Hot Issues Alerts – Organizations

SEC-Mandated Proxy Access: Don't Change A System That Works

The Editor interviews ***Thomas Quaadman,*** *Executive Director, Financial Reporting Policy and Investor Opportunity, U.S. Chamber of Commerce's Center for Capital Market Competitiveness.*

Editor: Please tell our readers about your background and professional experience.

Quaadman: After I graduated from New York Law School in 1991, I served a judicial clerkship in Connecticut and engaged in private practice for a few years. Following that I became chief of staff to Rep. Fossella (Rep. New York) for over eleven and a half years. During his tenure, he served on the House Financial Services Committee and later chaired a subcommittee of the Republican Policy Committee on Economic Competitiveness. I did a lot of work on issues which were of concern to both committees. I joined the Chamber about a year ago.

Editor: What major issues do you see on the corporate governance front?

Quaadman: This fall we face a very unique juncture in the experience of public corporations in the United States. The SEC will be reviewing comments to its proxy access rules and Congress will be considering Senator Charles Schumer's Shareholder Bill of Rights and Representative Gary Peters's Shareholder Empowerment Act. These measures can radically change the way U.S. corporations are governed.

If these proposals come to fruition, we will see a federalization of corporate law. It also represents an unprecedented takeover of our markets by the government. For the last 150 years, our corporate structures have been governed by state corporate law. This has provided a very diverse system of governance that has led to the most productive economy in world history.

While some are using the excuse of a financial crisis to make radical changes in the governance of U.S. corporations, the reality is that over 97 percent of our companies have had nothing to do with the financial crisis.

Some large activist investors (particularly union pension funds) see SEC-mandated proxy access as an important tool to get more leverage in the boardroom to push a political agenda. From our vantage point we believe that these misguided proposals will harm the American economy and constrain the ability of the business community to create jobs.

Editor: Describe the SEC's proxy access proposal.

Quaadman: The SEC proxy access proposal opens the door for an activist investor to put its nominee on the board if it held its stock for at least one year and the number of shares it held exceeded three thresholds: one, three and five percent of the outstanding stock depending on company size. We believe, as we stated in letters to the SEC, that this represents a fundamental re-altering of corporate governance in the United States. These changes will harm the American economy by creating strong incentives for public corporations to avoid the reach of the SEC by encouraging them to seek domiciles outside the United States and to avoid use of U.S. securities markets. This will make the United States less competitive in a global economy.

Editor: What actions has the U.S. Chamber taken?

Quaadman: Knowing that the SEC had proxy access as one of its top agenda items, we sent a letter to Chairwoman Shapiro in late April in which we made three points. One was that the process by which directors are elected is a matter of state corporate law and that states like Delaware have addressed this issue by authorizing corporations to adopt bylaws that provide for shareholder access to management's proxy statement. Secondly, the SEC does not have the legal authority to engage in such rule making. And finally, some issues where the SEC does have the authority to act, such as increased disclosure and proxy voting participation, are of such great importance that the SEC should focus its attention on those issues rather than on issues relating to the internal governance of corporations, which have traditionally been the domain of the states.

Editor: You mentioned the stock ownership thresholds for nominating stockholders. Has the U.S. Chamber taken a position on that?

Quaadman: We have not taken a position on thresholds. It is our position that this is a matter of state corporate law. We think that one of the advantages of the Delaware law amendments is that they provide flexibility by permitting companies to select the approach that works best for them. Thus, a company can decide that shareholder access is, or is not, the way to go. It leaves the decision with respect to proxy access up to the company. It permits the decision to emerge from a dialogue among investors, directors and management. If, as a result of that dialogue, a company decides that it is best not to engage in shareholder access, then it does not have to adopt it. But if it does decide that shareholder access is something that should be pursued, then it can structure shareholder access in a way that works best for that company.

Our comment letter to the SEC with respect to its proxy access proposal calls into question the SEC's authority to engage in that rule-making and makes the point that proxy access should be governed by state law.

Thomas Quaadman

Editor: Would the passage of Senator Schumer' s Shareholder Bill of Rights Act and Representative Peters's Shareholder Empowerment Act remove any question as to the right of the SEC to adopt its proxy access proposal?

Quaadman: Yes. We are opposed to both bills. Among other things, we feel, as I mentioned, that the SEC should not have the authority to intrude in matters reserved for state corporate law. In addition to confirming the authority of the SEC with respect to proxy access, the Schumer bill contains provisions for annual "say on pay" votes, majority voting, ending staggered boards and separating the CEO and chairman's role (the Peters bill is similar).

If you look at what is actually happening in corporate governance over the last five to six years, a lot of reforms have been taking place, and these are being done without government mandates. So, some companies are deciding to go with majority voting, and others aren't. Some companies are deciding to split up CEO and chairman's roles, and others aren't. You have some that are ending staggered boards, and others aren't.

This is happening because many companies are engaged in a dialogue with their shareholders, management and directors to come up with the structure that works best for that company. For some companies, all of these things may work, for others none of them may work. Most of them are going to fall in between.

The proxy access rule is not needed because corporations do listen to their shareholders. This is clear from a study by Professor Joseph Grundfest of Stanford Law School and The Rock Center School of Corporate Governance at Stanford University. The study revealed that 31 percent of the companies that were targeted by "just vote no" campaigns experienced disciplinary CEO turnover, and that another 50 percent of targeted companies made other strategic changes. When there is a concentrated effort by investors to really engage in a dialogue, there is an 80 percent change rate.

The problem with the one-size-fits-all approach is that it mandates how the structures are to work, and it leads to a system that forces square pegs to be pounded into round holes – and we think this is wrong.

Just to take one example, separating the CEO's and chairman's roles may work for some companies. Nevertheless, some companies where those roles are combined have been the most successful in recent corporate history. Take Warren Buffett, Bill Gates and Sam Walton – all of whom simultaneously held both the CEO and chairman's roles for extended periods. Over the same period each of their companies generated untold wealth for their shareholders and created thousands of jobs. Yet, for some reason some people think that is a practice that should be outlawed. Why should a successful practice be outlawed? There is no clear rationale for that.

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Please email the interviewee at tquaadman@uschamber.com with questions about this interview.

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C. The Nominee Must Meet Applicable Regulations and Director Guidelines.

- Non-discriminatory qualifications should apply to shareholder nominees.
  - Most state laws permit companies to establish qualifications in addition to those established by securities exchanges. Many companies have adopted such qualifications as part of their bylaws (e.g., U.S. citizenship requirements, specific licensing or national security requirements).
  - Many companies have also established non-discriminatory board service guidelines, such as mandatory retirement age, share ownership requirements and the maximum number of other boards on which the nominee may serve.

D. Need for Nominee to Complete a Company's Standard D&O Questionnaire.

- The time constraints of proposed Rule 14a-11 make it impracticable for a nominee to be duly vetted by a nominating committee.
- A shareholder nominee should be required, at the request of the company, to complete the company's standard D&O questionnaire prior to the printing of the proxy statement.
  - This would help the company determine if the nominee is independent, which is the same purpose for which companies collect information from current directors.
  - If the nominee did not meet the applicable standards or guidelines, the company could notify shareholders in the proxy statement, as it is relevant to shareholders.

E. Nominees that Count Against the Shareholder "Cap."

- If the board decides to endorse the shareholder's nominee, the nominee should continue to be counted against the maximum number of nominees that could be nominated pursuant to Rule 14a-11.
  - This will help facilitate discussions between boards and nominating shareholders. Otherwise, Rule 14a-11 is likely to have a chilling effect on negotiations between shareholders and boards.
- After election, Rule 14a-11 may encourage the board to not re-nominate the shareholder director in order to avoid that person from becoming a "management" director.
  - Any company nominee that was initially elected as a shareholder nominee should be counted against the cap for three years.

F. Largest Shareholders Should Get to Nominate; Window period.

- Rule 14a-11 does not specify the earliest date that a shareholder can file a Schedule 14N, which could result in a race by shareholders to be the first to file.
- The race to file could discourage potential communications between shareholders and boards, and companies could potentially have to address nominations throughout the year.
  - There should be a specific window period within which shareholders can make a nomination (e.g., no earlier than 150 calendar days and no later than 120 calendar days before the date that the company mailed its proxy materials for the prior year's annual meeting).
- The nominating shareholder with the largest holdings should be entitled to include its nominee in the company's proxy materials.
  - The largest shareholder has the greatest economic interest in the company, and is more likely to be aligned with the interests of the other shareholders.
  - With a window period this approach would be easier to administer.

G. Excluding a Shareholder Director Nominee.

- The deadline for submitting a nominee pursuant to proposed Rule 14a-11 should be no later than 120 calendar days before the date that the company mailed its proxy materials for the prior year's annual meeting (i.e., the same as the deadline for submitting a 14a-8 proposal).
  - The deadline in proposed Rule 14a-11 currently is calculated based on a company's advance notice bylaw provisions, which provides for much shorter notice periods, and as a result, a company would not be able to comply with the timeline in proposed Rule 14a-11 for excluding a nominee.
- If a nominee is excluded pursuant to proposed Rule 14a-11, the company should not be required to include a substitute nominee, as the company would not have sufficient time to go through the process again.

H. Additional Required Disclosures.

- Additional disclosures should be required on Schedule 14N such as material transactions between the nominating shareholder and the company, holdings of stock in a competitor company, meetings or contacts between the nominating shareholder and company managers or directors, et al.

I. Universal Proxy Card.

- Including a shareholder nominee in the company's proxy may confuse shareholders – shareholders may execute a blank proxy card without checking the boxes for any nominees, which could result in an invalid proxy card; shareholders may mistakenly check boxes for both the company's nominees and the shareholder's nominees, with uncertain results; and shareholders may not check boxes for a full slate of nominees, which could disenfranchise a shareholder.
  - Shareholders should be permitted to vote for the company's nominees as a group.
  - Any proxy that is voted in blank should continue to be deemed to be a vote for the entire board-nominated slate.

J. Liability of the Company.

- The company should not be liable for any information provided by the nominating shareholder or nominee.
  - The imposition of liability if a company "knows or has reason to know information is false or misleading" suggests that companies have a duty to investigate, and represents an inappropriate shifting of liability to companies.
  - Under existing Rule 14a-8(l), a company is not responsible for shareholder proposals or supporting statements and the 2003 proxy access proposal followed this approach.
  - The company should be entitled to explicitly state that it has done no investigation and takes no responsibility for the accuracy of information supplied by the nominating shareholder.

III. Proposed Amendment to Rule 14a-8(i)(8).

A. Substantially Implemented.

- If a company has a proxy access procedure, it would be inappropriately disruptive to allow proposals that seek only incremental changes to that procedure.
- The Commission should provide clear guidance regarding the application of the "substantially implemented" standard in Rule 14a-8(i)(10). The standard should be exclusion, except for "material" amendments.

B. Change of Control.

- Companies should be permitted to exclude any proposal that would create a proxy access procedure that could result in the election of more than a majority of a company's board of directors.

C. Ownership Requirements.

- The ownership standard for a proxy access proposal should be at least 1 percent (which would be higher than for other proposals under Rule 14a-8, but lower than the proposed modification to the ownership threshold under proposed Rule 14a-11).

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Editor: What problems emerge if one or more directors are nominated through a process other than one based on an evaluation by the directors and management of their value to the corporation?

Quaadman: The SEC proposal has the potential of electing directors whose goals may not include increasing long-term stockholder value. Injecting directors with their own agendas into board deliberations can create an adversarial atmosphere that fractures the board and puts the company's future at risk.

One of the unintended consequences is that the SEC is going to be turned into a larger version of the federal elections commission. Because the SEC will be forced to spend time and other resources trying to administer corporate elections, it will be diverted from the many pressing issues growing out of the financial crisis.

Editor: Some have said the current proxy voting system is beset with problems that affect its ability to accurately reflect shareholders' views. What is the U.S. Chambers' position?

Quaadman: The Chamber opposed the repeal of Rule 452 of the New York Stock Exchange that gave brokers the ability to vote shares of beneficial owners unless otherwise instructed. This greatly reduced the voting power of retail shareholders. Surveys show that the actual retail voting pattern correlates very closely with the pattern followed by brokers when voting uninstructed shares. It seems clear that the SEC is providing preferential treatment to a small group of investors within a larger investor community.

What we have seen is a reduction in the participation of retail investors with this trend being exacerbated by amended Rule 452; the current OBO/NOBO rules; e-proxies; the role of proxy advisory firms; naked voting and overvoting; and failure of some institutional voters to take voting seriously. The complexity of the current voting system has the potential for causing the vote to be miscast, not voted or otherwise influenced. This means that corporation policies will cease to be shaped by those who in fact own a majority of their stock.

Editor: Would you care to comment on the fact that while AFL-CIO administered pension funds have shown great interest in how those proxies are voted, the vast majority of institutional investors have been passive, having turned the voting of their shares over to proxy advisory firms.

Quaadman: As you mentioned, institutional investors have for the most part become passive about the way in which their shares are voted, with the result that proxy advisory firms apply their own standards to determine how those shares are voted. This means that proxy advisory firms are playing a critical role in the proxy voting system. Because they lack an economic interest in the shares they are voting, it is hard to say that their votes necessarily reflect the views of the institutions they serve or the investors in those institutions. There are a couple of proxy advisory firms that are extremely influential. Yet, they and the other such firms are not regulated by the SEC or other financial watchdogs.

In contrast to the passivity of most institutional investors, certain large institutional investors have become extremely active. A couple of months ago, we released a study, conducted by Navigant Consulting, of 166 shareholder proposals submitted by AFL-CIO-administered pension plans. The study found that those proposals did not increase shareholder value over the short term. Over the long term the evidence indicated that they actually decreased shareholder value.

These results provide an indication of how nominees of those pension funds would perform if they were elected directors. They would, like the shareholder proposals sponsored by union pension funds, place more emphasis on grandstanding than improving corporate performance.

For all the reasons I have discussed, any approach to proxy access makes little sense until ways are found to level the playing field so that the views of the retail shareholder are given proper weight notwithstanding the current defects in the proxy voting system. This is a pressing issue requiring immediate attention by a blue ribbon committee appointed by an appropriate body.