

Advocate

FOR INSTITUTIONAL INVESTORS

A Securities Fraud and Corporate Governance Quarterly

SEC Stands With Shareholders on Proxy Access Rules

By Katherine Sinderson

When investors' concerns over lax oversight and out-of-control executive compensation are ignored by a company's board of directors, the most direct method of demonstrating investor displeasure is to replace the board. However, the current SEC rules and incumbent-friendly state laws have made it almost impossible for shareholders to replace directors who have shown a tin ear to investors. Proposed "proxy access" rules by the Securities and Exchange Commission ("SEC") may change that.

Under existing rules, a shareholder cannot require a company to include shareholder director nominees in the company's annual proxy materials. Furthermore, a company can exclude from its proxy statement any shareholder proposal relating to the election or nomination of directors, including any shareholder proposal to adopt a "proxy access" bylaw (the "election exclusion" rule). Thus, any shareholder who wishes to elect a director without the company's consent is required to prepare and distribute its own proxy materials, waging a full-blown election contest — often a prohibitively expensive endeavor. As Harvard Law School Professor Lucian Bebchuk put it in a 2003 article, "the safety valve of potential ouster via the ballot is currently not working...[T]he prospect of being removed in a proxy contest is far too remote to provide directors with incentives to serve shareholders." Conversely, incumbent directors' campaign expenses are often fully funded by the company.

In response to "one of the most serious economic crises of the past century," the SEC has released proposed proxy access rules to permit shareholder participation in board elections. As the SEC announcement explains,

Current SEC rules and incumbent-friendly state laws have made it almost impossible for shareholders to replace directors who have shown a tin ear to investors. Proposed "proxy access" rules by the Securities and Exchange Commission may change that.

"[t]his crisis has led many to question whether boards of directors are truly being held accountable for the decisions that they make. These concerns include questions about whether boards are exercising appropriate oversight of management, whether boards are appropriately focused on shareholder interests, and whether boards need to be held more responsible for their decisions regarding such issues as compensation structures and risk management."

The SEC's proposed rules would make two major changes.

First, large shareholders or groups of shareholders in certain circumstances would have the right to place shareholder-selected nominees on the company-issued proxy statement. Only those shareholders owning at least a specified percentage of company shares (1-5%, depending on the size of the company) and who have owned those shares for at least a year would be able to place nominations on the company proxy. Shareholders would be permitted to aggregate their holdings to meet the minimum share ownership threshold.

SEC STANDS WITH SHAREHOLDERS

Continued from page 1.

However, the proposal allows companies to place a cap on the number of shareholder nominees — one nominee or 25% of the current board, whichever is greater. If the company has a staggered board (or a board in which the directorships are voted on in different years, rather than all at once), any shareholder-nominated director whose term extends past the election would count towards the 25% cap. If shareholder nominees exceed the 25% cap, then the nominees are accepted onto the ballot on a “first come” basis. If a shareholder or a shareholder group has an agreement with the company to nominate a director, that director will not count towards the 25% cap.

The proposed rules would allow the company to indicate on the proxy form whether the board recommends a vote “for” a director nominee, but the company cannot otherwise differentiate among the nominees. Significantly, the company would be prohibited from providing a company-recommended slate of directors for which a shareholder could vote with a single check of a box. Instead, where shareholder nominees are included, shareholders will have to vote for each director individually.

Notably, any shareholder nominating a new director would be required to certify that the shares were not acquired “for the purpose of or with the effect of changing control of the company” or “to gain more than a limited number of seats on the board.” This is because the SEC proposal is intended to fill the gap

Most importantly, the SEC proposal would provide a “floor” for shareholder proxy access that could not be undermined by state law or by incumbent directors through a unilateral change to a company’s bylaws.

where shareholders are dissatisfied with company leadership and wish to change that leadership without assuming control of the company themselves.

Second, the SEC’s former “election exclusion” rule would be repealed. This change would mean that companies would generally no longer be able to prohibit from the proxy shareholder proposals that address the director nomination process. Furthermore, this change will allow shareholders to determine the election process, rather than the very directors whose election is being decided.

Most importantly, the SEC proposal would provide a “floor” for shareholder proxy access that could not be undermined by state law or by incumbent directors through a unilateral change to a company’s bylaws. Indeed, the SEC proposal, if adopted, would preempt and render irrelevant Delaware’s recently-adopted proxy access statute that is scheduled to take effect on August 1. The Delaware statute sets a permissive standard where a Delaware corporation is allowed to adopt a bylaw that requires it to include in its proxy statements one or more shareholder nominees to the company’s board. The circumstances under which the shareholder is provided access would be set by the bylaws. The SEC proposed rules would instead require each corporation to provide such access in a uniform manner.

While the SEC proposal is an improvement over the recently-enacted Delaware statute, investors may question whether the SEC proposal goes far enough in protecting shareholder rights. For example, where an incumbent director’s campaign costs (beyond those of inclusion on the proxy ballot) are covered by the corporation, the corporation should also finance the campaigns of shareholders where they meet the stringent requirements discussed above. Furthermore, the SEC should prohibit the board from repealing election laws adopted by shareholders under the new rules.

The SEC proposal will likely face court challenges related to the SEC’s authority to issue such rules, as board elections are generally governed by state law. SEC chair Mary Schapiro has indicated that she would welcome legislative support from Congress making clear the SEC’s authority to issue these rules.

The SEC proposal is intended for the 2010 proxy season, so shareholders may soon see the benefits of increased proxy access. Although these proposed rules are merely tentative steps in the right direction, they indicate that the SEC is finally recognizing the benefits of shareholder democracy.

Katherine McCracken Sinderson is an associate in BLB&G’s New York office. She can be reached at katherinem@blbglaw.com.

The Advocate For Institutional Investors

is published quarterly by Bernstein Litowitz Berger & Grossmann LLP, 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. The materials in this newsletter have been prepared for information purposes only and are not intended to be, and should not be taken as, legal advice. Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm’s practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions.

© 2009. ALL RIGHTS RESERVED. Quotation with attribution permitted.