meaningful examples of state law deference in an effort to protect it against that kind of a challenge.

Interestingly enough, one day before the SEC approved its proxy access proposal, the Shareholder Bill of Rights Act was introduced in the Senate, which explicitly directs the SEC to establish proxy access rules. If that bill is passed, it should eliminate any doubt about whether the SEC has the authority to promulgate proxy access rules.

Editor: There have been complaints that the comment period is too short.

Kapen: Yes. The release gives interested parties 60 days from publication in the Federal Register to comment on the proposed rules, which means comments are due by August 17. Given the long history and the contentiousness of the debate, the SEC is expecting around 10,000 comment letters. The vast majority of those are going to be form letters, but the release itself poses over 500 questions and requests for data.

The Business Roundtable, U.S. Chamber of Commerce and other business groups submitted a joint comment letter to the effect that the 60-day comment period does not provide enough time to assess and comment on the many significant and complex issues raised. They point to the fact that the release contains extensive references to the comment letters that were submitted in response to the 2003 proposals, but it doesn't address how the analysis has been affected by what can be considered a sea change in corporate governance that has occurred in the last six years. They also make a point of the additional difficulty that is posed by the comment period occurring during the summer months, given member travel schedules and vacation plans.

These are all valid points that apply equally to the review period. Nevertheless, the SEC is under enormous political pressure to adopt final rules in time for the 2010 proxy season. Given that final rules of this magnitude become effective 60 days after adoption, the SEC will probably have to vote on the rules at an open meeting in early October.

There doesn't seem to be enough time for the SEC to evaluate all that comment

and data and properly analyze the enormously complex issues and act by early October. The better course would be for the SEC to take additional time to evaluate the voluminous letters that it anticipates receiving, in which case final rules could still be adopted in time to go effective in the middle of next year, rather than at the end of this year.

Editor: Assuming adoption of the rules in their current form, which shareholders are likely, and which are not likely, to benefit and why?

Kapen: You have to look at the eligibility requirements as well as the landscape to try to make a prediction about who's likely to take advantage of 14a-11. I think that those likely to benefit the most from 14a-11 are pension funds like CalPERS and TIAA-CREF that have the means and the critical mass of share ownership, and generally don't have holding period issues. Activists that probably won't be able to benefit from 14a-11 are social investors like PETA, who tend to be small shareholders and who would not meet the ownership threshold. The same is true of hedge funds who tend to be short-termists and would have a problem meeting the one-year holding period requirement, and most certainly so if final rules include a two-year holding period, which is entirely possible. Even those hedge funds for which the holding period is not an issue may take a pass on 14a-11 because there are certain advantages to having your own proxy statement and proxy card.

Editor: What practical issues will arise if the rules are adopted in their current form?

Kapen: One practical issue that I think will arise relates to the intent requirement. Remember, nominating shareholders will have to certify that their shares are not held for the purpose of changing control of the company, and a company will be allowed to exclude a shareholder nominee if the certification is false or misleading in any material respect. But because purpose is inherently subjective, disputes may arise between the company and the shareholder if the company has reason to question the certification. One practical issue is whether a shareholder's history of targeting other companies should be relevant to the veracity of the certification.

The SEC has indicated that the proposal is not intended to enable shareholder access to be used as a sort of Trojan horse for takeover activity. So what if a shareholder's certification was accurate at the time that it was made, but the shareholder afterwards reverses course and seeks control? This is all very much uncharted territory.

I think another practical issue has to do with company disclosures regarding the shareholder nominee. What if a company discovers material information about a shareholder nominee, such as a fraud violation, that is not technically required to be disclosed because it preceded the general five-year look-back period? The company could nevertheless conclude that it could face liability if it didn't disclose the information because it might have "reason to know" that the shareholder nominee information is false or misleading. Does the company have an affirmative obligation to include that information in its proxy statement even though it's outside of the five years?

Another practical issue can arise if two or more shareholders separately submit nominations and the aggregate number of nominees exceeds the limit of 25 percent of the board. If the aggregate number of nominees submitted by all shareholders exceeds 25 percent of the board in any year, the release states that it's a first-come-first-served sort of race to the corporate headquarters. This could result in an otherwise qualified nominee being excluded because his name was submitted, to take an extreme example, one day after other nominees. The release asks for comment on this issue and proposes other possible criteria, including the level of ownership or the holding period rather than who arrives at the corporate headquarters first.

Editor: What should companies be doing now, if anything, in light of the proposed rules?

Kapen: It's almost certain that the SEC will adopt final rules in time for the 2010 proxy season. So there are a number of steps that public companies should consider now before final rules are approved because they'll have very little time if they wait until after the final rules have passed.

If a company doesn't have an advance notice bylaw, it should probably adopt one well in advance of next year's annual meeting. If it does have an advance notice bylaw, it should be reviewed to determine whether it provides enough time to allow for the process under 14a-11 to resist proxy access for a shareholder nomination. That process is complicated and involves some back and forth with the SEC similar to the process under Rule 14a-8 for resisting proxy access for shareholder proposals.

Delaware companies may want to adopt a bylaw provision that requires a nominating shareholder to indemnify the company for false or misleading statements that it submits for inclusion in proxy materials, which is now permitted under new Delaware Section 112. I point out that, although liability for statements provided by the nominating shareholder rests with the shareholder, the company will also be liable if it knows or has "reason to know" that any shareholder provided a statement that is false or misleading, a very subjective concept.

In the case of the bylaw suggestions I just mentioned, I am not necessarily advocating that companies adopt them now because we don't know for sure what the final rules are going to look like, but I would urge companies to be ready to act so that they can take prompt action once the final rules are released.

Finally, it's always a good idea to consider ways to strengthen relationships with key institutional investors so that these investors don't feel that resorting to 14a-11 is their only recourse.