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Private Ordering for Proxy Access: What's Next?

The Securities and Exchange Commission ("SEC") has announced that proposed amendments to Rule 14a-8 permitting shareholders to submit proposals to create a right of "proxy access" — that is, the right of shareholders to include director nominees in a company's proxy materials — will go into effect for the 2012 proxy season. The amendments had been stayed as part of the litigation challenging the SEC's mandatory proxy access rule, which was vacated by a federal court in July 2011. The implications of the new private ordering regime for proxy access currently are unclear. As discussed below, companies should assess the likelihood of being targeted with a shareholder proposal providing for proxy access and the potential implications of the new SEC rules.

Background

On August 25, 2010, the SEC adopted two rules relating to proxy access. The first was new Rule 14a-11, which provided shareholders with a mandatory right of proxy access as long as certain conditions were met.[1] The second was an amendment to Rule 14a-8 to permit shareholders to include proposals in a company's proxy statement that seek to establish procedures relating to the election of directors or disclosures relating to director nominations. In its adopting release, the SEC indicated that the amendments to Rule 14a-8 were intended to permit shareholders to establish proxy access requirements that were more (but not less) lenient than those in Rule 14a-11.

Implementation of both rules was stayed by the SEC pending a legal challenge to Rule 14a-11. On July 22, 2011, the U.S. Court of Appeals for the D.C. Circuit vacated Rule 14a-11 as an "arbitrary and capricious" exercise of the SEC's authority. When the decision was rendered, the SEC expressed its disappointment while noting that the proposed amendments to Rule 14a-8 were "unaffected by the court's decision." The SEC subsequently chose not to request a rehearing or appeal the court's decision.

Although the legal challenge was directed only at Rule 14a-11, some commentators questioned whether the court's analysis might also undermine the amendments to Rule 14a-8, given the extent to which the two rules were intertwined. Nevertheless, on September 6, 2011, SEC Chairman Mary L. Schapiro issued a statement indicating that the SEC would proceed with implementing the amendments to Rule 14a-8. She explained that, under the new Rule 14a-8:

> Eligible shareholders are permitted to require companies to include shareholder proposals regarding proxy access procedures in company proxy materials. Through this procedure, shareholders and companies have the opportunity to establish proxy access standards on a company-by-company basis — rather than a specified standard like that contained in Rule 14a-11.

[1] As we explained in our previous client alert, Rule 14a-11 would have permitted a shareholder or group of shareholders who collectively owned at least 3% of a company's securities for at least three years to include one or more nominees in a company's proxy statement.

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The SEC will publish the effective date of the amended rule soon; it will be in place for the 2012 proxy season. Chairman Schapiro also left open the possibility that the SEC would revisit Rule 14a-11, stating that the SEC staff would "continue reviewing the [court's] decision as well as the comments that we previously received from interested parties."

Consequences of Private Ordering for Proxy Access

The implications of the new private ordering regime for proxy access will evolve with time. We expect many companies to receive shareholder proposals with respect to proxy access. This will be driven primarily by the minimal eligibility requirements under Rule 14a-8 for submitting a proposal: the shareholder must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for a period of at least one year by the date the proponent submits the proposal. Thus, nearly any shareholder could propose a proxy access bylaw, though proposals are unlikely to come from traditional institutional shareholders, hedge funds or ordinary retail holders. Rather, proxy access proposals will most likely be submitted by individual activists and by union and public pension funds just as they have done with proposals relating to majority voting, classified boards and similar corporate governance issues.

It is possible that some shareholder activists may not want numerous proxy access proposals submitted because it could undermine their ultimate goal of having a mandatory SEC rule. In particular, frequent use of the new Rule 14a-8 would support the business community's argument that private ordering, rather than mandatory access, is appropriate. Moreover, if shareholders routinely vote against proxy access proposals, it would undermine the argument in favor of mandatory proxy access. These sentiments are unlikely to restrain shareholder activists, however, and the SEC is unlikely to pursue mandatory proxy access in the near future.

The extent to which shareholders will support a proxy access bylaw proposal is also unknown. Although proxy advisory firms will likely recommend in favor of proxy access proposals, it is possible that many long-term shareholders will not be inclined to support them, given the potential to disrupt board composition and collegiality. It is more likely that shareholders will, subject to still-to-be-determined thresholds and other prerequisites, support the implementation of proxy access bylaws but then assess, on a case-by-case basis, any nominee included in a company's proxy statement pursuant to any such bylaw. Notably, in 2007, shareholder proposals for proxy access received approximately 40-45% support at Hewlett-Packard Company (proposed by the AFSCME Employee Pension Plan, among others) and UnitedHealth Group Incorporated (proposed by the California Public Employees' Retirement System, or CalPERS) and one was approved at Cryo-Cell International.

Some companies may be inclined to act preemptively by voluntarily implementing a proxy access bylaw. This might be done, for example, to establish appropriate procedures, conditions and thresholds applicable to a nomination, including requirements as to the number of shares held by the nominating shareholder, the length of time during which those shares must have been held, and disclosures required of the nominating shareholder and the nominee. While shareholders could submit proposals to amend any proxy access bylaw adopted by the company, shareholders likely would be less inclined to support such proposals if the company's bylaw was reasonable. The company could also condition the bylaw on a shareholder vote, which presumably would allow the company to exclude for that year any competing shareholder proposal under Rule 14a-8(i)(9), which allows for exclusion where a shareholder's proposal conflicts with the company's own proposal. For the time being, however, we believe most companies will not voluntarily adopt proxy access bylaws and will continue to watch how this develops. In any event, further developments relating to proxy access are expected as shareholders, boards and proxy advisory firms consider possible options.

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At this point, we suggest the following steps be taken:

- Ensure that boards are informed about the new Rule 14a-8, its implementation and the potential implications for corporate governance. Nominating and corporate governance committees may want to pay particular attention since they could play a key role in reviewing any shareholder proposal to adopt a proxy access bylaw or, eventually, the eligibility of a nominee submitted under such a bylaw.
- Assess the potential grounds for excluding a proposal under Rule 14a-8. Virginia followed the Model Business Corporation Act and amended its statute to make clear that a proxy access bylaw is permitted. Delaware has done the same thing.
- Consider the limitations and conditions that might be included in a proxy access bylaw, including with respect to any required share ownership and/or holding period. We do not recommend adoption of a proxy access bylaw now. It is likely that proxy advisory firms and large institutional holders will articulate their expectations regarding proxy access bylaws as the 2012 proxy season approaches. With that information in hand, a board will be in a better position to assess its options.
- Evaluate the likelihood of receiving a shareholder proposal to implement a proxy access bylaw, including by examining your shareholder base.
- Focus on maintaining good relations with key shareholders — clear lines of communication with large shareholders are necessary to build investor confidence in a company's board and management.
- In connection with shareholder relations, review key corporate governance practices that may be "hot buttons" for shareholders. Whether the company has a history of perceived governance troubles presumably will be an important factor in how shareholders vote.

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