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What's Wrong With Access: How the SEC's Proposed Rules on Shareholder Access to Proxy Statements Miss the Mark

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The Securities and Exchange Commission (SEC) recently released proposed amendments to its proxy rules that would give shareholders of publicly-traded companies a federal right of access to such companies' proxy materials.[1] This right of access would permit shareholders to include their nominees for directors in the companies' proxy materials at the companies' expense in order to solicit votes for the shareholders' nominees. The proposed amendments also would require companies to include in their proxy materials shareholder proposals to amend the procedures for director nominations in the company's organizational documents (i.e., its articles of incorporation, bylaws, or similar documents). In its proposing release, the SEC stated that the amendments are intended to "remove impediments so shareholders may more effectively exercise their rights under state law to nominate and elect directors at meetings of shareholders,"[2] and noted, without expressly endorsing, commentators' views that "the presence of shareholder-nominated directors would make boards more accountable to the shareholders who own the company and that this accountability would improve corporate governance and make companies more responsive to shareholder concerns."[3]

The proposed new federal proxy access right is problematic for several reasons. First, the belief that the proposed right will result in better corporate governance is based on the faulty premise that good corporate governance requires such broad access for small groups of shareholders to nominate directors. In fact, cohesive boards consisting of directors with complementary backgrounds, experience and skills are more conducive to good corporate governance than fragmented boards chosen in an uncoordinated way by various constituencies with different goals and objectives. Second, the proposed right is unnecessary because of the significant changes in corporate governance that have occurred in recent years, including widespread adoption of majority voting in uncontested director elections, amendments to state corporate law in various states that either authorize proxy access bylaw amendments or create proxy access rights, the availability of proxy contests (the costs of which have been reduced by the Commission's e-proxy rules and the possibility of reimbursement under recent amendments to Delaware corporate law authorizing proxy reimbursement bylaws) and other avenues for shareholder input, including shareholder proposals and the increasing number of "vote no" campaigns. The proposed right would also amplify a focus on short-term corporate performance and decision-making and discourage qualified individuals from serving as directors, potentially making it more difficult to satisfy independence and expertise-related requirements applicable to directors and boards.

The Proposed Rule Change Does Not Acknowledge the Importance of Board Cohesion in Corporate Performance and Good Governance.

Directors are fiduciaries, charged with exercising their oversight role in the best interests of the corporation and its shareholders. As a collective body, the board oversees management, including hiring and firing senior officers and approving officer compensation. Typical corporate statutes, exemplified by the Revised Model Business Corporation Act,[4] mandate that the business of the corporation be managed under the direction of its board of directors. Under such statutes, shareholders generally have the right to (1) vote for the election or removal of directors, (2) amend the charter and bylaws, and (3) vote on extraordinary transactions such as mergers or liquidation, if and when proposed by the board of directors. In its oversight role, the board also collectively provides overall strategic direction, including input regarding long-range business strategy and approval of annual business plans. Consequently, well-functioning boards tend to operate by consensus and to seek members who complement the backgrounds, experience and skills of existing directors, in light of the company's business needs. Directors should not be special interest group representatives elected to represent the unique agendas and special interests of their respective constituencies.

Under the SEC's current proxy rules, shareholders must file and disseminate their own proxy materials in order to seek votes in favor of their own full slate of director nominees. The newly proposed right of proxy access, by contrast, would require companies to include in their own proxy materials individual candidates nominated by shareholders. The presentation of multiple candidates in the company's own proxy materials would make more likely the election of a board consisting of directors nominated by a variety of special interest constituencies, including hedge funds, labor unions and social issue investors. Unlike long-term investors with substantial economic interests in the company, such constituencies are more likely to nominate "single-issue" directors to further only the individual agenda item and special interests most important to that constituency. Easy access to the company's proxy materials, and therefore easier election of directors, by such constituencies could lead to politicization and balkanization of the boardroom. Recent history shows the perils that can arise from a dysfunctional board that does not operate by consensus. For this reason, some are of the view that, when a board fails, it "should be removed as a whole."[5] The procedures for shareholder nomination of full board of director slates under the current proxy rules require a more substantial commitment than would the proposed new federal proxy right, and thereby discourage single-issue investors from pursuing the nomination of single-issue individual directors.

The Proposed Rule Change Disallows Private Ordering and Ignores Corporate Governance Reform that Is Already Taking Place

The proposed proxy access rule would take a "one-size-fits-all" approach: it would not permit shareholders to adopt less open proxy access policies or to opt out of proxy access altogether. As some commentators have observed,[6] this is inconsistent with the SEC's stated intention of empowering shareholders. Shareholders should instead be able to choose their companies' approach to proxy access depending on their own assessments of the relative costs and benefits of proxy access.

The proposed rule changes are unnecessary because of significant changes in corporate governance that have occurred in recent years that have increased alternatives for shareholder involvement. These changes include widespread adoption of majority voting in uncontested director elections, amendments to state corporate law in various states that either authorize proxy access bylaw amendments or create proxy access rights, the availability of proxy contests (the costs of which have been reduced by the SEC's e-proxy rules and the possibility of reimbursement under recent amendments to Delaware corporate law authorizing proxy reimbursement bylaws) and other avenues for shareholder input, including shareholder proposals and the increasing number of "vote no" campaigns. The impact of these changes is increasing as a result of the movement to majority voting in uncontested director elections and the recent amendment to New York Stock Exchange Rule 452 prohibiting discretionary broker voting in uncontested director elections. Many companies have provided for significant shareholder influence on board composition through the adoption of majority voting standards and declassified boards and shareholders' ability to recommend director candidates to nominating committees.

The Proposed Rule Change Would Increase Short-Term Focus and Discourage Qualified Directors from Serving

The proposed federal proxy access right would have an adverse impact on corporate governance and corporate performance by amplifying a focus on short-term corporate performance and decision-making. With increased proxy access, incumbent directors will feel increasingly vulnerable to challenge by nominees of significant but short-term investors, such as hedge funds, and will therefore feel increased pressure to cause the company to deliver short-term returns merely to placate such investors. This heightened sense of vulnerability may increase the directors' concentration on delivering short-term results at the expense of the longer-term robustness of the company. Short-term investors such as hedge funds also may use the threat of proxy access as a lever to force short-term actions.

The proposed federal proxy access right is likely to discourage qualified individuals from serving as directors, potentially making it more difficult to satisfy independence and expertise-related requirements applicable to directors and boards. The prospect of more frequent and highly contested proxy contests relating to their nomination may discourage some qualified individuals from serving as directors of publicly traded companies. Since the pool of talent for qualified directors is not limitless, this disincentive could lower the overall quality of directors of public companies, thereby negatively affecting the companies' performance. A smaller pool of qualified directors could also make it harder for companies to locate willing directors who will satisfy applicable independence and expertise-related prerequisites.

The Solution: Shareholder Choice

Rather than mandating proxy access for all publicly-traded companies, the SEC would be better served by only amending the rules on shareholder proposals so that companies are no longer allowed to exclude from their proxy materials appropriate shareholder proposals relating to proxy access. Requiring companies to include appropriate shareholder proposals relating to proxy access would accomplish the SEC's stated goal of "remov[ing] impediments so shareholders may more effectively exercise their rights under state law to nominate and elect directors at meetings of shareholders" in a manner consistent with shareholder choice and private corporate governance, rather than imposing an overly broad "one-size-fits-all" mandate of proxy access with low ownership thresholds on all publicly traded companies.

The SEC's proposal includes a rule change that is intended to allow such shareholder proposals, but the rule as proposed is ambiguous and overly broad, and should undergo a number of changes. The rule as proposed would eliminate the current exclusion for proposals that "relate[] to a nomination or an election for membership on the company's board of directors . . . or a procedure for such nomination or election," and substitute a number of narrower exclusions, for proposals that "[w]ould disqualify a nominee who is standing for election" or "remove a director from office before his or her term expired," or that "[q]uestions the competence, business judgment, or character of one or more nominees or directors . . . [n]ominates a specific individual for election to the board of directors, other than pursuant to [the proxy access rule], an applicable state law provision, or the company's governing documents," or that "otherwise could affect the outcome of the upcoming election of directors." The SEC intends these exceptions to codify unofficial interpretations. These untested exceptions, however, would lead to uncertainty over the inclusion of shareholder proposals relating to subject matter ranging well beyond proxy access and reimbursement. Given the subject matter of the proposed change, the SEC's rule should also be revised to require a greater percentage ownership for a shareholder to submit a bylaw proposal and a longer holding period. More stringent ownership requirements would allow only long-term shareholders with vested interests in the company's long-term performance the right to propose amendments relating to proxy access, and would not give short-term opportunists such as hedge funds the same ability to change the company's governance structure or to use their new empowerment to force other short-term or short-sighted changes at the company.

An Alternative: Modified Proxy Access

If the SEC nevertheless determines to adopt the federal proxy access right being proposed, significant changes should be made. First, a federal proxy access right should not preempt state law and private ordering with a federal "one-size-fits-all" approach that substitutes the SEC's judgment for that of shareholders, boards and state legislatures who are responding to this issue. Preemption is inconsistent with the SEC's objective of removing impediments to shareholder use of state law rights and the long tradition of addressing corporate governance matters at the state level through private ordering by shareholders, boards and companies. The proposed proxy access rule would, for example, deprive shareholders of the choices that the recent Delaware proxy access amendment provides, including the ability to set eligibility criteria with respect to director nominations that will be included in company proxy materials.

Shareholders should be eligible to nominate proxy access directors only if they hold a significant percentage of a company's shares for a substantial period of time. The ownership threshold in the proposed rule could be too easily satisfied by opportunistic, relatively short-term investors and function as a "Trojan horse" for takeover activity. Only individual shareholders that have held at least 5% of a company's outstanding shares for at least two continuous years should be eligible to include director nominees on the company's proxy statement, and shareholders should not be permitted to aggregate their share holdings to meet the ownership eligibility threshold. These changes would help to ensure that only shareholders who have a demonstrated, substantial interest in the company's long-term performance may nominate directors and that shareholders with narrow agendas or otherwise short-term interests in the company will not have the same ease of access.

Under the proposed rules, there would be no limits on a shareholder's repeated use of the proxy access right regardless of how much or how little support the shareholder's candidates received. Such use should be limited to mitigate the cost to the company associated with addressing shareholder nominations and use of the company's proxy statement, and to permit other shareholders to include their nominees. Specifically, any federal proxy access rule should provide that a shareholder is not permitted to nominate proxy access directors for at least two years if the shareholder's prior proxy access nominee failed to receive a significant percentage of votes cast. To further mitigate the costs of proxy access to the company, any proxy access right should include a requirement that nominating shareholders reimburse the company for the incremental costs associated with including such shareholders' nominees in the company's proxy statement if the nominees do not receive a certain percentage of the shareholder vote.

The number of proxy access nominees should be capped at one director, rather than, as under the current rule, up to 25% of the entire board. In the case of multiple proxy access nominees, the rule should provide that the nominee submitted by the shareholder who has the most significant holdings or who has held company shares the longest should be included, rather than the "first in time" standard included in the proposed rules. The first in time rule would result in a perverse incentive for shareholders to propose director nominees even when they are not dissatisfied with the company's slate, simply to preempt other shareholders from proposing nominees to which the shareholder may object. A "largest" or "longest" holding rule would ensure that shareholders with the longest interest in the company are able to access the company's proxy statement and would remove the incentive for a shareholder to submit a nomination merely to preserve its ability to do so. Any proxy access nominees should also be prohibited from being affiliated with the nominating shareholder and should be required to satisfy the company's director qualification/independence standards.

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The SEC has received many comment letters on the proposed proxy access rules, some of which include critiques and proposals for reform similar to those outlined in this article. It is our hope that the SEC will be receptive to the recommendations of practitioners and academics who recognize the potential harm to publicly traded companies and corporate governance represented by the proposed rules in their current form.

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[1] *See* Facilitating Shareholder Director Nominations, Securities Act Release No. 33-9046 and Exchange Act Release No. 34-60089 (June 10, 2009).

[2] *See id.* at 10.

[3] *See id*.

[4] *See* Revised Model Business Corporation Act § 8.01.

[5] Leo E. Strine, Jr., Toward a True Corporate Republic: A Traditionalist Response to Bebchuck's Solution for Improving Corporate America, 119 HARV. L. REV. 1759, 1768 (2006).

[6] *See* Joseph A. Grundfest, Internal Contradictions in the SEC's Proposed Proxy Access Rules, Rock Center for Corporate Governance Working Paper No. 60 at 2 (2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1438308).