

# Corporate Governance Commentary

Proxy Access Analysis No. 5

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Latham & Watkins LLP and Georgeson Inc. are pleased to publish the next in our series of *Proxy Access Bulletins* and *Analyses*. By combining thoughtful legal analysis from Latham & Watkins with Georgeson's expertise on trends related to corporate governance, the shareholder voting process and other shareholder matters, we hope to provide you with timely, useful and practical guidance as you navigate the issues created by proxy access.

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## The Pros and Cons of Voluntary Implementation of Proxy Access at 2010 Annual Shareholder Meetings

- Although many things about proxy access remain uncertain, it is clear the SEC remains committed to adopting a final rule in early 2010. The new rule will likely be effective for the 2011 proxy season.
- In our previous [Proxy Access Analysis No. 4](#) we observed that:
  - A critical question for companies and investors alike is whether the final rule will permit shareholders to adopt bylaws that impose greater limitations on proxy access than the SEC rule (for example, by raising the minimum number of shares that a nominating shareholder must own or increasing the holding period).
  - If the final rule does permit shareholders to adopt such a bylaw (commonly called an opt-out bylaw), it seems safe to assume many companies will propose opt-out bylaws to their shareholders in order to tailor proxy access better to the particular circumstances of each company.
  - It would make sense for companies to consider over the next several months whether they would prefer to propose an opt-out bylaw at their 2010 annual meetings, rather than waiting until their 2011 meetings or later.
- This *Proxy Access Analysis* sets forth the principal considerations we believe companies should take into account in deciding whether or not to propose opt-out bylaws at their 2010 annual meetings.
- The pros of proposing opt-out proxy access bylaws at 2010 annual meetings include:
  - Ensuring that an appropriate, company-tailored proxy access regime is in place and operative for 2011 annual meetings at which the SEC's one-size-fits-all prescriptive rule would otherwise apply.
  - Acting before proxy advisory firms and institutional investors develop their own detailed and prescriptive voting policies that could have the effect of limiting flexibility in the design of opt-out bylaws.

- If there are aspects of the SEC's final rule that some companies conclude are not workable or are otherwise not optimal, the need for company proposed bylaws correcting the deficiencies in the SEC rule would be clear. For companies in this position, acting sooner rather than later would benefit the company and its shareholders.
- Countervailing reasons for not proposing opt-out bylaws during the 2010 proxy season include:
  - Uncertainty whether a final rule will be adopted prior to the time a company would have to file a preliminary proxy statement containing its proposed bylaw and whether the proposed bylaw will be consistent with any limitations on private ordering contained in the final rule.
  - The natural reluctance of senior managements and boards to spend time, energy and expense to deal with a rule that has yet to be adopted and the terms of which are uncertain.
  - The equally natural concern of senior managements and boards about getting too far in front of potentially contentious issues by being one of only a handful of early proponents of opt-out bylaws.
- Even a cursory evaluation of the pros and cons makes clear that adoption of a proxy access bylaw at 2010 annual meetings is not the right choice for every company.
- However, it is a strategy worth considering and will be the right one for a number of companies, particularly those that feel particularly exposed to the possible abuse of the SEC's proxy access regime by corporate governance or investor activists.

### Some of the Perils of Proxy Access

- The issues relating to how proxy access would work and its impact on corporate governance have been set forth in detail by a wide variety of commentators.<sup>1</sup> One of the most fundamental issues is how proxy access will be used once the SEC rule is adopted and the underlying reasons for its use.
- In the debate on the SEC's proposed proxy access rules, the activist corporate governance community (principally labor unions and public employee pension plans) has taken the position that proxy access will rarely be used and then only in the most egregious situations.
- Nevertheless, a prescriptive proxy access rule could be subject to potential "abuse" in the form of frequent, quite possibly annual, proxy access election contests waged by corporate governance activists at "targeted" companies that have run afoul of those activists.
  - It is not far-fetched to worry that corporate governance activists will justify frequent proxy access election contests based on any number of reasons that, in their view, demonstrate a lack of board accountability, such as failure of the company to adhere to compensation guidelines of proxy advisory firms, failure of the company to accept other corporate governance initiatives favored by governance activists, failure of the company to implement shareholder proposals that receive high votes even if the board believes the proposals are not in the best interest of the company or, simply, perceived poor financial performance.
  - The ultimate threat, of course, is that corporate governance activists will use proxy access nominations in the same way, as often and for the same reasons they support withhold vote campaigns, with the difference being that an access nomination packs a lot more punch than a withhold vote campaign, particularly at companies that have plurality rather than majority voting.

- A second potential abuse would be for hedge funds and other activist investors to utilize proxy access election campaigns to influence control of the company by taking advantage of any number of possible loopholes in the SEC rule. While the SEC has stated that it does not intend proxy access to have control implications, commentators have pointed out a large number of provisions in the rule proposal that would permit activist investors to end-run the SEC's intent.
- Ironically, perhaps, large-capitalization companies would not be nearly as threatened by either form of potential proxy access "abuse" as mid-capitalization and small-capitalization companies. The reason is that large companies, when faced with an access election contest, would not, as a rule, react passively and allow nature to take its course. Rather, boards, having rejected adding the access nominee to the board's slate, would conduct a full fledged election campaign. To succeed in electing an access director, the nominating shareholders would need to respond in kind. The likely result would be the equivalent of a full-fledged conventional proxy contest, replete with shareholder "fight letters." The theoretical cost advantage to the access nominating party of getting 500 free words in the company proxy statement supporting its access candidate and a place on the company's proxy card would be overwhelmed by the cost of a full-bore election contest. Moreover, use of a universal proxy card under proxy access would significantly disadvantage an insurgent campaign because, under existing vote tabulation procedures, the insurgents would not have access to the votes being cast on completed proxies. The running tally of completed proxies would be communicated only to the company.
- On the other hand, the exposure of mid-cap and small-cap companies to potential abuse of proxy access by activists of either stripe would be much higher. Here the smaller investor base would better lend itself to an election campaign based on Internet and telephonic communications, rather than shareholder mailings. Moreover, the company's resources to contest the access election would often be more limited, thus reducing the expense of a proxy contest. Given the significantly reduced cost implications of a proxy access candidacy, it would not be surprising, for example, to see activist investors or governance advocates trying to utilize proxy access. Additionally, the limited resources of mid-cap and small cap companies, coupled with the economic costs and management and board distractions of an election contest, make it more likely that mid-cap and small-cap companies would be willing to settle with a proxy access nominating shareholder by adding the access director rather than fight to the finish.

## The Pros of Early Adoption of a Proxy Access Bylaw

- The primary reason for proposing an access bylaw at the 2010 annual meeting is to get ahead of the timing of the potential SEC rule with an appropriately tailored proxy access regime.
  - If, as widely expected, the SEC rule is effective for the 2011 proxy season, companies would be subject to the SEC proxy access regime at their 2011 annual meetings unless they adopted opt-out bylaws at their 2010 annual meetings.<sup>2</sup>
  - Moreover, if the SEC were to provide a one-year grace period until 2012, companies may face shareholder generated proposals for proxy access regimes at their 2011 annual meeting that conflict with what the company considers appropriate for its circumstances and therefore may find themselves on the defensive if they respond with alternative proposals for a company designed regime.
- Early adoption of a proxy access bylaw at 2010 annual meetings has advantages in addition to insulating a company from living with the SEC regime in 2011 or a shareholder proposed regime in 2012 and thereafter.
  - If the final SEC rule is not workable at a given company or considered inappropriate (for example, because of the company's particular board or capital structure, or its perceived vulnerability to proxy access "abuse"), the company would have nothing to gain by deferring proposal of an alternative proxy access regime more suited to the company's circumstances.

- Voluntarily proposing a proxy access bylaw should be perceived as both shareholder friendly and an endorsement by the company and its board of progressive corporate governance. For many companies, this would be an attractive reason for adoption of an opt-out bylaw.
- More importantly, over time it is likely that proxy advisory firms and institutional investors will establish voting policies for proxy access bylaws that, as a practical matter, will limit a company's flexibility in setting the terms of opt-out bylaws. Acting before these voting policies become set in stone could give early adopters of proxy access bylaws more leeway to tailor proxy access system to their particular circumstances than later adopters.<sup>3</sup>

## The Cons of Early Adoption of a Proxy Access Bylaw

There are, however, a number of reasons for not acting at the 2010 annual meeting.

- The absence of a final SEC access rule until sometime in the first quarter of 2010 (or, perhaps, later) raises uncertainties about whether a final rule will be in place prior to the filing of company proxy materials, whether the final rule will permit private ordering in the form of shareholder adopted bylaws, whether private ordering will be restricted and, if so, the nature of the restrictions.
  - These uncertainties will raise obvious questions from senior management and boards about why it makes sense to rush in before the final rules are in place and there has been ample time to evaluate their potential effect on the company. Moreover, senior managements and boards naturally may be reluctant to assume the role of an early mover and find themselves too far out in front of their peers. These concerns will be compounded by the time, energy and expense (not to mention the "political capital" expended with senior managements and the board) of preparing a tailored proxy access bylaw which could be for naught if the final SEC rule precludes private ordering or severely limits its scope.
- Another possible negative of proposing a proxy access bylaw at a company's 2010 annual meetings is the quandary a company would face if the final rule is not available when the company files its preliminary proxy statement<sup>4</sup>—should it delete the proposal to avoid the potential embarrassment of misjudging the final rule or should it go public by filing its preliminary proxy statement with the proposed access bylaw. (Of course in the latter case, a company would have the ability to modify the proposed bylaw or withdraw it entirely so long as the SEC acts prior to the company's 2010 annual meeting).
  - The worst case would be if the SEC doesn't act prior to a company's 2010 annual meeting, the opt-out bylaw is approved by shareholders and the SEC subsequently adopts a final rule that precludes private ordering entirely or that restricts private ordering in some respects that conflict with the shareholder adopted bylaw.
    - In the former case, there is not much to say, other than the company tried and failed.
    - In the latter case, provided the bylaw has a broad savings provision (which we would recommend), only those provisions that conflict with the SEC rule would fall, and the balance of the bylaw should remain operative. While this would not be an optimum result, it is quite possible that the SEC restrictions on private ordering would only go to certain salient features of proxy access, such as the threshold number of shares required for a nomination, the duration of the required holding period and the standards of independence a nominee must have with regard to the company.
    - If this proves to be the case, there could be much left of value in well-drafted proxy access bylaws, such as assuring workability, closing loopholes that could be abused for control purposes, imposing uniform informational requirements on all shareholder nominees modeled on modern advance notice bylaws and adjusting timetables to those of the company's nominating process.

- Another consideration militating against early adoption of a proxy access bylaw is that preparing a proposal for an access bylaw at the 2010 meeting would require many difficult judgments in terms of investor acceptability. For example, should the ownership threshold be set at 1 percent, 3 percent, 5 percent or higher, should the continuous holding period be one year or two, should the bylaw impose higher independence requirements from the company than the proposed SEC rule and should it require that the nominee be independent from the nominating shareholder? The list of design issues is long and complicated, making the design of a proxy access bylaw challenging.
  - The concern about shareholder acceptability can (and we recommend should) be substantially ameliorated through an informal consultation process with key shareholders. Many companies engage in a regular dialog with their larger shareholders and could use their existing process to vet a proposed access bylaw in advance. Those who don't follow this practice could do so on a one-time basis. In so doing, companies could present the bylaw proposal in the spirit of fostering positive shareholder relations, being responsive to shareholder views and being progressive in their approach to corporate governance.<sup>5</sup>
- Finally, companies may be concerned that successfully proposing a bylaw proposal considered too favorable to the company by corporate governance activists will inevitably make those companies targets for shareholder proposals for far more investor "friendly" access bylaws. This risk, however, is not confined to early adopters at 2010 annual meetings. It is an inextricable risk for all companies that successfully sponsor access bylaws in lieu of the SEC rule.

## Conclusion

- Early adoption of a proxy access bylaw at the 2010 annual meeting is not for every company.
  - Companies that have established policies of being leaders in corporate governance and confidence in their ability to engage in a constructive consultative dialog with their key investors and RiskMetrics are most likely to find the strategy appealing.
  - A large number of companies will not be focused on proxy access and will probably not worry about it until a final SEC rule is promulgated, or perhaps not until they actually receive a proxy access nomination or shareholder proposal. These companies will not be first movers on an opt-out bylaw.
  - We suspect most companies will fall somewhere between these extremes. Consideration of an early adoption strategy would be appropriate for these companies. Most, in all probability, will await the final SEC rule before considering proposing an opt-out bylaw. Some number, however, may decide to become early adopters of proxy access bylaws.
- Companies that decide to consider proposing a proxy access bylaw at their 2010 annual meeting should take immediate steps to analyze their shareholder base and to discuss the basic terms of their proxy access proposal with at least their key institutional shareholders, to determine whether the requisite vote on the proposal is achievable. This practical assessment should also include, if feasible, discussions of the basic terms of the access bylaw proposal with the leading proxy advisory firms to ascertain their views.
  - As we noted in our [Proxy Analysis No. 4](#), institutions that commented on the proposed rule had widely differing views on how proxy access should work. For example, the comment letter submitted by Barclays Global Investors, often a significant shareholder of large-cap and mid-cap companies, favored a triggering mechanism for proxy access (such as a high director withhold vote at a previous annual meeting). Many more institutions opposed any triggering mechanism. A significant number of institutions favored a two-year holding period, rather than the one-year period in the proposed rule. Many institutions, but hardly all, favored a higher ownership threshold than that of the proposed rule.

- As a result of the wide divergence of views expressed in the comment letters by institutional investors, the absence of guidelines from proxy advisory firms and the lack of any voting track record on proxy access bylaw proposals, the outcome of a particular vote almost certainly will hinge upon the mix of institutional and retail shareholders and the specific provisions of a proposed bylaw. Rather than plunging into a shareholder vote headfirst and blindfolded, so to speak, we recommend that companies informally test the waters with their particular shareholder base and, to the extent feasible, the leading proxy advisory firms.

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## Endnotes

<sup>1</sup> These commentaries include our prior *Proxy Analyses*, available at: <http://www.lw.com/AboutLatham.aspx?page=proxyAccess> and [http://www.georgeson.com/usa/resources\\_research.php](http://www.georgeson.com/usa/resources_research.php); and the comment letters submitted to the SEC in response to its proposed rule entitled "Facilitating Director Nominations" by the Committee on Federal Regulation of Securities of the American Bar Association dated August 31, 2009, Cravath, Swaine & Moore LLP, Davis Polk & Wardwell LLP, Latham & Watkins, LLP, Simpson Thacher & Bartlett LLP, Skadden, Arps, Slate, Meagher & Flom LLP, Sullivan & Cromwell LLP and Wachtell, Lipton, Rosen & Katz dated August 17, 2009; the Corporate Leadership Initiative, Business Roundtable dated August 17, 2009; and The Society of Corporate Secretaries and Governance Professionals dated August 13, 2009.

<sup>2</sup> This assumes (1) the SEC rule will not permit opt-out through board adopted bylaws and (2) few or no companies will call special stockholder meetings later in 2010 to vote on a company proposed opt-out bylaw in time to foreclose application of the SEC rule at the 2011 annual meeting

<sup>3</sup> RiskMetrics has a proxy access provision in its bylaws for continuous holders of at least 4 percent of the common stock for at least two years. Unless and until amendment of this bylaw, it could be embarrassing for RiskMetrics to issue a voting recommendation against an otherwise reasonable access bylaw that fits within these parameters.

<sup>4</sup> The inclusion of the management proposal to adopt an opt-out by law would invoke the SEC's traditional proxy review process.

<sup>5</sup> We also recommend that companies seeking to adopt proxy access bylaws at their 2010 annual meetings consider vetting their proposed bylaw with RiskMetrics before filing their proxy materials. It seems unlikely that RiskMetrics will adopt any voting guideline policy for proxy access for the 2010 proxy season. It may, however, be willing to consult informally with companies contemplating a proxy access proposal.

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