Who's Afraid of Proxy Access?

By Richard S. Grant and Jane Whitt Sellers

The Dodd-Frank Wall Street Reform and Consumer Protection Act enacted by the U.S. Congress this summer has received conflicting reviews — some see it as a defining event in financial services and public company regulation and others question how much it accomplishes when some of the more far-reaching proposals considered along the way did not make it into the final bill. In reality, the Act has some of both. It remains a work in progress, since many of its provisions are directives for rule-making by federal agencies, a process which will likely take at least another year to complete in a substantial way. However, one aspect has received a jump start, due to the fact that the Securities and Exchange Commission had already been working on the rules for years. That aspect is "proxy access" and it attracts adjectives like "game-changing," "empowering," "controversial," "imprudent," "sweeping," and "problematic."

What is proxy access? The term refers to new SEC rules that will allow eligible shareholders of a public company to use the company's proxy materials to solicit votes for the shareholders' nominees for the board of directors. The new rules will be effective in time for most of the 2011 annual meeting season (March to June), although smaller reporting companies will have three years before proxy access rules will apply.

Shareholder eligibility to make nominations is determined based on the amount of shares owned and the length of the ownership period. Access will be available to a shareholder who owns, and has owned continually for at least the prior three years, a minimum 3 percent of the company's voting stock. The rules include detailed provisions on how to calculate this amount. A key feature allows shareholders to aggregate holdings (but not to borrow stock) to meet the threshold.

The rule limits the total number of nominees available to qualifying shareholders under this new process to the greater of one or 25 percent of the board. Shareholders will not be able to use the new rules if they hold their stock with the intent of changing control of the company or gaining more seats on the board than is permitted under this process. The policy goal behind the rule is to give shareholders who are really the owners of the company, the ability to participate directly in determining the composition of the board of directors. Presumably this will occur only if they have been unable to prevail upon management and the existing board members to consider their suggestions. There is, however, no requirement that the shareholders employ informal means to obtain their objectives before availing themselves of the new direct route.

Another issue covered by the rules is what happens if there are a plethora of nominees. A company must include in its proxy materials the nominee or nominees of the nominating shareholder or group of shareholders with the highest qualifying voting power percentage. A previous proposal by the SEC that a "first in time" or "race to the ballot" approach be utilized was scrapped in the final rules.

To understand the new rules' significance, one must understand the traditional methods of nominating and electing corporate directors and some of the other changes that are taking place concurrently with the adoption of the proxy access rules. While shareholders have always voted to elect directors, the nominations normally come from the board itself. Historically, there may have been a great deal of overlap between boards and management but today, due to stock exchange rules and SEC requirements for the populating of key committees, U.S. public company boards are predominantly composed of directors who are independent of management and significant relationships with the company itself. Many boards use search firms to identify new candidates with desired characteristics or background, but in the end the new choices are vetted by the current board and in most cases, also by the chief executive officer. While thought by some to be nefarious, this approach seeks to ensure that a collegial and productive working relationship will exist on the board and between the board and management.

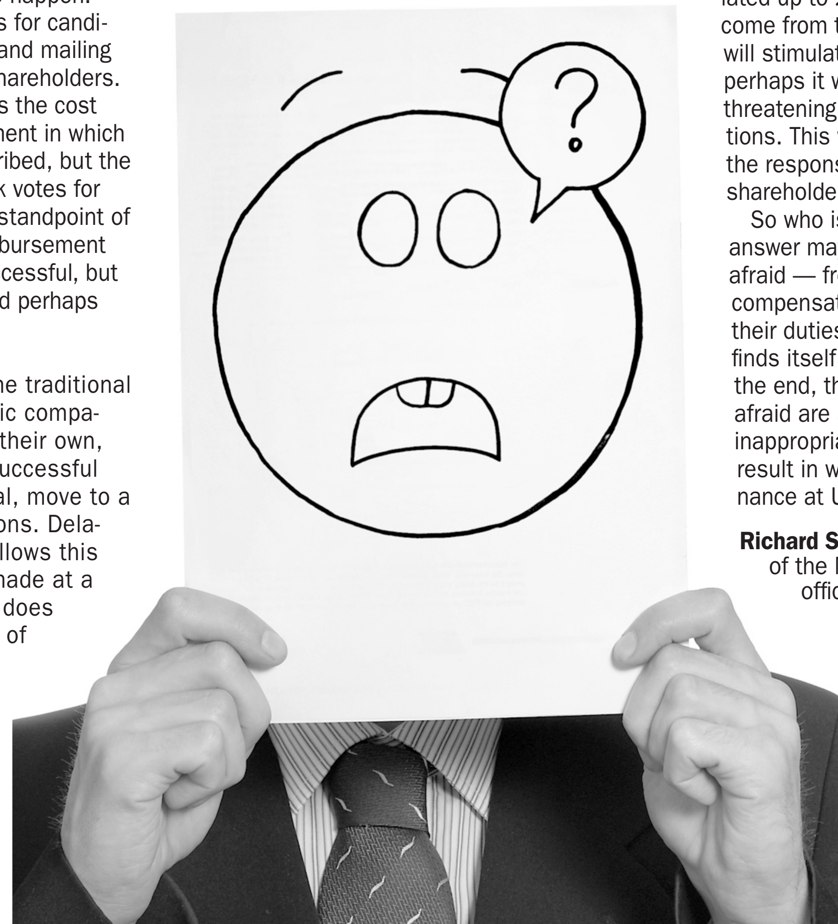
Once all nominees have been identified for positions on the board (where directors serve one year terms, the open positions will be all the seats on the board), they are put before the shareholders for a vote. The law of the state in which the corporation was organized will determine the manner in which the voting is conducted. For reasons we need address here, that state will usually be Delaware. However, the same general rules also apply to public corporations formed in California. The default election method under Delaware and California law is to elect the directors by plurality vote, which means that the nominees receiving the most votes will be elected. However, when the number of nominees is equal to the number of open seats, this means that as long as each nominee receives at least one vote, they will all be elected.

From a shareholder perspective, this process may largely foreclose their participation in the process of selecting directors. Even if they vote against the board's nominees, as long as someone votes for them, they will be elected due to plurality voting. If the shareholders wish to nominate additional candidates, most public companies' bylaws allow that to happen. The issue is that soliciting votes for candidates requires the preparation and mailing of a proxy statement to other shareholders. The company prepares and pays the cost of disseminating a proxy statement in which the board's nominees are described, but the shareholder who wishes to seek votes for its slate is on its own from the standpoint of the expense of a contest. Reimbursement may be available if they are successful, but the cost in the first instance and perhaps forever, is the shareholder's.

A primary change to the traditional process is that public companies may, either on their own, or as a result of a successful shareholder proposal, move to a majority vote system of elections. Delaware and California law now allows this alternative. If this change is made at a company, then a director who does not receive at least a majority of the votes cast at his or her election, will not be allowed to serve or, if an incumbent, to continue serving. This gives shareholders more opportunity to influence the composition of a board, particularly if they are able to convince the board to appoint their suggested candidate to fill the vacancy that occurs when a nominee fails to receive the majority vote.

However, even with majority vote, which may not be adopted at a company without a fight, it is still an expensive process to mount a successful election campaign for alternative candidates. This is where the new proxy access rules come in to change the game. Not all public companies have shareholders or groups of shareholders who will meet the eligibility criteria, but many do because of the current domination of the markets by institutional holders, such as mutual funds, pension funds and hedge funds. Where these shareholders are happy with the way their companies are being run, from operating results to investment decisions to management compensation, they will presumably take no interest in utilizing the new rules.

But in the current market, the aftermath of government bailouts of mismanaged companies, and perceived inappropriately high compensation to management of poorly performing companies, the desire of shareholders to have a greater say or a feeling of more independence from management in the boardroom is clearly present. The proxy access rules give these shareholders a relatively inexpensive way to satisfy those desires. Even if they do not follow through with nominations, or withdraw them before the election, the ability to make them gives new and significant leverage to shareholders who wish to make their influence felt.



And what of the boardroom if it is populated up to 25 percent with directors who come from the blue? Perhaps the new blood will stimulate new and fruitful deliberations; perhaps it will be such a distraction or so threatening that it impedes board functions. This will depend to a great extent on the responsible exercise by the nominating shareholders of their new power.

So who is afraid of proxy access? The answer may be that everyone should be afraid — from directors who have been well compensated, but have not fulfilled well their duties in the past to management that finds itself subject to new oversight. But in the end, those who perhaps should be most afraid are shareholders themselves — the inappropriate use of this tool could indeed result in worse, or at least no better, governance at U.S. public companies.

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