THE BOARD INSTITUTE

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"THE PROXY ACCESS DEBATE"

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Executive Summary. Pursuant to pending SEC rule proposals, a public company would have to include shareholder nominees in its proxy along with the nominees of the nominating committee of the board. In addition, a public company would be required to ask for a shareholder vote on shareholder initiated proposals to change the company's nomination and election process. These are significant and controversial proposals.

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Corporate directors are elected by shareholders in an annual process that is governed by a combination of state and federal law. State law (the law of the state in which the corporation is incorporated) controls the director nomination process and the vote required for election. In a publicly held corporation, most shareholders do not attend the annual shareholders meeting in person. Rather, the corporation solicits proxies so that shareholders may indicate their choice with regard to the election of directors by returning a proxy card or by using electronic voting. The proxy voting process is regulated by federal law pursuant to the Securities Exchange Act of 1934, as amended, and regulations adopted by the Securities and Exchange Commission ("SEC").

On more than one occasion in the last decade, the SEC has indicated that the proxy solicitation process should be enhanced in order to facilitate shareholder nominations for directors, and several proposals have been advanced in order to accomplish this goal. These proposals are generally known as proxy access proposals. The SEC's most recent proxy access proposals were issued in June 2009. http://www.sec.gov/rules/proposed/2009/33-9046.pdf. The SEC proposed changes to the federal proxy rules to do two things. First, under certain circumstances, a company would be required to include in its proxy material information about a shareholder's (or group of shareholders) nominees for director and include the names of those nominees on the company's proxy voting card along with any candidates proposed by the Nominating Committee of the board. This aspect of the SEC's proposals is known as "direct access," pursuant to a brand new SEC rule, to be designated Rule 14a-11.

Second, the SEC proposed rules (known as the "14a-8" rules) that would require a company to include in its proxy material certain shareholder proposals aimed at changing the corporation's nomination and election process. Currently, proposals to change this process may be excluded by the company from its proxy material on the basis of Rule 14a-8(i)(8), which allows a company to exclude shareholders proposals that relate to a nomination or an election of a director or a procedure for such nomination or election. The SEC's proposal would reverse the existing rule and specifically require such proposals to be submitted to shareholders for a vote, thus allowing shareholders to vote on and "customize" a corporation's director election process. For example, a shareholder could propose that a corporation adopt diversity requirements for board membership. The proposal would be presented to shareholders for adoption or rejection under the new proposed SEC rule. This concept is sometimes referred to as "private ordering" of proxy access.

Direct Access. The SEC's proposal for direct access to the proxy process includes several requirements. New Rule 14a-11 would apply to all public companies except those that are subject to the proxy rules solely because they have a class of publicly held debt. Only holders of a significant long-term interest in a company would be able to take advantage of proposed Rule 14a-11, and the SEC has proposed minimum ownership thresholds that would be tiered according to company size. For the largest companies (non-affiliate market cap of $700 million or more), a shareholder or shareholder group seeking direct access would have to own 1% of the company's securities that are entitled to vote on the election of directors. For the next largest tier of companies (non-affiliate market cap of $75 - $700 million), the ownership requirement would be 3%, and for all other companies, the ownership requirement would be 5%.

The ownership requirements are for beneficial ownership held continuously for at least one year. In prior years, the SEC had proposed a two-year holding requirement, but reduced the holding to one year in the most recent proposal.

There would be disclosure requirements with respect to proposed nominees. The shareholder or shareholder group (shareholders may align to propose nominees) proposing to make a direct access nomination must state that it is not holding its securities for the purpose of, or with the effect of, changing control of the company or to gain more than a limited number of seats on the Board of Directors. In other words, proposed Rule 14a-11 is not intended to function as a substitute for an election contest. Shareholder nominees must be in compliance with applicable law and regulations requiring that directors and director nominees be independent.

Thus, any proposing shareholder would be required to represent that the nominee satisfies any applicable national securities exchange requirements regarding director independence and to represent that there are no relationships or agreements between the nominee and the company or its management. However, there is no requirement that the shareholder nominee be independent of the nominating shareholder. In its proxy access proposals in 2003, the SEC proposed a limitation on relationships between the nominating shareholder or shareholder group and its director nominee. However, those limitations were eliminated in the SEC's 2009 proposals.

There would be a maximum number of shareholder nominees that a company would be required to include in its proxy materials as a result of direct access. As currently proposed, a company would be required to include no more than one shareholder nominee or the number that represents 25% of the company's board of directors, whichever is greater. When several shareholders or shareholder groups seek to utilize proposed Rule14a-11 at the same time, a "first notice" rule would apply, and the first shareholder group giving timely notice of its intent to nominate a director would be entitled to the first director slot or slots available. The SEC considered giving additional consideration to the size of holdings of the shareholder group proposing a nominee, but did not pursue that concept.

Private Ordering. The SEC's proposed revisions to Rule 14a-8(i)(8) would enable shareholders, under certain circumstances, to require a company to include in the company's proxy material proposals that would amend the company's director nomination and election process. Thus, company A might have a shareholder nomination process different from company B. Each company's shareholders could determine its own process, as opposed to the "one size fits all" concept of proposed Rule 14a-11 (direct access). But shareholder proposals would not be allowed to conflict with Rule 14a-11 (assuming it is adopted). The SEC considers this to mean that shareholders could require ownership thresholds, holding periods, or other qualifications different than those in Rule 14a-11, but could not "opt out" of Rule 14a-11 or prevent the operation of Rule 14a-11 allowing shareholders to directly nominate directors. The relationship between these two rules will require additional guidance.

Legal Issues. The SEC's proxy access proposals have been controversial, particularly the provisions for direct access. After the most recent proposals were published in June 2009, the SEC received over 500 letters of comment (an unusually high number). A group of seven of the largest law firms on Wall Street submitted a joint letter urging that direct access not be adopted, while a group of 80 law, business, economics, and finance professors submitted a joint letter urging that all of the proxy access proposals be adopted quickly. The U.S. Chamber of Commerce threatened to sue the SEC, arguing that the SEC lacked legal authority to regulate direct proxy access.

In view of the large number of comments and the legal uncertainty, the SEC in January 2010 reopened the comment period on proxy access proposals for an additional 30 days (http://www.sec.gov/rules/proposed/2009/33-9086.pdf), with SEC Chairman Mary Schapiro stating publicly that she expected the SEC to move forward with a final rule sometime in early 2010. Financial reform legislation also addresses proxy access. On July 21, President Obama signed the "Dodd-Frank Wall Street Reform and Consumer Protection Act." (http://www.docs.house.gov/rules/finserv/111_hr4173_finsrvcr629.pdf) This legislation authorizes (but does not require) the SEC to adopt proxy access (without mandating the detail of what shall be included) and also authorizes the SEC to exempt smaller companies from such requirements. There was a move to include in the legislation a requirement that a shareholder or shareholder group seeking direct access must have a 5% ownership stake held for at least two years. This requirement was not included in the final version of the financial reform legislation.

Pros and Cons. Proxy access proposals have been made by the SEC in 2003, 2007, and in 2009. Each time, there have been sharply divided opinions. Currently, there seems to be a grudging recognition that private ordering is an acceptable idea, but there is still strong dispute about direct access.

Pros. Proxy access advocates say the following:

- Shareholders should have a greater voice in corporate governance, and proxy access will enable this.
- Corporate boards have not functioned well, and proxy access will result in greater accountability to shareholders by making directors more responsive to shareholders' opinions and input.
- The ability to nominate director candidates is a fundamental shareholder "right."
- The incumbent board should not have sole control of the proxy card and the election process.
- Proxy access creates greater alignment between the board and the interests of shareholders, thus improving corporate governance.
- Prior efforts to reform boards have had little effect, so proxy access is needed now.

Cons:

- Proxy access as it is now prescribed is not the best way to upgrade shareholders' rights because the new rules would allow shareholders to bypass an objective recruiting process. Board members with the right mix of background, expertise, experience, and perspective are the fundamental prerequisite for a good board.

- The process of filling Board seats may become politicized and subject to campaigning, special interest pressures, sizable expenditures to lobby other shareholders, horse trading for seats, and other disruptions that will divert the resources of the company and the rightful focus of the board on the business of the business.

- Shareholders frequently represent short term financial interests, special interests, or narrow agendas and constituencies that may be in direct conflict with the long term interests of the corporation. Shareholder blocks of 1% - 5% are frequently held by hedge funds whose viewpoint is narrow and opportunistic, as opposed to long-term and strategic. Allegiances may sharply diverge and discourage deliberative, thoughtful, and strategic corporate governance. Management tenure could be subject to blocks of shareholders jockeying for control.

- Many (if not most) corporate boards function very well, and it is not wise to blame all of corporate America for the faults of the well-publicized failures.

- There are too many inconsistencies and incongruities in the rules as now proposed. The details of proxy access are a concern, especially the “first in” proposal.

- Private ordering by which each company can adapt the rules to suit its needs seems preferable to a one size fits all approach, especially when traditional state law principles are tossed aside.

- Under proxy access, there would be no way to ensure or enhance board diversity. Direct access might result in a divisive and less diversified and functional board rather than one that is more accountable, representative, and forward looking.

- The ability of activist shareholders to bypass a thoughtful, proactive process of recruitment may encourage a professional director class – closing the door to diversity in age, experience, gender, ethnicity, geography, global representation, functional expertise, industry knowledge, vision, and culture. Further, this approach would create a barrier to those who currently do not hold board seats and thus could perpetuate the failed practice of recycling directors. This seems in direct conflict with the recent SEC directive that boards must disclose how they have addressed diversity in the composition of their board.

- Directors should be recruited proactively, objectively, and independently. In order to avoid conflicted allegiances on the board, the New York Stock Exchange now requires issuers to disclose the method of recruiting. Last year, 51% of companies disclosed the source of their new directors.

What's Next. Unless the SEC decides to move more slowly than it has promised, some form of shareholder proxy access will be in place by the end of 2010. We expect the SEC to issue a final proposal in the near future. At this point, however, it is not possible to accurately predict the details that proxy access will include. The authors believe that direct access is not a good approach and that many alternatives exist that can result in an objective board recruitment process and enhanced shareholder engagement. SEC Chairman Schapiro said in June 2010 "the Commission's approach to corporate governance is not to mandate outcomes. We don't believe that there is a single structure that ensures accountability in all circumstances." Hopefully the SEC will take these words to heart.

In a related development, the SEC has issued a request for comment on a broad range of proxy voting topics, including the ability of companies to directly contact investors, accuracy in vote tabulation, the role of proxy advisory firms, and other matters.
http://www.sec.gov/rules/concept/2010/34-62495.pdf

The untold stories are the thousands of companies, public and private, that have avoided crises; that have succeeded, because of the advice and counsel of diligent, independent, strategic boards of directors.

Just as Congress is elected to protect our national interests, so boards of directors can safeguard our investments – and thus our nation's financial health. The financial team's ability to ensure transparency and accountability is key to the vibrancy of our free enterprise system.

Steps to Take Now.

1. Watch for the SEC's final proxy access proposals and consider filing a comment.
2. Start working on the mechanics that will be needed if direct access is adopted, as is anticipated.
3. Take another look at your large shareholder groups and evaluate your current shareholder relations capabilities and resources.
4. Evaluate your existing board and consider ways of improving accountability, transparency, and (most important) effectiveness.

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