Proxy Access – a Decision Framework

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Recent high-profile developments have thrust proxy access back onto the agenda for many U.S. public companies. Here is a framework for how to approach the topic.

Proxy access is back in the news and back on the agenda for many U.S. public companies. Four years after the DC Circuit invalidated the SEC's proxy-access rule, we are seeing company-by-company private ordering with a vengeance, including a record number of Rule 14a-8 shareholder proposals in the current 2015 proxy season. Events have moved at high speed in the past few weeks, leading many companies to wonder whether they should be initiating their own approach to proxy access.

As **we argued** in 2009 in response to an earlier SEC proxy-access proposal, we believe that each company's approach to proxy access should be grounded in a consideration of its particular circumstances. Despite recent high-profile adoptions of proxy-access procedures, we don't believe that most U.S. public companies should, in knee-jerk fashion, be preparing to revise their bylaws proactively. We do, however, think that boards should be assessing on an ongoing basis the broader issues of board composition, tenure and refreshment, which are not only important in their own right but also relevant to potential vulnerability to proxy-access proposals. We also think that boards should communicate a willingness to exercise their discretion in considering all shareholder suggestions regarding board membership in order to assure shareholders of a means of expressing their views and to create a level playing field for shareholders.

Background

Prelude to the 2015 Proxy Season. The SEC's Rule 14a-11 granted proxy access to 3% shareholders who had held their shares for at least 3 years, limited to 25% of the board. Although that rule was struck down by the DC Circuit in 2011, the basic approach of the rule has formed the basis for the most successful form of proxy-access proposal, beginning in 2013: most notably Verizon (a 3%/3 year/20% proposal that carried by 53% despite board opposition); Hewlett-Packard (a 3%/3 year/20% proposal that was recommended by the board and carried by 97%) and Chesapeake Energy (a 3%/3 year/25% proposal that was recommended by the board and carried by 99%). The success of these proposals led to the abandonment, by 2015, of an alternative retail approach, which featured much lower ownership thresholds and holding periods and which never gained traction with institutions or proxy advisory services. Even so, only 17 proxy-access proposals were voted on in the 2014 proxy season; of 10 proposals that hewed to the SEC model, 5 passed and 3 narrowly failed, while all 7 retail proposals failed.

2015 Proxy Season. The private-ordering process has ramped up dramatically in the 2015 proxy season, with over 90 companies receiving proxy-access proposals – and an unexpected SEC announcement that upended planning at more than one company. The chronology illustrates how dynamic this subject has become –

- ***Whole Foods requests no-action relief.*** In October 2014 Whole Foods submitted a no-action request to the SEC staff seeking to exclude an SEC-style proxy-access proposal, on the grounds (prescribed in Rule 14a-8) that the company's board intended to present its own, "conflicting," proxy-access proposal, which would permit a shareholder, but not a group of shareholders, owning 9% or more of the company's stock for five years to make proxy-access nominations, limited to 10% of the board. While the SEC staff had not before considered the "conflict" exclusion in the context of proxy-access proposals, it has frequently permitted companies to exclude

shareholder proposals on other topics, such as special meeting rights, where elements of the shareholder's proposal were inconsistent with the company proposal.

- ***New York City Comptroller submits 75 proxy-access proposals.*** While the Whole Foods decision was pending, in November the New York City Comptroller announced a campaign called the Boardroom Accountability Project, filing 75 proxy-access proposals that targeted companies based on climate change, board diversity and CEO compensation. The proposals used the 3%/3 year/25% framework and requested shareholder approval of the proxy-access bylaw after adoption by the board.
- ***SEC staff grants no-action relief to Whole Foods.*** On December 1 the SEC staff granted Whole Foods' exclusion request, triggering similar requests from some 16 other companies by mid-January. These proposals included minimum ownership thresholds that ranged between 5 and 8%, some of which were limited to one shareholder or a group of shareholders with a cap, with holding periods of 3 to 5 years, and restricting the number of board nominees from 1 director to 10% or 20% of the board.
- ***An outcry ensues.*** The Whole Foods shareholder proponent, supported by the Council of Institutional Investors, asked the SEC staff to reconsider its December 1 decision, with CII expressing concern over both the decision and the different ownership thresholds proposed by companies in subsequent no-action requests, asserting they were "unworkable" and "wildly at odds" with the SEC-style bylaw that CII believes is "broadly supported" by investors. While setting ownership thresholds higher than 3% drew criticism, what particularly bothered some investor advocates were the restrictions on aggregating holdings to achieve the ownership threshold.
- ***Whole Foods revises proxy-access proposal.*** On December 30, after engaging with "many of its shareholders to discuss their views on various matters, including corporate governance," Whole Foods filed a preliminary proxy with a proxy-access proposal that lowered the 9% ownership threshold to 5% and counted a family of funds as a single shareholder.
- ***Institutional investors chime in.*** On January 14 Vanguard updated its proxy voting policies to indicate that it will likely support proxy-access proposals featuring a 5%/3 year/20% model, permitting aggregation of shareholders. A couple of days earlier, BlackRock reiterated its belief that proxy access is a fundamental right, and that it preferred the SEC model, with the ability to aggregate shareholdings. Other investors have, at least publicly, continued to support a case-by-case approach.
- ***SEC abruptly reverses course.*** Before the SEC staff had ruled on any of the other pending Whole Foods-style no-action requests, on January 16 Chair White directed the staff to review the "conflicting proposal" exclusion from Rule 14a-8 and report back to the Commission, whereupon the Division of Corporation Finance announced that it was withdrawing its Whole Foods no-action letter and would express no views on the application of the conflicting proposal test during the 2015 proxy season.
- ***Companies rethink their strategies.*** Companies with proxy-access shareholder proposals that had pursued no-action letters, and expected to put forth their own conflicting proposals, began to evaluate their options after the SEC announcement. None of the choices were appealing. Although many expressed the view that a company did not need an SEC no-action letter in order to exclude a shareholder proposal that conflicted with a company proposal, companies worried about potential litigation if they were to go that route, and also worried about how taking that approach would be perceived by influential institutional investors and the major proxy advisory services.
- ***Monsanto shareholders approve proxy access.*** On January 30 Monsanto's shareholders adopted a 3%/3 year/25% proxy-access shareholder proposal opposed by the board. The

proposal carried by 53%, even though at the same meeting shareholders otherwise showed significant support for management, approving a say-on-pay proposal with 97% support and rejecting a proposal calling for an independent chairman by more than 80%. It appears that advisory firm recommendations played a decisive role in the differing vote tallies.

- ***GE proactively adopts proxy access.*** Surprising many, GE announced on February 11 that it had adopted a 3%/3 year/20% proxy-access bylaw, limiting to 20 the number of shareholders whose holdings may be aggregated. Although two much smaller companies also announced the adoption of proxy access around the same time, the news that one of the nation's largest and most high-profile companies had adopted proxy access before seeing the matter put to a shareholder vote caused some to ask whether the issue had reached a tipping point. GE's actions may not have been entirely unprompted, however, as GE earlier received a 3%/3 year/20% shareholder proposal, with no aggregation limits, for the 2015 season that in December GE tried unsuccessfully to exclude.
- ***Whole Foods postpones its annual meeting.*** Citing the SEC's decision to withdraw its no-action letter, on February 13 Whole Foods postponed the date of its annual meeting to a later, to-be-announced time, with no indication of how it would proceed on proxy access.
- ***Companies continue to evaluate their options.*** Although the 2015 proxy season is still young, different paths are being considered. Many companies with proxy-access proposals will opt for the traditional route of including the shareholder proposal on the ballot, and opposing it through written arguments and shareholder engagement. Others may include both the shareholder proposal and the company proposal in the same proxy, advocate for the company proposal and see which one gets more votes. Still others may include the shareholder proposal and recommend in favor of it. And we can't rule out the possibility that a company may seek a court order confirming its ability to omit the shareholder proposal. Whatever an individual company decides, it's clear that we will hear a lot more on this topic as the 2015 proxy season swings into high gear.

A Decision Framework

The vast majority of companies are not facing the immediate pressure of a proxy-access shareholder proposal, but it is not too early for companies to be considering the implications of these recent developments. While we expect to see some companies taking the GE approach, in response to a shareholder proposal or otherwise, at this juncture we do not think it is necessary for most companies to do so, and we think that a company can make the decision in light of its own facts, and in many cases on its own timetable.

Below, we sketch out some of the factors we think a company should consider in reaching its decision.

Consider the Broader Governance Picture. We believe that proxy access is best viewed in the larger corporate governance context that takes into account a number of overlapping concerns regarding board composition and other governance issues that have gained increasing prominence in the past few years –

- ***Board composition*** – Does the board count among its members individuals with a diverse mix of skills, experience, genders and backgrounds relevant to the company and its operations?
- ***Board refreshment*** – Is the board regularly adding new members in order to ensure the presence of fresh perspectives and avoid a tendency towards self-reinforcing viewpoints?
- ***Board tenure*** – Does the board strike the right balance between having directors of sufficiently long tenure to understand the company and its operations, but not so long that, rightly or wrongly, they become viewed as less likely to bring an independent, outsider's eye to the company's challenges and opportunities?

- ***Shareholder engagement and outreach*** – Is the board open to nominee and board-composition suggestions from the company's shareholders, and does it have a formal process for considering such suggestions? How does management or the board communicate their willingness to engage with the company's largest shareholders and consider director suggestions from shareholders?

Other things being equal, we believe that a board (or a nominating and governance committee) that has an active and ongoing internal process and an appropriate external dialogue on these matters should be in a better position to know whether a proxy-access proposal is likely to arrive and to assess the company's chances for resisting a proposal if the board concludes it is not in the shareholders' best interests. This is just good corporate governance hygiene, even apart from the proxy-access question.

Is the Company Likely to Receive a Proxy-Access Proposal in the Near Term? Predicting when or if a particular company will receive a proxy-access shareholder proposal is speculative at best. But there are a handful of factors that empirically affect the probabilities –

- ***Company size*** – Larger companies – companies in the Fortune 100 or S&P 500, for example – tend to get the bulk of Rule 14a-8 shareholder proposals and are more likely to receive a proxy-access shareholder proposal. Conversely, smaller companies, including many that have just recently IPO'd, tend to be somewhat more under-the-radar of governance activists, or may be enjoying a governance grace period as they develop a record of performance, and may have many more years before being prodded to confront the issue.
- ***Financial performance*** – Companies whose recent financial performance has lagged their peers are always at a greater risk of activist and institutional shareholder attention, and we would expect that to be a factor in decisions about which companies to target for proxy-access proposals.
- ***Negative publicity*** – Recent negative publicity – particularly if attributed to lax risk oversight or poor corporate governance – can increase shareholder concerns about board stewardship and be a motivating factor in targeting a company for proxy access.
- ***Significantly differing from peers*** – Boards that lack gender, racial and/or ethnic profiles comparable to their peers, or who have executive compensation practices that are richer than their peers, may be appealing targets for proxy-access proposals by public and union-affiliated investors in particular.
- ***Operating in a scrutinized industry*** – We also expect public and union-affiliated investors to focus their proxy-access efforts on companies that operate in industries under scrutiny for environmental, public health, public safety or consumer financial practices.

We believe that many companies will conclude that they are not likely targets in the short term. Even these companies should, however, recognize the possibility of being swept up in a broad-based campaign, like those that have effectively eliminated staggered boards at larger companies.

Is the Company Better Off Acting Proactively or Better Off Waiting? There are both upsides and downsides to acting proactively to institute proxy access before receipt of (or, as in GE's case, holding a vote on) a proxy-access shareholder proposal –

- ***On the upside***, the company would have greater leeway to tune the details to its preferences. These details include –
  - Ownership threshold and length of ownership
  - Limits on aggregation of ownership
  - Prioritizing among multiple nominations in a given year

- Treatment of hedged or derivative holdings
- Proportion of board seats eligible to be held by shareholder nominees
- Whether a shareholder nominee that is included on the management slate in later years should continue to count against the proportional limit
- Objective criteria (such as independence and sources and types of compensation) that a shareholder nominee must satisfy
- Information required of shareholder nominees and nominating shareholders
- Requiring nominating shareholders to disclaim a control purpose

Although shareholder proposals are typically "precatory" (i.e., non-binding) and companies therefore have some leeway in how, or if, to implement them, at least one proxy advisor has stated that it will scrutinize proxy-access bylaws adopted by companies in response to shareholder proposals, with the implication being that the advisor could recommend a "withhold" vote against any directors that it felt did not adequately carry out shareholder intent.

- ***On the downside*** –
  - We are still at a very early stage in the development of proxy access and we have no empirical record as to whether it is of benefit to companies and their shareholders and, if so, which provisions are most effective. We believe that many boards will, if given the choice, concede to others the honor of early-adopter status. It is also unclear whether a company will receive laurels for being proactive. If a company adopts a different threshold that it believes is better suited to its own circumstances, that may itself trigger a proposal in response.
  - While an increasing number of boards are open to the idea of engagement with and even board representation for certain activist shareholders, adopting a proxy-access bylaw in effect creates a *carte blanche* that can be used even where the board concludes that it would not be in the interests of shareholders. The risk of unintended consequences is real.
  - Many of the benefits of proxy access that a board might wish to secure – such as increased shareholder involvement in the nomination process – are obtainable even if the board does not act on proxy access itself.
  - In many instances, a proxy-access bylaw will create a race to be first among proposing shareholders – thus increasing the likelihood of shareholder nominees. If the board is doing a good job of fairly considering shareholder suggestions, the use of the governance committee as a filter may be best for the company's governance and fairest to all shareholders.

If a company does not expect to be high on the list of companies that will be targeted in the near term, and is comfortable that it has done a good job of addressing legitimate shareholder concerns about board composition, board refreshment and board tenure, the company may well feel comfortable waiting until it receives a proxy-access shareholder proposal, and even seeing the results of the subsequent shareholder vote, before deciding how to proceed.

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