

A Practitioner's Guide to Shareholder Access

Highlights

The term "shareholder access" refers to the ability of shareholders to use the company's proxy statement and proxy card to solicit votes for their director nominees in opposition to candidates nominated by the board of directors. The SEC has issued two quite different rule-making proposals for shareholder access, and Chairman Cox has stated that he desires a clear resolution of the access debate in time for the 2008 proxy season.

- The SEC staff had long permitted companies to exclude shareholder access proposals from their proxy statements under the Rule 14a-8 exclusion for proposals relating to the election of directors on the grounds that the proposals could have the effect of causing proxy contests in future years.
- The Second Circuit rejected the SEC's interpretation in *American Federation of State, County & Municipal Employees, Employees Pension Plan v. American International Group*. Corporate governance activists heralded the decision as judicial vindication that shareholder access proposals were permissible under Rule 14a-8, while companies and business groups worried that shareholder proposals for access bylaws would become rampant, without any conditions or limitations.
- In response to the uproar and confusion, the Commission issued two rule-making proposals in July 2007, the "Exclusion Proposal" and the "Access Proposal."
- The "Exclusion Proposal" would reaffirm the Commission's historic interpretation, while the "Access Proposal" would explicitly permit greater than 5% shareholders to propose an access bylaw under certain circumstances with significant disclosure requirements.
- Few commentators supported the Access Proposal. Corporate governance activists concluding that the eligibility conditions were far too stringent and the disclosure requirements were too onerous. Companies and business groups predictably also opposed permitting shareholder access proposals under Rule 14a-8 even under limited circumstances.
- The comments on the "Exclusion Proposal" were predictably mixed, with companies supporting the proposal and corporate governance activists opposing it.
- One Democratic Commissioner has left the Commission and the other has announced her imminent departure. After losing its two core supporters, the Access Proposal seems a clear non-starter. While the Exclusion Proposal is controversial, it is the only game in town. If the SEC takes any action this year, it is likely to be some form of the Exclusion Proposal.

A cause célèbre of the coming 2008 proxy season has been the proposals of the Securities Exchange Commission concerning “shareholder access.”¹ The term sounds mysterious and is hardly self-descriptive. So what is the fuss all about?

Question: What does “shareholder access” mean?

Answer: The term refers to the ability of shareholders to use the company’s proxy statement and proxy card to solicit votes for their director nominees in opposition to candidates nominated by the board of directors. Shareholder access would represent a fundamental change from the current regime, whereby shareholders have to use their own proxy statements and proxy cards to solicit votes for their nominees.

Question: How and when did issue of shareholder access arise?

Answer: This is a fairly long story. The issue of shareholder access surfaced during the 2003 proxy season when the American Federation of State, County and Municipal Employees, commonly called AFSCME, submitted a proposal under Rule 14a-8 for inclusion in Citigroup’s proxy statement for a bylaw that would establish a right of shareholder access. Citigroup requested the Commission staff to confirm the proposal could be excluded from its proxy materials under the provision of Rule 14a-8 allowing exclusion of proposals relating to the election of directors (commonly called the “director election exclusion”). The Commission staff confirmed the proposal could be excluded, relying on its long standing interpretation that the director election exclusion applied because adoption of shareholder access proposals could have the effect of causing proxy contests in future years.² AFSCME appealed, and the Commission unanimously declined to review its staff’s position, noting that it was consistent with prior staff interpretations and that any change would require other significant adjustments to the proxy rules.³

However, the Commission led by then Chairman William Donaldson directed the Division of Corporation Finance to study the proxy rules regarding procedures for the election of corporate directors and report its findings and recommendations to the Commission. This request ushered in a more than one-year rule-making process. Following receipt of the Staff Report,⁴ the SEC proposed a rule that would have permitted shareholder access under limited circumstances.⁵ After a heated debate on the pros and cons of the proposal, the SEC effectively abandoned the proposal because of the Commissioners’ inability to reach a consensus on the merits. Importantly, the Commission split along party lines with the two Democratic Commissioners being staunchly in favor of the shareholder access rule proposal, the two Republican Commissioners being staunchly against and Chairman Donaldson, also a Republican, being unwilling to use his decisive vote to force a decision without a broader consensus.

Question: Why didn’t this end the shareholder access debate?

Answer: AFSCME refused to take “no” for an answer. It proposed a substantially similar shareholder access bylaw at AIG during the 2005 proxy season, to be met with another staff no-action response permitting AIG to exclude the proposal under the director election exclusion in Rule 14a-8.⁶ Rather than acquiescing, AFSCME sued AIG in federal district court arguing that its access proposal was not excludable under Rule 14a-8, properly read. The District Court found in favor of AIG.⁷ Still not daunted, AFSCME appealed to the Second Circuit, and to the surprise of most corporate governance observers won the appeal in September 2006.⁸ The appellate court based its ruling on administrative procedure considerations. It concluded the Commission had failed to explain its reasons for what the court considered a major reinterpretation of the Rule 14a-8 director election exclusion in the early 1990s. Therefore, the court held that the Commission remained bound by its original reading of the exclusion, which in the court’s judgment did not apply to shareholder access proposals.

Question: Why was the Second Circuit decision such a big deal?

Answer: Corporate governance activists seized on the decision and claimed it not only vindicated their earlier lobbying for shareholder access but also constituted a judicial determination that access proposals were permissible under Rule 14a-8. Moreover, although not always articulated, many activists believed the Second Circuit decision was a far better outcome than the failed SEC rule proposal, because, unlike the proposed rule, there would be no pre-set limitations on the availability of shareholder access.

By the same token, companies and business groups (principally the Business Roundtable and the Chamber of Commerce) saw the Second Circuit decision as re-opening the shareholder access debate and raising the specter that, absent SEC rule-making intervention, shareholder proposals for access bylaws would become rampant. Worse yet, absent SEC intervention, shareholder access proposals would not be subject to any conditions or limitations. The concern was activists could propose and shareholders adopt bylaws that, for example, would permit director nominations by even the smallest shareholders and/or that would not limit the number of candidates that could be nominated at an annual meeting and thus be used to effect changes in control.

Finally, from the SEC's standpoint, the court decision was not only a rebuke to its administrative process, but also an invitation to mass confusion because the Second Circuit decision would not be controlling in other circuits. Accordingly, it could open the door to companies outside of the Second Circuit claiming the right to exclude access proposals based on the Commission's historic interpretation of the director election exclusion under Rule 14a-8.

Question: What happened next?

Answer: Chairman Cox of the SEC seized the initiative by announcing just days after the Second Circuit decision that the SEC would review and resolve the shareholder access debate in time for the 2007 proxy season.⁹ However, resolution in this time frame proved impossible because the Commission once again split along party lines, with the two Democratic Commissioners favoring a shareholder access regime under Rule 14a-8, the two Republicans being adamantly opposed to shareholder access and Chairman Cox, also a Republican, trying to find a broader consensus.

In the face of the SEC impasse, the corporate governance activists, with the tacit support of the business community, took a statesman-like position and only three access proposals came to a vote during the 2007 proxy season.¹⁰ This gave the SEC a year's respite to find a solution by the fall of 2007 in time for the 2008 proxy season. Following additional months of study and three Roundtable Discussions of the issues, the Commission issued two different rule-making proposals on shareholder access in July 2007.

Question: Why did the SEC issue two rule-making proposals for shareholder access and how were they related?

Answer: This is a puzzle to many observers. One proposal (the "Exclusion Proposal") reaffirmed the Commission's historic interpretation that the director election exclusion applied to any shareholder proposal, including one for shareholder access, that could have the effect of creating an election contest either at the forthcoming annual meeting or at future annual meetings. In addition, the Exclusion Proposal included a proposed amendment to the director election exclusion to make that reading of the rule explicit. The Exclusion Proposal was supported by Chairman Cox and the two Republican Commissioners, but was opposed by the two Democratic Commissioners, so its political connotations were clear.

The second proposal (the "Access Proposal") was to amend the director election exclusion in Rule 14a-8 to explicitly permit inclusion in a company's annual meeting proxy statement of a bylaw proposal to institute shareholder access. However, the Access Proposal would limit the availability of Rule 14a-8 to greater than 5% shareholders (including groups formed for that purpose), who had held that position for a year and were eligible to file or had filed on Schedule 13G thereby disclaiming an intent to exercise or influence control of the company. It also would establish specific minimum disclosure requirements for proponents of a shareholder access bylaw, including the substance of any prior discussions with the company, any interests

in the company other than share ownership and any discussions with proxy advisory firms. The Access Proposal approval process was a mirror image of the Exclusion Proposal, with the two Democratic Commissioners voting in favor, the two Republicans voting against and Chairman Cox breaking the tie by voting in favor.

The answer to why two proposals seems to be one of policy or politics, depending on how cynical the viewer. It was obvious neither proposal could command better than a 3-2 vote. The question why Chairman Cox supported both is less certain. It is clear he was committed to finding a resolution of the shareholder access debate during the fall of 2007. Perhaps he thought that exposing both proposals to comment would help resolve the debate in one fashion or another.

Question: Did the comment process provide any clarity concerning either the Access or Exclusion Proposal?

Answer: Yes and No. Yes for the Access Proposal in that very few commentators supported the Access Proposal. The reasons for criticizing the Access Proposal generally fell into two distinct camps. The first camp, not surprisingly, consisted largely of companies, business groups and lawyers. Their opposition to the access proposal was based on a number of factors, including the desirability and appropriateness of permitting access bylaw proposals under Rule 14a-8 as a matter of SEC policy, the state law issues that access bylaws would raise and the absence of SEC imposed conditions on access bylaws, creating the possibility that access bylaws could result in myriad election contests sponsored by "corporate gadflies," as well as control contests sponsored by hedge funds and other dissidents.

The second camp, composed principally of corporate governance activists, concluded that the conditions for eligibility to use Rule 14a-8 for access bylaws were far too stringent and advocated instead that there be no conditions for availability of Rule 14a-8 for access proposals, or at least much easier to meet conditions. These commentators voiced approval of the Second Circuit decision in the *AIG* case and urged the Commission to revert to its initial interpretation of the director election exclusion so that access proposals would always be permissible under Rule 14a-8.

Question: What was the commentators' reaction to the Exclusion Proposal?

Answer: Here the two camps were more predictable. The "company" camp supported the Exclusion Proposal as you would expect. The corporate governance activists opposed the Exclusion Proposal, also as you would expect.

Question: Where does the Commission go from here?

Answer: The tea leaves seem fairly easy to read. First, one of the Democratic Commissioner's has left the Commission and his successor has not been nominated. Moreover, the second Democratic Commissioner has announced her imminent departure and no successor is in sight. Given the political split at the SEC, the Access Proposal seems a clear non-starter. Not only was it almost universally opposed by commentators, but without at least two Democratic votes to join Chairman Cox (assuming that he would vote in favor of a final version), there seems no way it could garner a majority vote.

The Exclusion Proposal is also controversial. Neither Democratic Commissioner voted in favor of it, and one branded it as a "midnight" proposal alluding to the approximate time he alleged it was put on the agenda the day before the Commission meeting. It is also bitterly opposed by the corporate governance activists. However, three sitting Commissioners did support it initially. Moreover, Chairman Cox has stated that he desires a clear resolution of the access debate in time for the 2008 proxy season. A failure to adopt the Exclusion Proposal would not resolve the debate and in all likelihood would lead to a flood of access bylaw proposals under Rule 14a-8. This is exactly the result that Chairman Cox has been trying to avert for the last year. As a result, if the SEC takes any action this year it is likely to be some form of the Exclusion Proposal.

Question: If the Commission adopts the Exclusion Proposal, does that end the controversy?

Answer: Maybe not. The corporate governance activists have actively sought Congressional support for the proposition there should be a federally mandated right of shareholder access. Chairman Barney Frank of the House Financial Services Committee, in particular, has been sympathetic to this campaign. As a result, there could well be an attempt to have Congress legislate shareholder access.

Question: Are there other important issues to look out for?

Answer: Yes. The first consists of other proposed rule changes set forth in the Access Proposal release. These proposed rule changes are intended to make clear that shareholder participation in electronic forums, such as company or issue specific "chat rooms," would be exempt from the proxy rules until the beginning of a 60 day "cooling off" period preceding an annual meeting. As a consequence, activities that ordinarily would or might constitute proxy solicitation and require the filing of proxy material would be given a free pass under the amended proxy rules (although the antifraud rules would continue to apply).

The SEC release setting forth these rule proposals clearly viewed shareholder forums on the Internet as totally benign. Giving the SEC and its staff the benefit of the doubt, they don't seem to have connected such forums and their proposed proxy rule exemptions to the reality of hedge fund and activist shareholder "wolf pack" tactics, often coordinated through Internet communications. If the rule proposals are adopted, hedge fund tactics won't likely change that much, but hedge funds will be able to be far more brazen in their use of the Internet to find fellow wolves.

Given the likelihood that the principal Access Proposals will not be adopted, the odds are against the Commission acting on the ancillary rule proposals relating to electronic shareholder forums. But stay tuned, just in case.

Question: Is there anything else I should know about the Access Proposal.

Answer: There arguably is a glimpse of a silver lining imbedded in the Access Proposal release. At the end of the release, the SEC inquires whether companies should have the ability to adopt bylaws that would effectively curtail or eliminate non-binding (often called "precatory") shareholder resolutions at annual meetings.

The implication of the inquiry is that the Commission might be prepared explicitly to confirm that such a bylaw would override Rule 14a-8 and preclude the ability of shareholders to include some or all non-binding proposals in company proxy materials. For example, a company might provide in its bylaws that non-binding shareholder resolutions are not proper subjects for a shareholder meeting, thereby banning them outright. A perhaps more realistic alternative in our current age of corporate governance activism might be a bylaw relegating non-binding proposals to an Internet based polling system so that they don't take up proxy statement room or annual meeting time but are still available to shareholders.

Before companies get their hopes up, it is important to note that, like electronic shareholder forums, the odds are low that this concept will survive the likely demise of the Access Proposal. Indeed, a number of corporate governance activists have based their objections to the Access Proposal at least in part on this feature of the proposing release and their belief that the limited right of shareholder access is not worth the risks of the Commission openly accepting the proposition that a company could use its bylaws to bypass the current availability of Rule 14a-8 for non-binding proposals.

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- ¹ Shareholder Proposals, Exchange Act Release No. 34-56160 Fed. Sec. L. Rep. (CCH) ¶87,935 (July 27, 2007) (the "Access Proposal") and Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56161, Fed. Sec. L. Rep. (CCH) ¶87,934 (July 27, 2007) (the "Exclusion Proposal").
 - ² See Citigroup, Inc. (Recon), Fed. Sec. L. Rep. (CCH) ¶78,503 (Apr. 14, 2003).
 - ³ Citigroup, Inc. (Recon), Fed. Sec. L. Rep. (CCH) ¶78,503 (Apr. 14, 2003); Press Release No. 2003-46, U.S. Securities and Exchange Commission, Commission to Review Current Proxy Rules and Regulations to Improve Corporate Democracy (Apr. 14, 2003), *available at* <http://www.sec.gov/news/press/2003-46.htm> (last visited Oct. 13, 2007).
 - ⁴ U.S. Securities and Exchange Commission, Division of Corporation Finance, *Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors*, Fed. Sec. L. Rep. (CCH) ¶86,938 (July 15, 2003).
 - ⁵ Security Holder Director Nominations, Exchange Act Release No. 34-48626, Fed. Sec. L. Rep. (CCH) ¶87,101, (Oct. 14, 2003).
 - ⁶ American International Group, Inc., SEC No-Action Letter, 2005 WL 372266 (Feb. 14, 2005).
 - ⁷ *Am. Fed'n of State, County & Mun. Employees Pension Plan v. Am. Int'l Group*, 361 F. Supp. 2d 344 (S.D.N.Y. 2005).
 - ⁸ *Am. Fed'n of State, County & Mun. Employees Pension Plan v. Am. Int'l Group*, 462 F. 3d 121 (2d Cir. 2006).
 - ⁹ Press Release No. 2006-150, U.S. Securities and Exchange Commission, Commission Calendars Proposed Amendment to Rule 14a-8 Governing Director Nominations by Shareholders (Sep. 7, 2006), *available at* <http://www.sec.gov/news/press/2006/2006-150.htm>.
 - ¹⁰ See American Federation of State, County and Municipal Employees, AFL-CIO, Comment Letter Regarding File No. S7-16-07 and File No. S7-17-07 (Sep. 28, 2007), *available at* <http://www.sec.gov/comments/s7-17-07/s71707-65.pdf>.