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SEC Offers Competing Proxy Access Proposals for Public Reaction

Outcome Unclear as Vigorous Public Debate Begins

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OUTCOME UNCLEAR

AS VIGOROUS PUBLIC DEBATE BEGINS

BY LOIS YUROW

On July 25, the Securities and Exchange Commission took a novel approach to the long-simmering issue of whether, and under what circumstances, shareholders can nominate prospective members to the boards of public companies without mounting a proxy fight. Rather than issue a single proposal attempting to reconcile the various options, the SEC issued two packages of conflicting amendments for public debate. As explained by SEC Chairman Christopher Cox — the only commissioner who voted in favor of publishing *both* proposals — the Commission's goal was to inspire "the full breadth of commentary about different ways of attacking this issue."

Before we look at the proposals and consider what they mean to investors and public companies, let's cover some background for the IRO.

Shareholder Proposals and Rule 14a-8

SEC Rule 14a-8 describes when public companies must include shareholder proposals in their proxy materials and when proposals may be excluded. The rule sets out shareholder qualifications (primarily an ownership threshold) and procedural requirements (such as a submission deadline). If a shareholder satisfies these criteria, the company must include the shareholder's proposal in its proxy materials unless the proposal falls into one of thirteen categories of proposals deemed excludable.

Several types of excludable proposals are obvious and easily understood. For example, companies need not include proposals that would (if implemented) violate the law. Other bases for excluding a proposal are subject to interpretation. Notably, one paragraph of Rule 14a-8 permits exclusion of any proposal that "relates to an election for membership on the company's board of directors." This so-called election exclusion is increasingly a point of contention for institutional investors.

For years, SEC opined that the election exclusion covers two types of proposals: (1) those dealing with an upcoming election (either nominating a candidate or opposing one of management's

candidates), and (2) those suggesting bylaw amendments to force companies to include shareholder nominees in future proxy materials (generally known as a "shareholder access" or "proxy access" proposal). The SEC's interpretation prevailed until 2005, when the American Federation of State, County & Municipal Employees (AFSCME) filed a lawsuit after AIG refused to publish its shareholder access proposal in company proxy materials.

The Landmark AFSCME v. AIG Case

The AFSCME proposal would have amended AIG's bylaws to establish conditions under which AIG would publish information about shareholder nominees to the board. Relying on the election exclusion, AIG refused to publish the proposal and the SEC supported that decision. Arguing that proposals should only be excludable if they relate to a forthcoming specific election and ***not*** to elections generally, AFSCME sued in federal district court to compel AIG to include its proposal, but lost. On appeal to the Second Circuit Court of Appeals, AFSCME won support for its position.

A court presented with a regulatory question ordinarily will defer to the government entity charged with implementing the regulation(s) at issue. To that end, the Second Circuit reviewed instances in which SEC staff addressed questions about the election exclusion. In the court's view, the SEC's interpretation evolved from one that would exclude only proposals relating to specific candidates and elections to one that would exclude a wider range of proposals addressing elections generally.

When an agency revises its own interpretations, courts aren't obligated to defer to those revisions unless the agency gives a rationale for the shift. The Second Circuit found no rationale present in the SEC staff writings, and relied on what it found to be the SEC's *original* interpretation. (The SEC later argued its position was consistent all along and no rationale for an interpretive shift was necessary.)

Based on this analysis, the Second Circuit held that "[shareholder access proposals do] not relate to an election within the meaning of . . . Rule [14a-8] and therefore cannot be excluded from corporate proxy materials under that regulation." The court explicitly was not commenting on the policy question of whether proxy access proposals should be excludable from a company's proxy, stating that "such issues are appropriately the province of the SEC."

Backing the SEC Into a Corner

As IROs no doubt are aware, the SEC has attempted to accommodate shareholder access before, but has been stymied by intense opposition to both the concept of access (generally from business interests) and the conditions for access (generally from shareholder advocates). After the AFSCME decision, the SEC had no choice but to try again. Federal proxy rules should be consistent nationwide, yet the court whose opinions control in the key state of New York (and Connecticut and Vermont) opened the door to a whole class of shareholder proposals that the SEC did not want published — at least not without significant changes to other proxy rules.

And so, the recent "competing" votes by SEC commissioners that now open a broader debate on shareholder access to the proxy.

"We Mean What We've Been Saying"

In Release No. 34-56161, the SEC says, *"We mean what we've been saying all these years, and if the Second Circuit wants us to explain our views, here goes..."* The proposed amendments merely tweak the election exclusion to support the SEC's objection to

shareholder proposals that address specific elections *or* elections generally so that no other court can find the provision ambiguous.

As the SEC explains, the election exclusion is designed to prevent a contested election from occurring except within the framework of other proxy rules. Among other things, those rules impose disclosure requirements for investor-challengers and ensure the truthfulness of that disclosure with liability provisions. Since shareholder proposals are subject to less stringent disclosure requirements, the SEC does not want those proposals used to proffer candidates' names.

Similarly, the SEC is wary of proposed bylaw amendments that would allow shareholder nominees in the company's proxy statement for future elections. What if a proposal suggests a system for nominating candidates *without* sufficient disclosure safeguards?

On the Other Hand . . . .

The SEC's "status quo" proposal may appear overly cautious. If the concern is that shareholder access will foster contested elections without sufficient disclosure, why not craft a rule requiring companies to include access proposals, but only if they meet certain criteria? So, Release No. 34-56160 takes that approach with amendments imposing three requirements.

First, under the proposed amendments, shareholder access proposals must comply with the law of the state of the company's incorporation and the company's charter or bylaws. Most states permit shareholder access proposals, but the SEC's interpretation of the election exclusion generally prevents shareholders from exercising that right.

Second, the SEC addresses disclosure concerns by "enhanc[ing] the disclosure of information about the proponents of bylaw amendments concerning the nomination of directors, about any shareholders that submit director nominees …, and about any director nominee that is submitted by a shareholder." The proposed disclosure mirrors the existing requirements for shareholders that initiate a proxy fight.

Third, the SEC limits the number of shareholders that could take advantage of this enhanced opportunity for access. Proxy access proposals could be introduced, and directors could be nominated, only by shareholders or groups of shareholders, that meet all of the following criteria:

- Have owned at least five percent of the company's stock for at least one year,
- Did not acquire their stock with intent to control the company, and
- Have filed a Schedule 13G — the disclosure form required of certain five percent owners.

To ensure that shareholders do not try to circumvent these rules, companies can exclude proposals that would permit nominations by holders of less stock or by holders that give less disclosure.

The Fallout

Generally speaking, the only constituency happy with either set of proposed amend-

HIGHLIGHTS: THE COMPETING SEC PROPOSALS

The SEC's proposals, which have inconveniently similar names, both recommend amendments to existing federal proxy rules.

RELEASE NO. 34-56161— SHAREHOLDER PROPOSALS RELATING TO THE ELECTION OF DIRECTORS

Proposed amendments would simply confirm what the SEC says has been its position for years—that public companies can exclude shareholder proposals from their proxy statements if those proposals:

- nominate or oppose particular candidates for election to the board of directors, *or*
- introduce a bylaw amendment that would enable shareholders to directly nominate board members in the future.

RELEASE NO. 34-56160—SHAREHOLDER PROPOSALS

Proposed amendments would require companies, under certain conditions, to include in their proxy statements proposed bylaw amendments that would enable shareholders to nominate prospective board members in the future. To take advantage of these amendments:

- The proposing shareholder or group of shareholders must have owned at least five percent of the company's stock for at least one year, and cannot have acquired that stock with an intent to seek control of the company; *and*
- The proposing shareholder or group of shareholders must meet certain disclosure requirements; *and*
- The proposal must comply with the law of the state of the company's incorporation and the company's charter and bylaws, and cannot be excludable under other federal proxy rules.

(Note: This release discusses several other shareholder proposal-related issues that are beyond the scope of this article.)

— Lois Yurow

ments is those business interests who argue that shareholders should *not* have access to a company's proxy statement to reach other shareholders — or to impose "the tyranny of the minority." These business interests want to perpetuate the SEC's current interpretation of the election exclusion.

Among those who favor *greater* proxy access, there are many objections to the SEC's proposal. A major concern is that the amendments would not advance shareholder rights because the ownership requirements are insurmountable. The SEC anticipated this objection, and requested comments about whether the five percent ownership threshold should be adjusted, whether the criteria should vary with the size of the company, and whether there should be an ownership threshold at all.

Some governance experts worry that the extensive disclosure requirements will deter individual investors from joining to create a five percent group. Others note the irony that it is relatively easy for a shareholder to force a company to publish a proposal that is "at the periphery of shareholder's rights" — say, a non-binding proposal to reduce greenhouse emissions — but near impossible to get an audience for a proposal that concerns "the most fundamental of shareholder rights"— the right to vote. Moreover, if it is a shareholder right to choose directors, why does the SEC suggest reducing the costs and burdens of exercising that right only for the largest and wealthiest shareholders?

What Happens Next?

SEC Chairman Christopher Cox is determined to have a shareholder access rule in place for the next proxy season, so these amendments should come up for a vote in the fall after public comments (due by October 2) are reviewed. That schedule does not bode well for those who favor proxy access. Commissioner Roel Campos, who supports the more liberal amendments, is leaving his post in September. If he is not immediately replaced, the four remaining commissioners likely will end up in a 2-2 tie vote on both proposals. If no amendments are adopted, federal proxy rules will remain in their current uncertain state, with the SEC articulating one view and the opinion in AFSCME v. AIG calling that view into question. And the debate about "what to do" will begin anew, but not in time to have clear rules in place for the 2008 proxy season. Investor relations officers will be watching developments to try to understand which way the competing proxy proposals may be going. IRU

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