The Harvard Law School Forum on
Corporate Governance and Financial Regulation

Shareholder Choice in a World of Proxy Access

Posted by Stanley Keller, Edwards Angell Palmer & Dodge LLP, on Thursday December 31, 2009

Editor's Note: Stanley Keller is partner of Edwards Angell Palmer Dodge LLP. This post is by Mr. Keller, Robert Todd Lang and Charles M. Nathan. Mr. Lang is a partner of Weil, Gotshal & Manges LLP; and Mr. Nathan is a partner of Latham & Watkins LLP. The views expressed in this paper are solely those of the authors and not those of other members of their respective firms, any of their firms' clients or any organizations with which they are associated.

Although there can be legitimate debate over whether there should be a federally-mandated proxy access rule, if we assume that the Securities and Exchange Commission does adopt a final proxy access rule in 2010, two critical issues are whether the rule will allow for shareholder choice and, if so, what paradigm will be used. This paper first addresses the cases for and against shareholder choice and concludes that shareholder choice should be permitted on proxy access. It then explores the two principal paradigms the Commission's final proxy access rules could utilize to provide shareholder choice and makes recommendations on key implementation issues under each paradigm.

The debate at the Commission's open meeting in May 2009, preceding its divided vote to propose proxy access rules, centered on issues of shareholder choice and private ordering. As proposed, the proxy access rules would give shareholders only a right to liberalize proxy access, but no right to make the terms of proxy access more restrictive or to opt-out completely. Many commentators have criticized the asymmetrical, "one way street" aspect of this version of shareholder choice and argued for a broader version that would allow greater freedom to shareholders to vary the SEC prescribed access regime in either direction.

Shareholder choice has a number of possible meanings in the context of proxy access. For purposes of our analysis, we define shareholder choice as a right of shareholders of a company, through bylaw adoption or ratification of a board adopted bylaw, to implement or vary the terms and conditions of proxy access for that company or to choose not to apply a proxy access regime, possibly but not necessarily in favor of an alternative approach, such as a proxy contest reimbursement policy. This definition is intended to be broad and non-prescriptive. We will

address in later sections of this paper how shareholder choice should be implemented and whether and under what circumstances shareholder choice might or should be circumscribed.[1]

Paradigms for Shareholder Choice; Purpose of Proxy Access

There are two fundamental paradigms for integrating shareholder choice into a proxy access regime intended to make proxy access available at public companies subject to Commission proxy access rules.

- The first presupposes a prescriptive SEC "default" rule that would be applicable to all covered public companies, unless shareholders of a company adopt a different proxy access regime by amending the company's bylaws or by ratifying a board amendment to the company bylaws—commonly called an "opt-out" structure. As noted above, the opt-out could be in favor of a different proxy access process, easier or more limited in terms of shareholder ability to make proxy access nominations, or it could eliminate proxy access in its entirety.
- The second would invert the process by creating an "opt-in" structure, which would provide for shareholder action to implement a proxy access regime by directly adopting a bylaw or by ratifying a board adopted bylaw that creates a proxy access process.

Under either paradigm, we would expect the Commission to amend the existing grounds for exclusion of shareholder proposals under Rule 14a-8 to permit proxy access proposals.[2] As we explore in more detail below, amending Rule 14a-8 to permit shareholder proposals for proxy access will encourage company boards to implement proxy access under an opt-in regime and will create significant shareholder leverage against board "overreaching" in an opt-out regime. In addition, as we describe below, the two paradigms are not mutually exclusive but could be combined on a temporal basis to form a rational implementation process—for example, by utilizing opt-in for an initial transitional period and then changing to a default rule driven opt-out regime.

We consider it important that agreement on the rationale for providing proxy access be established at the outset. Absent a commonly held view of purpose among the Commission, its staff, company boards and the investor community, it is impossible to prescribe and implement an access regime that is coherent, consistent and workable and that does not go beyond the agreed purpose in its operation.

---

[1] To be clear, we believe shareholder choice regarding proxy access should be a continuing right, not a one time election. Shareholders should, in our view, remain free to change their mind regarding whether to adopt, modify or eliminate a shareholder approved proxy access regime.

[2] There is widespread agreement that Rule 14a-8 should be amended to permit shareholder resolutions regarding proxy access. As we discuss below, the critical question is not whether shareholder proxy access proposals should be permitted, but rather the limits on and conditions of the availability of this mechanism in terms of the content of shareholder proposals regarding proxy access.

We believe there is, in fact, a widespread consensus that the purpose of proxy access is to facilitate through use of a company's proxy materials the ability of long-term shareholders who have a meaningful ownership stake in the company and no-control purpose to seek election of a limited number of persons they nominate for election as directors in a manner that has no control effect.

The following discussion of shareholder choice on proxy access is premised on this statement of its purpose. Moreover, as we will develop in a later section of this paper, that purpose should be key in determining whether, and if so what, limitations should be placed on the exercise of shareholder choice regarding proxy access.

The Pros and Cons of Shareholder Choice

The arguments for shareholder choice can be concisely stated.

- The rationale for shareholder choice begins with the observation that the fundamental basis for a proxy access regime is to provide shareholders with a more effective process for participating in the nomination and election of directors. At its heart, proxy access is about enhancing shareholder choice in the selection and election of directors. It would be anomalous, to say the least, for the Commission to enact a prescriptive regime intended to facilitate shareholder choice in director elections, while at the same time denying shareholders the right to vary that regime to make it easier or harder to utilize the proxy access mechanism.
- The desirability of shareholder choice is also based on the universal enabling premise of state corporation law statutes—that within very broad parameters shareholders of a company have the right and ability to choose the particulars of their corporation's governance system. Shareholder choice is far more compatible with the enabling philosophy of corporate laws than a one-size-fits-all prescriptive rule.
- A closely related argument in favor of shareholder choice is that matters of internal corporate governance have historically been reserved to the states and have not been the province of federal regulation. Accepting for present purposes that the Commission has statutory authority to adopt a prescriptive proxy access regime, permitting shareholder choice under that regime squares best with our federal system and long-standing tradition of according priority to the states in matters of internal corporate governance.
- Finally, and to many most important, is that all relevant constituencies seem to agree that proxy access must be workable in practice and suitable in the context of the various circumstances presented across the spectrum of the 10,000 or so companies estimated to be subject to the Commission's proxy access proposal. For the Commission to achieve

workability and suitability in a one-size-fits-all prescriptive proxy access rule would be nothing short of remarkable. Moreover, as circumstances and corporate and shareholder structures change among the vast number of covered companies, a prescriptive rule becomes increasingly more likely to raise workability and suitability issues. Rule interpretation by the SEC staff (which would not be binding) and courts is a cumbersome and impractical process for assuring workability and suitability. Rule amendment by the Commission would be an even more cumbersome and impractical way to address workability, suitability and changed circumstances. Shareholder choice, in contrast, particularly in combination with director action (as would be the case in a board-designed access bylaw ratified by a majority of shareholders), would afford a practical and time-tested process to achieve the workability and suitability that proxy access requires in the context of the thousands of companies subject to the Commission's regime.[3]

The arguments against shareholder choice can also be succinctly summarized.

- First, a number of opponents of shareholder choice argue that the Commission's proxy access rule is nothing more or less than a disclosure rule and does not create substantive rights regarding either the nomination or election of directors which are matters of state corporate law. These observers note that neither shareholders nor registrants have the option to vary any other proxy or disclosure rules. Why, they argue, should a proxy access rule be treated differently?
- A second argument against shareholder choice begins by noting correctly that not all companies permit shareholders to amend bylaws by a simple majority vote of outstanding shares: a small number do not permit shareholders to amend bylaws and some require a supermajority vote of outstanding shares.[4] Similarly, critics of shareholder choice also point to the fact that a number of companies have multiple classes of stock with disparate voting rights. In many of these capital structures a high vote class of stock would have the voting power to adopt a proxy access bylaw not favored by holders of a majority of the low vote shares, even though the latter might represent a larger portion of the company's equity capital.[5]

---

[3] Professor Grundfest has published an article that makes a forceful case shareholder choice is required to be part of the Commission's access rules to achieve compliance with the Administrative Procedure Act. See Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, available at http://ssrn.com/abstract=1491670 (the "Grundfest Article").

[4] Some critics of shareholder choice cite the recent amendments of the Delaware General Corporation Law and the Model Business Corporation Act as evidencing a lack of authority under corporate enabling statutes for board or shareholder adopted proxy access bylaws. We disagree that there were any intended negative implications in the Delaware and Model Act amendments and believe boards and shareholders have the authority to adopt proxy access bylaws under enabling corporate statutes. Those amendments were first, confirmatory, and second, spelled out the ability to include reasonable conditions.

[5] These arguments are the linchpin of a study conducted by Beth Young, Senior Research Associate at The Corporate Library, for the Council of Institutional Investors and Shareholders Education Network. We refer to this paper as the "Corporate Library Study".

- A third argument, not often articulated but we believe firmly held by a large number of corporate governance activists, is that shareholder choice in practice is often influenced or even determined by the control of boards and management over proxy materials and the proxy process, notwithstanding the right of shareholders to vote their true interests. In this view, shareholder choice might be a prescription for companies successfully to persuade shareholders to act against their true interests and therefore should not be permitted.
- An even more paternalistic reason not to permit shareholder choice is that proponents of proxy access know better than shareholders what governance system is good for shareholders. In this view, the advantages of proxy access are so inherently valuable that any dilution or elimination of shareholder access should not be permitted.[6]

The Pros Have It

In the view of the authors, the arguments in favor of shareholder choice clearly prevail.[7]

- First, to characterize the Commission's proposed proxy access rule as being only about disclosure is disingenuous and inaccurate.
    - Proposed Rule 14a-11 does not deal with disclosure (except to the extent it mandates filing of a Schedule 14N), but rather with creation of a substantive entitlement to utilize company resources for proxy access that does not now exist under federal or state law (except for North Dakota). The disclosure aspects of the proposed regime are contained in separate proposed Rules 14a-18 and 14a-19, in proposed Schedule 14N and in other proposed rule amendments. In fact, the Commission's proposals include an independent disclosure Rule 14a-19 that is intended for proxy access regimes established by state law or company bylaw independently from the Commission's proposed Rule 14a-11, thus recognizing that the latter rule is not about disclosure but rather about eligibility for proxy access.
    - Moreover, if the Commission believed that its proxy access regime was merely about disclosure, why would its rule proposals permit shareholders to vary the terms of proxy access by making access easier, but not more restrictive. The

[6] Professor Grundfest advances a more cynical explanation for the ardent opposition of public pension funds, union pension funds and unions to allowing shareholder choice. He argues that these constituencies want an easily accessible prescriptive regime for proxy access, without any opportunity for shareholder choice, to create what he calls "megaphone externalities and electoral leverage" and that the political alliance between labor and the Democratic administration and Congress heavily influences the Commission's decision -making with regard to proxy access. See Grundfest Article at Section 4.

[7] Both Professor Grundfest and Professor Bebchuck, who agree on very little in the context of proxy access, do agree that shareholder choice should be included in any Commission proxy access regime. See Grundfest Article and Lucian A. Bebchuck & Scott Hirst, *Private Ordering and the Proxy Access Debate*, available at The Social Science Research Network Electronic Paper Collection: http://papers.ssrn.com/abstract=1513408 (the Bebchuck & Hirst Article), particularly at Section III.

notion of shareholders having the ability to alter other disclosure rules does not exist anywhere else in the proxy rules (or any other Commission disclosure rules). Why, then, is this concept included in proposed Rule 14a-11 if the rule truly is only about disclosure?

  - The simple fact is proposed Rule 14a-11 is not about disclosure but about the circumstances under which shareholders would have the ability to utilize the company's proxy materials to promote nominees for director in opposition to board candidates. It creates substantive rights to use what is clearly recognized as a company document that simply do not exist under any state law, other than that of North Dakota.
  - In sum, although the Corporate Library Study asserts that shareholder choice and other private ordering would be "a departure from the mandatory approach seen in other areas of US securities regulation," it is proposed Rule 14a-11 that represents unprecedented SEC rulemaking by seeking to preempt state law sanctioned governance measures, including those approved by shareholders. It is thus appropriate to permit shareholder choice in order to reconcile a federally imposed governance rule with the traditional state law role on corporate governance.

- The second argument against shareholder choice, based on the fact that some companies require greater than majority shareholder votes to amend bylaws and/or have different classes of stock with disparate voting rights, suffers from several logical fallacies.
  - First, that some 35-40% of companies included in three major stock indices[8] have supermajority voting requirements for bylaw amendments has no logical connection to the merits of shareholder choice. It is analogous to saying that we should not have Presidential elections because the Electoral College may not mirror the popular vote or that we should not elect legislators because some legislative districts are gerrymandered. The fact that valid voting systems may be viewed as imperfect does not mean we should not use the voting systems we have. If shareholder democracy is allegedly imperfect because some companies require supermajority votes for bylaw amendments, then an appropriate remedy would be to promote reform of the bylaw amendment rules for those companies. It is a *non sequitur* to conclude that because some companies are perceived to have imperfect bylaw amendment processes, there should not be a right at any

[8] The Corporate Library Study reports that 39.1% of Russell 3000 index companies, 36.1 % of Russell 1000 index companies and 35.4% of S&P 500 index companies require supermajority votes for shareholder amendments of bylaws. The Corporate Library seems to inflate these percentages by combining companies with supermajority voting provisions and those with classes of stock with disparate voting rights to produce higher percentages of companies where shareholder choice is "impeded" by corporate voting structures. As we discuss below, the latter type of voting structure is simply not comparable to supermajority voting and combining the two creates a wrong impression and is not useful analytically.

company for shareholders to adopt or amend proxy access bylaws. Moreover, supermajority voting requirements reflect a governance regime approved or accepted by shareholders companies with those regimes.[9]

- Second, conceding for the sake of argument that achieving a supermajority vote for a bylaw amendment is more difficult than achieving a simple majority,[10] the degree of difficulty cuts two ways.
  - In an opt-out regime based on a prescriptive SEC default rule, where shareholder choice in the form of a bylaw amendment is required to vary the proxy access process, any perceived or actual difficulty of opting-out reinforces the prevalence of the SEC default rule. Supporters of an SEC default rule should be pleased, not critical, that some 35-40% of corporate America requires a supermajority voting standard for shareholders to adopt an opt-out bylaw.
  - On the other hand, in an opt-in regime where shareholders must adopt or ratify a proxy access bylaw to implement a proxy access regime, a supermajority vote requirement can fairly be criticized by proponents of proxy access regime as making opt-in some instances more difficult to achieve than would be the case under a majority voting standard. But to the extent the argument has validity[11], it does so only in the context of an opt-in proxy access regime and only in limited circumstances.
  - Moreover, critics of an opt-in regime based on imperfections in shareholder rights to adopt proxy access bylaws by simple majority voting should acknowledge that shareholder ratification of board adopted access bylaws would rarely (if ever) require supermajority approval[12] and that management support of a shareholder proposed proxy access bylaw

[9] We do not believe that supermajority voting requirements for bylaw amendments are inherently contrary to good corporate governance or otherwise unfair or inappropriate. Supermajority voting may not accord with simplistic notions of shareholder democracy, but it nonetheless may serve valid purposes that are compatible with good corporate governance models. Many democratic political models require supermajority votes for some purposes. It may be harder to defend a governance regime that does not permit shareholder amendment of bylaws under any circumstances, but these are rare. Moreover, as with supermajority voting requirements, the solution is not to deprive shareholders of all other companies of their right to exercise shareholder choice; it is to consider change in the governance structure of the small minority of companies that do not permit shareholders to amend their bylaws.

[10] Whether in any particular case a supermajority is more difficult to achieve than a simple majority depends on the supermajority required (e.g., 66 2/3%, 75%, 80%), whether the supermajority is of the shares voting, the shares represented at a meeting or the shares outstanding, the composition of the shareholder body (e.g., the presence or absence of a large cohesive block of shares favoring or opposing the proposal or a very high proportion of institutional investors that vote in accordance with proxy advisory recommendations) and the degree of support for the proposal among shareholders (e.g, board declassification and separation of the CEO and the board chair typically draw far higher shareholder support than environmental proposals). Many shareholder votes, particularly on uncontested matters supported by management, routinely achieve supermajority support sufficient for bylaw amendment.

[11] The criticism ignores that shareholders of companies with supermajority voting requirements made a choice when they acquired stock in the particular company.

[12] Indeed, we believe in both opt-out and opt-in regimes the far more prevalent pattern would be for boards to adopt bylaws and seek shareholder ratification requiring only a majority vote. The reasons include the natural desire of boards to assure workability and to avoid shareholder proposed regimes that could be used to affect control or to eliminate meaningful limits on eligibility to utilize the proxy access process. The Corporate Library Study ignores the likely prevalence of the shareholder ratification pattern which would eliminate the supermajority voting requirements that the Study assails.

would often result in adoption of the bylaw by the requisite supermajority.[13]

- Critics of an opt-in proxy access system should also acknowledge that the ability of shareholders to use Rule 14a-8 to propose proxy access bylaw amendments and the increasing success of director "vote no" campaigns create significant leverage on behalf of shareholders that can and, we are confident, would be used by shareholders in an opt-in regime.
- In sum, the likely prevalence of shareholder ratification, as opposed to shareholder adoption, of proxy access bylaws and the threat of shareholder access proposals counter balance to a significant degree the existence of supermajority voting requirements at many public companies.

  - As noted above, critics of shareholder choice also point to the existence of separate classes of voting stock with disparate voting rights as a "distortion" in the voting system at a relatively small minority of public companies as a reason not to incorporate any shareholder choice in a SEC prescribed proxy access regime.[14] This argument ignores, among other things, that if the high vote stock has sufficient voting power to "thwart" the will of the holders of a majority of the lower voting shares, the holders of the higher vote shares likely would have sufficient voting power to deny election to proxy access nominees. Little purpose would be served by an SEC imposed proxy access regime, if, as supposed by the critics of shareholder choice, holders of majority voting power would be antagonistic to proxy access in theory and practice.

- We conclude by turning to the "paternalistic" arguments against shareholder choice premised on a lack of trust in the wisdom or legitimacy of a choice by a majority of shareholders for a governance regime different from that prescribed by the Commission or advocated by the corporate governance activist community.
  - This objection to shareholder choice must fail because it simply ignores the reality that not all shareholders agree on the appropriate structure for proxy access. This is illustrated by, but hardly limited to, the more than 500 hundred comment letters the Commission received in response to its proxy access rule proposal. These comment letters contained a wide diversity of views even on the

[13] According to the Corporate Library Study, in companies requiring supermajority votes for declassification of boards, 85% of management supported declassification proposals achieved the required supermajority votes during the period 2004-2009.

[14] According to the Corporate Library Study, 7.5% of Russell 3000 companies, 8.8% of Russell 1000 companies and 7.1% of S&P 500 companies have multiple classes of stock with disparate voting rights, although it is not clear from the Study whether all of these companies have two classes of common stock, one high vote and the other low vote, or whether the classification also includes other capital structures where the higher vote class has a commensurately greater economic value, as would be the case with certain preferred stock capital structures.

most fundamental questions, such as size of ownership threshold, minimum holding period, maximum number of access directors and provisions to obviate access from being used as a vehicle for a change of control.

- More fundamentally, of course, is whether and why there should be access at every public company. Some shareholders might well prefer an alternative to access in the form of a proxy expense reimbursement policy. Indeed, it is far from implausible that a majority of shareholders of some companies might conclude that access will be too costly, distracting and divisive and therefore vote not to have any access regime. Similarly, some shareholders might view proxy access as undermining the efficacy of majority voting for directors because it promotes election contests to which majority voting typically would not apply. Put another way, what is so compelling about the creation of a proxy access right that should lead the Commission to create a regime which affirmatively excludes the judgment of shareholders as to its structure and application to the companies in which they have invested?

Transition Issues for Implementation of Shareholder Choice

Assuming the Commission's final rule provides scope for shareholder choice, it is important to consider transition issues in terms of the timing of the effectiveness of the final rules and the initial opportunity to exercise that shareholder choice. These transition issues will differ for an opt-out regime and an opt-in regime.

Transition to an Opt-Out Proxy Access Regime

The fundamental transition issue for an opt-out regime arises from timing considerations based on the corporate annual meeting cycle.[15] If, as seems probable, the Commission adopts final proxy access rules in the early part of 2010, it is natural to assume they would become effective for the 2011 proxy season. However, this timing would not provide any opportunity for companies and shareholders to exercise shareholder choice in time for the alternative shareholder adopted regime to become effective in time for the 2011 annual meeting cycle.[16] The outcome would be that the Commission's default rule, as a practical matter, would apply universally for the 2011 annual meeting cycle, and it would not be until the 2012 annual meeting cycle that companies and shareholders would have the opportunity to implement a more workable or suitable proxy

[15] It is important to note that workability would still be a significant issue under an opt-out regime because the default rule would still have to be workable for the companies subject to it. At best, an opt-out regime would mitigate the significance of workability concerns by permitting individual companies and their shareholders to tailor the default rule to fit their particular needs.

[16] We assume few companies would be willing to go to the trouble and expense of holding a special shareholder meeting later in 2010 merely to propose an alternative proxy access regime for shareholder adoption in time for their regular 2011 annual meetings.

access regime.[17] The lack of an effective transition period prior to the operation of a default access rule in this scenario would both undermine the efficacy of shareholder choice and lead to potential confusion and inefficiency as companies grapple with the workability and suitability issues presented by the Commission's prescriptive rule at their 2011 annual meetings and simultaneously ask their shareholders to adopt a more workable or suitable alternative at their 2011 annual meetings to take effect for the 2012 annual meeting cycle.[18]

We believe there are two practical ways the Commission could deal with the transition issues inherent in adopting a default proxy access regime that permits shareholder choice through an opt-out procedure.

- The first would be for the Commission to provide that, ***for the 2011 proxy season only***, boards as well as shareholders could adopt proxy access bylaws which have the effect of opting-out of the Commission's default access regime. However, in 2012 and thereafter, the Commission's default rule would apply to all companies, unless they had opted-out through a shareholder adopted or a shareholder ratified bylaw.
    - This structure would lead many company boards to adopt alternative shareholder access bylaws to be effective at their 2011 meeting, and put those bylaws to a vote of their shareholders at the same meeting. If approved by shareholders, the board designed access bylaws would substitute for the Commission's default rule. If not approved, the board adopted access bylaws would become ineffective after the 2011 annual meeting, and the Commission's default access rules would apply to the company in question going forward, unless subsequently changed by shareholder action.
    - This transitional structure has several advantages. First, in the initial 2011 proxy season, the Commission's default rule would apply only to those companies that had chosen not to adopt their own proposals. This would limit the number of disputes that the staff would be forced to handle in the first year of the new rules' existence. Furthermore, boards would be motivated to implement access provisions that would be acceptable to their shareholders immediately and would have the bulk of 2010 and the early part of 2011 to work with investors on

[17] For simplicity, we are focusing on companies with year-end fiscal years. Depending on when it takes final action, the Commission would need to provide a comparable transition for fiscal year companies.

[18] There is one other potential solution to the transition problems that would arise if the Commission were to apply its default rule for the 2011 annual meeting cycle. Companies could ask their shareholders to adopt a more tailored proxy access regime at their 2010 annual meetings. As commentators have pointed out, while feasible, this strategy has a number of practical drawbacks and is unlikely to be adopted by very many companies. See *Latham & Watkins LLP and Georgeson & Co. Corporate Governance Commentary: Proxy Access Analysis No. 5* available at http://www.lw.com/upload/pubContent/_pdf/pub2914_1.pdf and http://www.georgeson.com/usa/download/reports/CorpGovCommentary_120709.pdf.

workability and other issues in a reasonable and unhurried timeframe.[19] If no consensus could be reached within that timeframe, the board adopted bylaws for 2011 would not be ratified by shareholders and the Commission's access rules would serve as an automatic fallback beginning in 2012.

  - The obvious objection to this transitional structure is that in the first year boards will be able to adopt opt-out bylaws without shareholder ratification. For the initial transition year, in theory if not practice, the opt-out process would have nothing to do with shareholder choice, and there would be no protections against board "abuse" of its one-year "free-writing" opportunity. While many observers of corporate governance will consider the risks of boards behaving badly exaggerated and inconsistent with how most public company boards act (citing, for instance, public company board initiatives to adopt majority voting, to declassify boards and to split the functions of board chair and CEO), corporate governance activists may well argue as or more vociferously against any provision, even a one-year transition rule, that permits boards to exercise unfettered discretion to adopt opt-out bylaws.[20]

- The alternative transition process would be for the Commission to delay effectiveness of its default rule until the 2012 proxy season and thereby permit companies and their shareholders a year to fashion an alternative, more workable and suitable proxy access system for shareholder ratification at the 2011 annual meeting, with the shareholder adopted system to take effect at or prior to effectiveness of the Commission's default rule in 2012.[21]

  - This transition process would have the obvious benefit of making shareholder choice the *sine qua non* of the opt-out regime. There would be no opportunity for boards to act "badly" for even a single transition year. It would effectively make opt-out a matter of shareholder choice in all circumstances, thus vindicating the rationale for shareholder choice in the proxy access context without providing even a temporary aberration from that principle.
  - On the other hand, this transition process will obviously have the effect of delaying implementation of proxy access at some, perhaps most, companies from 2011 until 2012.[22] While presumably not satisfying to proponents of proxy

[19] We also note that if Rule 14a-8 is amended to permit proxy access shareholder proposals in 2011, boards will be under additional pressure to design alternative proxy access regimes acceptable to a majority of shareholders.

[20] The Commission, in designing the opt-out right, could seek to limit director discretion but in view of its short-term nature, the preexisting authority of directors and the inherent complexities we do not believe this would be necessary or desirable.

[21] See note 17 above.

[22] A related transition issue is whether the Commission should amend Rule 14a-8 to permit shareholder proposals on proxy access at the 2011 annual meeting or should also defer effectiveness of this amendment until the 2012 proxy season. The comment letter submitted by the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association on August 31, 2009 (available at http://www.sec.gov/comments/s7-10-09/s71009-456.pdf) recommended that amended Rule 14a-8 not take effect at least until 2012 to give boards an opportunity to deal with proxy access on a voluntary basis. The delay would permit companies to engage in an orderly

access, we believe that the need for an orderly transition to a workable proxy access regime applicable to perhaps more than 10,000 public companies and the vindication of shareholder choice which is the primary rationale for proxy access itself far outweigh the loss of a year in implementation. In light of the fact that proxy access has been a hotly debated agenda item in the corporate, governance and regulatory communities at least since 2003, we think that implementing proxy access wisely and efficiently is far more important than the loss of a year of its effectiveness.

Transition to an Opt-In Proxy Access Regime

Transition to an opt-in regime does not appear to raise any significant issues. By hypothesis, there would be no Commission default rule and therefore no need to give shareholders an opportunity to act before imposition of a default rule. This, of course, is a major objection to an opt-in regime on the part of corporate governance activists and other supporters of proxy access—what would motivate boards to propose reasonable proxy access regimes in the absence of a "hammer" in the form of a Commission default rule. Other objections include impediments to shareholder ability to adopt access bylaws without board support, the "inefficiency" of an opt-in regime in terms of achieving the optimum proxy access process at each company in terms of what shareholders truly want as opposed to "half loaves" that may be adopted because of board support and the likelihood that in an opt-in regime all companies will not have proxy access initially and many may never have it.[23]

Proponents of opt-in counter by asserting that so long as Rule 14a-8 is amended to permit shareholder access proposals, there will be an ample "hammer" in the form of the threat or actuality of receipt of shareholder proposals for proxy access. The advocates of opt-in point to the huge success shareholders have had over the last ten years in dramatically restructuring corporate governance in the United States, including widespread redemptions of poison pills, declassification of boards, separation of the functions of board chair and CEO, adoption of majority voting by well over a majority of S&P 500 companies and the like. They also rightly point to the very changed perceptions of corporate governance and the role of shareholders in shaping corporate governance over the last decade. Boards no longer act with blissful indifference to

---

process to adopt an access bylaw tailored to each company's particular circumstances. However, supporters of proxy access are likely to argue against any delay in implementation of an amended Rule 14a-8 beyond the 2011 proxy season on the basis that absent the pressure of shareholder proposals companies will not deal with the proxy access issue. We believe the looming effectiveness of a Commission default rule in 2012 will provide sufficient incentive for all companies to act, even if they have no concern of receiving a shareholder proposal in 2011. On the other hand, if the Commission chooses not to delay implementation of an amended Rule 14a-8, we do not believe that shareholder proposals would be disruptive for companies seeking shareholder action on a board designed access rule at their 2011 annual meetings because the shareholder proposal would be excludable as conflicting with the board's proposal.

[23] See Bebchuck & Hirst Article at Section II. It is interesting to note that, at bottom, the fundamental pragmatic difference between Grundfest and Bebchuck is that the former favors an opt-in regime and the latter an opt-out regime.

shareholder views on corporate governance, compensation and a host of other issues. Recalcitrant boards are routinely subjected to "vote no" campaigns, which are increasingly common and increasingly effective. These dynamics, the advocates of opt-in argue, will give shareholders more than enough leverage with boards to ensure, if a broad group of investors so choose, that in a very few years proxy access will become the corporate norm under an opt-in system.

More fundamentally, the supporters of opt-in argue that a default rule will never be able adequately to deal with the workability and suitability issues across the spectrum of some 10,000 public companies. In their view, only private ordering (through shareholder choice under an opt-in structure) has sufficient flexibility and adaptiveness to deal with the variations of board and capital structures, shareholder composition and relationships to companies and their boards and other particular circumstances of all of our public companies.[24] Moreover, supporters of opt-in also point to the policy and regulatory implications of the adoption by the Commission of a default rule that in all probability will not be workable at all covered companies. In their view, the fact that shareholders may correct for workability problems is no basis for adoption of a rule inherently flawed by workability issues, foreseen or unforeseen.

The Need For Limitations on Freedom of Shareholder Choice

Both the proponents and opponents of shareholder choice are fearful that permitting shareholder choice could lead to bad decisions and inappropriate access regimes.

- Opponents of shareholder choice frequently cite the possibility that permitting shareholder choice could result in egregiously high standards for exercise of access (such as 10% or greater ownership thresholds, more than a two year holding period or, worse yet, a complete eradication of shareholder access).
- On the other hand, companies are fearful that an unbridled regime of shareholder choice operating through shareholder proposals under Rule 14a-8 could lead to evisceration of the purpose of proxy access and permit proxy access to be used for change of control purposes, nuisance proxy access nominations because eligibility standards are set too low or threats of proxy access nominations to create leverage for advancement of unrelated agendas.[25] Any of these or other shareholder "misuses" of proxy access would totally undercut the premise that proxy access is ***only*** for long-term, significant holders of stock without a control intent whose interests are presumably aligned with those of the bulk of shareholders.

[24] The Commission could promote company action under an opt-in regime by making Rule 14a-8 unavailable for shareholder proposals if a company has adopted a compliant proxy access regime that is consistent with the purpose for proxy access.

[25] See Grundfest Article at Section 4.

We believe this debate can be resolved by two simple but important structural devices:

- The first structural device would be to limit boards' rights to adopt or amend proxy access bylaws as follows:
    - First (except for a transitional year in 2011 if the Commission adopts the first transition structure we posited for an opt-out regime), boards would generally not be permitted to adopt or vary proxy access bylaws without shareholder ratification. The requirement for shareholder concurrence with board adopted access bylaws should alleviate all concerns of proxy access advocates about runaway boards eviscerating proxy access. If proxy access is eviscerated, it would only be with the approval of shareholders who would be exercising independent shareholder choice.
    - The only exception to the general principle that shareholder approval would be required for board adopted access bylaws that we would urge the Commission to include in its default rule would be to permit boards to adopt interim bylaw amendments solely for the purpose of curing obvious mistakes, ambiguities or other similar technical workability issues in either the Commission default rule or a shareholder adopted bylaw solely for the next annual meeting. Such technical corrective board action would not undermine the purpose for requiring shareholder approval of access bylaws and would require shareholder ratification to operate at any future shareholder meetings. In this way boards would be permitted to cure workability issues without giving them leeway to do more than necessary to make access workable at the next shareholder meetings.[26]
    - The underlying basis for significant constraints on unilateral board action is both a recognition that shareholder choice is the rationale for permitting private ordering and that requiring shareholder approval of board adopted bylaws provides a useful check and balance approach, which assures proponents of proxy access that boards won't abuse their bylaw adoption power to achieve results not acceptable to their companies' shareholders.
- The second structural device is intended to assure boards (and minority shareholders) that a majority of shareholders could not adopt a shareholder access bylaw that would be inconsistent with the purpose of proxy access. Because shareholder proposals under Rule 14a-8 would not be subject to the structural check and balance dynamic of requiring board and shareholder concurrence, we believe the appropriate and necessary structural solution would be for the Commission explicitly to provide that shareholder access

[26] The amendment to the Model Act permits limited director amendment of a shareholder adopted proxy access bylaw "in order to provide for a reasonable, practicable and orderly process," which otherwise would not be permitted under the Model Act.

proposals under Rule 14a-8 that do not meet the purpose for access may be excluded.[27] Under this structure:

- Rule 14a-8 would be amended to authorize shareholder proposed proxy access bylaws that comply with the stated purpose of proxy access (which would be defined by Commission rule) and that met compliance guidance parameters established by the Commission.
- The purpose of proxy access would be defined by Commission rule as limited to the facilitation through use of a company's proxy materials of the ability of long-term shareholders who have a meaningful ownership stake in the company and no-control purpose to seek election of a limited number of persons they nominate for election as directors in a manner that has no control effect.
- As we conceive this structural device, the Commission would also adopt guidance for compliant shareholder proposals that would cover, for example, such matters as:
    - Shareholder nominating groups could not exceed a specified number, for example ten.
    - Continuous minimum beneficial ownership of the shares may not be less than one nor more than three years.
    - Beneficial ownership means a net long position in shares including related voting rights. Continuity of ownership may be deemed not interrupted, among other reasons, by share loan arrangements and arrangements with respect to the voting of the shares by means of proxy, power of attorney or other instruments or arrangements related to death, disability, liquidation or occurrence of a comparable event.
    - The number of shares required to be beneficially owned during the holding period may vary with the capitalization, size, voting arrangements and other relevant factors applicable to the particular company but may not be less than 1%.
    - The maximum number of access nominees serving at a particular time may relate to the number of total directors on the board or in a class of directors, other contracts or arrangements to nominate directors and other relevant factors, but may not exceed, for example, 15% of the total number of directors, rounding down to the nearest whole number.
    - Each access nominee would be required to be independent of the company as defined by the rules of the applicable securities market or exchange and may be required to be independent of the shareholder proponent and its affiliates.

[27] The resolution of disputes regarding compliance would take place within the context of Rule 14a-8 as is now the case with other Rule 14a-8 proposals.

- Nominating shareholders would be required to disclaim a control intent or effect from the time notice of nomination is first given at least through the date of the shareholder meeting.

Concluding Remarks

If the Commission does adopt a default proxy access regime, it is essential that it be workable at all covered companies. We earlier expressed our doubts that this is a likely or, more fundamentally, a feasible outcome. Accordingly, it is critical that the Commission's final rule include practical and flexible means by which boards and shareholders can achieve the necessary workability in their particular situations. Moreover, whether the Commission chooses an opt-in or opt-out system, it is also essential that the purpose of proxy access be understood and accepted by all of the relevant constituencies so that proxy access may be properly and efficiently implemented and interpreted.

In any event, the debate over shareholder proxy access has gone on long enough and it is time to end it, especially in the context of what is realistically involved. The best way for the Commission to resolve this debate (and to assure workability can be achieved in all cases) is to allow for meaningful shareholder choice. We have tried to demonstrate in this paper why shareholder choice is the correct approach and that the fears of those who oppose it are unfounded. We also have explored alternative approaches the Commission could take for providing for shareholder choice on proxy access.