

Corporate Governance Commentary

Proxy Access Commentary No. 1

May 19, 2009

We welcome our clients and friends to the first of a series of *Proxy Access Commentaries*. These Commentaries and related *Proxy Access Bulletins* are designed to:

- Facilitate your understanding of the various proposals being made on multiple fronts to enable shareholder proxy access
- Support your efforts to shape the outcome of these proposals on the legislative and regulatory fronts
- Assist you in taking concrete action in response to the final rules as a matter of both procedure and best practices as they emerge

Our *Proxy Access Bulletins* will be brief updates on “breaking” events related to proxy access, to be delivered quickly following material new developments. They will be short, fact-specific alerts intended to keep our clients and friends up-to-date on a real time basis. Our *Proxy Access Commentaries* will focus on in-depth analysis of the relevant legal and practical issues of proxy access as they develop and will suggest concrete actions we think companies should consider in response to proxy access developments.

The Battle for Shareholder Access The Current State of Play

Highlights

- Shareholder proxy access is coming, and it will be the hottest issue of the 2010 proxy season. Public companies should expect, and be prepared for, the strong likelihood of shareholder proxy access in the 2010 proxy season.
- The SEC is scheduled to vote on a proposed shareholder proxy access rule tomorrow, May 20, 2009. We assume that Chairman Schapiro intends the rule to become final around the end of October—that is, in time for the 2010 proxy season.
- Senator Charles Schumer of New York has introduced a bill that, among other things, would confirm the SEC’s authority to adopt a proxy access rule and that would require the SEC to adopt rules directly regulating proxy access, rather than deferring to state law.
- The Delaware General Corporation Law has been amended to authorize companies expressly to adopt bylaws providing for shareholders access to the company’s proxy statement for director nominations.
- Most observers now believe the question is not whether there will be shareholder proxy access for 2010, but rather what it will look like. The shape of proxy access depends principally on *whether* the final version of the SEC rule:
 - merely empowers shareholders to submit access proposals under Rule 14a-8;
 - provides minimum standards for proxy access, leaving many of the details of implementation to state law and “private ordering;” or
 - entirely pre-empts state law by creating a full-fledged and exclusive federal regime for proxy access.

- For those who accept that shareholder proxy access is a foregone conclusion, the key is the details of how shareholder access will be implemented—the so-called “workability” issues. Workability in the context of proxy access is far more complicated than it may first appear. However, it will be the key to whether proxy access becomes, as many of its supporters assert, a sparingly used device that has the effect of instilling greater accountability of directors or, as many of its opponents fear, the progenitor of countless election contests and divided and dysfunctional boards.

Background

What is Proxy Access?

Shareholder proxy access is a proposed regime that would allow shareholders of a public company to include in a company’s proxy materials (proxy statement and proxy card) candidates for director nominated by the shareholder in opposition to the company’s candidates for election. Under the current regime, only the company’s nominees for election to the board of directors are included in company proxy materials. If a shareholder wants to nominate opposition candidates, it must prepare, pay for and distribute separate proxy materials. The obvious point of shareholder proxy access is to change the classic election contest paradigm and thereby facilitate shareholders’ ability on a virtually costless basis to elect directors who are not on the board slate.

Who are the Players?

There are six main groups of players in the proxy access struggle:

- Corporate governance activists, spearheaded by labor unions, state and local government pension funds and the Council of Institutional Investors, have been the main proponents pushing for proxy access. Although not as vocal, activist investors are also supporters of proxy access;
- The SEC, where Chairman Schapiro has announced that she views proxy access rulemaking as a key priority;
- Members of Congress, such as Senator Schumer and other prominent Democratic lawmakers, seem committed to creating a shareholder access regime of some type;
- The business community, led by the US Chamber of Commerce (the Center for Capital Market Competitiveness) and The Business Roundtable, has been strongly opposed to proxy access since the first SEC rule-making foray in 2003;
- The legal community, through its various bar associations and a number of law firms, will weigh-in on the latest round of the proxy access debate once the SEC issues its proposed rule; and
- The proxy advisory firms, most notably RiskMetrics, which will have a large say on shareholder voting on proxy access proposals and on contested director elections resulting from proxy access, are expected to support proxy access.

Recent History of the Proxy Access Debate

Rule 14a-8. Rule 14a-8, adopted by the SEC under the Securities Exchange Act of 1934, provides that a public company must include a shareholder’s proposal on its proxy card, along with a supporting statement in its proxy statement, if certain procedural requirements are met. Rule 14a-8 also enumerates certain circumstances when a company is permitted to exclude a shareholder proposal (after submitting its reasons to the SEC), including that the proposal relates to an election for membership on the company’s board of directors or analogous governing body. This so-called “director election” exclusion has traditionally been interpreted by the SEC as permitting exclusion of shareholder proposals that would lead to election contests, as well as proposals that would directly create an election contest.

Round One: SEC's 2003 Proposal. During the 2003 proxy season, the American Federation of State, County & Municipal Employees (AFSCME) submitted an access proposal to Citigroup. The SEC staff permitted Citigroup to exclude AFSCME's proposal under the director election exclusion of Rule 14a-8. AFSCME appealed to the Commission, which unanimously upheld the staff's position. But, at the same time, then-SEC Chairman William Donaldson ordered the SEC staff to review the question of shareholder access under the proxy rules.

In October, 2003, the SEC issued a proposed proxy access rule, which provided that if certain "governance failures" occurred at a public company, holders of 5 percent or more of the stock could nominate directors at the following annual meeting through inclusion in the company's proxy materials. In addition to specifying the triggering "governance failures," the rule proposal dealt with a number of practical issues, including the maximum number of proxy access directors that could be elected, that proxy access would not be available to shareholders with a control intent and independence and informational requirements for utilization of the proxy access process. The proposed rule engendered significant criticism, and was ultimately abandoned in 2004 because of a lack of consensus among the SEC Commissioners.

Round Two: SEC's 2007 Proposals. During the 2005 proxy season, AFSCME again submitted a Rule 14a-8 proxy access proposal, this time to AIG. The SEC staff permitted AIG to exclude the proposal as relating to an election of directors. AFSCME sued AIG in a federal district court. The district court found in favor of AIG and AFSCME appealed.

In September 2006, the Second Circuit held that AFSCME's proposal to include specific names of shareholder-nominated candidates did not "relate to an election for membership on the company's board of directors" within the meaning of Rule 14a-8 and therefore could not be excluded by AIG, basing its holding on what it viewed as a flawed SEC administrative process for interpretation of the director election exclusion. The practical result was that, under the court's decision (technically only binding in the Second Circuit), the SEC staff could no longer allow companies to exclude access proposals from proxy statements. Within days of the Second Circuit decision, SEC Chairman Cox announced that the SEC would resolve the issue for the 2007 proxy season. But it was not possible to reconcile fully the differing views of Commissioners (which were split along party lines) and no resolution was achieved.

In July 2007, after additional months of study and three roundtable discussions, the SEC issued two different—and to some extent conflicting—proposals.

- *The "Exclusion Proposal"* reiterated and justified the SEC's long-standing position that shareholder proxy access proposals are excludable. It further proposed amendment of Rule 14a-8 to provide explicitly that access proposals can be excluded from company proxy materials, on the ground that these proposals cause contested voting.
 - Predictably, companies supported this proposal and corporate governance activists opposed it.

 - *The "Access Proposal"* permitted 5 percent shareholders to propose access bylaws, provided that they held the stock for at least one year and did not have a control intent. The proposed rule imposed additional disclosures on shareholders proposing access bylaws or nominating director candidates under access bylaws.
 - This proposal was supported by very few commentators.
 - Companies, business groups and lawyers were predictably opposed.
 - Corporate governance activists were also opposed and preferred the *status quo* because they felt that the eligibility conditions were too strict and the disclosure burdens too onerous.

 - The issuance of each proposal for public comment was approved by a 3-2 split along party lines, with the two Republican Commissioners supporting the Exclusion Proposal and the two Democratic Commissioners supporting the Access Proposal. SEC Chairman Cox supported both proposals. In November, 2007, after the departure of one of the Democratic Commissioners and over opposition of the remaining Democratic Commissioner, the SEC adopted the Exclusion Proposal but announced that it would revisit the issue in the near future.
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SEC'S 2009 Proxy Access Proposal

In April 2009, SEC Chairman Mary Schapiro publicly stated that she supported shareholder proxy access as a way to make company boards more accountable to investors, and to ensure that a company's owners have a meaningful opportunity to nominate directors. Chairman Schapiro also noted that the United States is one of the few developed countries that does not give shareholders some access to the proxy and emphasized that proxy access has not led to "enormous dislocations in other countries."

The SEC is scheduled to consider a proxy access rule proposal on May 20th. The proposed rule, of course, will be open to public comment before being adopted by the Commission. But if, as we expect, Chairman Schapiro intends to have the proposal finalized in time for the 2010 proxy season, the comment period could well be quite short (perhaps as little as 30 days). It is likely that the Commission will attempt to adopt its proxy access rule in the fall of this year in order to allow any shareholder proposals under the new proxy access rule to comply with the Rule 14a-8 submission deadline. Alternatively, if (as seems increasingly likely) the SEC's new proxy access rule bypasses Rule 14a-8 and provides a direct, federal right to proxy access, early adoption of the rule would be just as critical to permit its implementation for the 2010 proxy season.

Updates Regarding the Other Constituencies

State Corporation Law. In April 2009, the Delaware legislature amended the Delaware General Corporation Law to permit a Delaware corporation to adopt a proxy access bylaw that would allow "private-ordering" by companies for adoption and implementation of proxy access. As amended, the statute authorizes (but does not requires) a Delaware corporation to adopt bylaw provisions that give shareholders the right to include in the corporation's proxy solicitation materials shareholders' nominees for the election of directors. The bylaw may establish procedures and conditions governing the access right, which may include:

- minimum stock ownership and duration of ownership by the nominating shareholder;
- a definition of beneficial ownership that may include options or other rights;
- a requirement of specified information about the nominating shareholder and the director nominee;
- a limit on the number or proportion of directors that may be nominated;
- preclusion of nominations by persons or of persons who have acquired a specified percentage of the voting power of the company; and
- appropriate indemnification of the company for any false or misleading statement made or provided by the nominating shareholder.

The Schumer Bill. Today, Senator Charles Schumer of New York introduced a bill that, among other things, would confirm the authority of the SEC to issue a proxy access rule. In addition to establishing SEC authority to regulate proxy access, the proposed legislation would require the SEC to adopt substantive regulations governing proxy access. We assume that the Schumer bill aims to pre-empt contrary state law in the administration of proxy access, although the posted draft is silent on the topic.

The other main features of Senator Schumer's "Shareholder Bill of Rights Act of 2009" are:

- SEC-reporting companies must include in their annual meeting proxies a separate resolution for a non-binding shareholder vote on the compensation package for executives. They must also include a resolution in a merger proxy for a non-binding shareholder vote on "golden parachute" arrangements;
 - The SEC must establish rules requiring listed companies to meet the following corporate governance standards:
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- *Independent Chair*: The company must have an independent chairperson of the board of directors (who shall not have previously served as an executive officer of the company).
 - *No Staggered Board*: Each member of the company's board must be subject to annual election by the shareholders.
 - *Majority and Plurality Voting; Holdovers*: In uncontested elections, directors must be elected by a majority of votes cast for each nominee. In contested elections, directors must be elected by a plurality. If a member of the board does not receive a majority vote in an uncontested election, the director must resign and the board must accept the resignation—directors will not be permitted to “hold over” under any circumstances.
 - *Risk Committee*: The company must have a risk committee, comprised entirely of independent directors, with responsibility for the company's risk management practices.

The US Chamber of Commerce. In a public letter sent to SEC Chairman Schapiro on April 28, 2009, the US Chamber of Commerce stated that it is “opposed to a federal shareholder access right,” and that “there is no compelling need for a federal access right.”

- The Chamber emphasized the main reasons for its opposition, as follows:
 - “Substantive regulation of shareholder rights and director elections fall squarely within the purview of state corporation law and pre-empt action by the [SEC];” and
 - “Numerous reforms of recent years have provided shareholders with sufficient access to relevant information and to corporate decision-makers.”
- The Chamber then asserted the SEC lacks authority to regulate corporate governance, which is a matter of state law. The Chamber also stressed that “the recent actions by Delaware should give pause to any federal action in the field of shareholder access.”
- Finally, the Chamber urged “flexibility in design and implementation” of any proxy access right, and emphasized that a one size fits all federal access right would result in unnecessary burdens for small and mid-sized companies.

The Business Roundtable. On April 30, 2009, the Business Roundtable started a preemptive lobbying campaign against Senator Schumer's proposed legislation. According to the *Washington Post*, an e-mail sent by the Business Roundtable to its members warned that Senator Schumer's bill would overturn “two hundred years of state corporate law” by “drastically altering board structure, governance and the role of shareholders.” Several CEOs reportedly contacted Senator Schumer to urge him not to introduce the legislation, but a spokesman for the Senator said that he has no intention of cancelling plans to introduce his bill later this month.

The Bar and the Proxy Advisors. To date, both constituencies have been quiet. The former is waiting for more concrete information in the form of a proposed SEC rule, which will then be the subject of detailed commentary from bar associations and law firms, as is customary for significant SEC rule proposals. As for the latter, the conventional wisdom is that RiskMetrics, in particular, will be an avid supporter of proxy access as a concept and will issue influential recommendations for voting in contested elections under a proxy access regime.

Workability

The raging debate over proxy access has been fought largely at the conceptual level—is it a good, even necessary, improvement in corporate governance, or is it not just the beginning of the end, but the end, of the classic board of director-centric model for corporate America? The rhetoric at this level has obscured the painful reality that implementation of proxy access requires a myriad of decisions on a variety of levels that can be grouped together, albeit somewhat loosely, under the rubric of “workability.”

To mention just a few of the more obvious:

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- While there appears to be general agreement that there should be both an ownership threshold and a holding period to be eligible for proxy access, those limits will be both controversial and critical in determining how proxy access will work in practice.
 - Similarly, while there appears to be general agreement that shareholders should be allowed to aggregate their holdings for purposes of the ownership threshold, the underlying details (for example, whether there are limits on the number of shareholders who can aggregate without implicating the proxy rules and how questions and disputes regarding ownership and holding periods are resolved) will be important to the actual functioning of proxy access.
 - Will there be “independence” requirements for the nominating shareholder and/or for the nominee? Will the independence be merely from the company or should the nominee be required to be independent from the nominating shareholder?
 - Will proxy access be available for shareholders with a “control” intent? If not, what mechanisms will be appropriate to separate the “sheep” from the “wolves”?
 - Proxy access will require a so-called “universal” proxy cards listing all nominees for director, which will be more than the number of open seats on the board. This form of proxy has not been previously used in the US Its mechanics will raise numerous questions, such as how companies should deal with dealing with over-votes, under-votes and other voting errors.

While the list of “workability” issues can easily be expanded, the point is that the nature and operation of proxy access will, even more than usual, depend on the old saw—“the devil is in the details.” And “devil” is an appropriate characterization, because the implementation details of proxy access will be the new battleground for proxy access proponents and opponents.

Conclusion

It is highly likely that shareholder proxy access in some form will become a reality. The SEC will consider a proxy access rule tomorrow during an open meeting and promulgation seems a foregone conclusion (even if by a 3-2 vote). In light of concerns about the SEC’s statutory authority to regulate proxy access and the apparent commitment of key Democratic lawmakers to achieving proxy access, Congressional action seems highly likely; Senator Schumer’s bill may well be the vehicle for such action. The new amendments to the Delaware law will become effective this summer, and other states may adopt similar enabling legislation. The ABA may also revise the Model Business Corporations Act to include proxy access provisions.

In these circumstances, because there is extreme uncertainty as to what the law on proxy access will be, we believe that (absent exigent circumstances), a “wait and see” approach is preferable to a voluntary, pre-emptive adoption of a shareholder access bylaw. Several model bylaws have been proposed, but none of these models take into account the yet to be determined federal requirements. Additionally, the workability issues discussed previously should be carefully considered before the adoption of a voluntary by-law, a challenging task, to say the least, in the face of uncertainty regarding SEC and Congressional action. Because shareholder proposals for the 2010 proxy season will not start being received until the fall of this year, companies have time to monitor evolution of the coming proxy access regime and still be prepared to act promptly when a new federal regime is clarified.

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