August 6, 2007

## SEC Proposes Two Alternatives on Shareholder Access to Director Nominations in Company Proxy Statements

Revisiting a long-running controversy, the Securities and Exchange Commission (SEC) late last month issued two alternative proposals on shareholder access to company proxy statements for director nominations. Each proposal was approved by a vote of 3-to-2, with SEC Chairman Cox voting in favor of each proposal and the other Commissioners equally split on party lines. The SEC seeks comments on each proposal by October 2, 2007.

The first proposal would codify the SEC's existing position that shareholder proposals on proxy statement access for board nominations are categorically excludable under Exchange Act Rule 14a-8(i)(8), a position that was called into question last fall by the Second Circuit Court of Appeals decision in *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006). <u>Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56161</u>

The second proposal would allow shareholders (or a group of shareholders) owning 5% or more of a company's voting shares to include in the company's proxy materials, under Rule 14a-8, a proposal for an amendment to the company's bylaws that would mandate procedures to allow shareholders to nominate board of director candidates to the extent permissible under the laws of the company's state of incorporation as well as the company's charter and bylaws. <u>Shareholder</u> Proposals, Exchange Act Release No. 56160

The first release reviews the rationale for the director election exclusion currently set forth in Rule 14a-8(i)(8), which provides that a company need not include a shareholder proposal in the company's proxy materials that "relates to an election for membership on the company's board of directors or analogous governing body." When the exclusion was proposed in 1976, the SEC noted that "Rule 14a-8 is not the proper means for conducting campaigns or effecting reforms in elections of that nature, since other proxy rules . . . are applicable," referring to the enhanced disclosure requirements for contested elections of directors. The release notes that the SEC staff has "expressed the position that a proposal may result in a contested election if it is a means either to campaign for or against a director nominee or to require a company to include shareholder-nominated candidates in the company's proxy materials" and that "[t]he staff's position is consistent with the explanation that the Commission gave in 1976 and with the Commission's interpretation of the election exclusion."

In *AFSCME v. AIG*, the Second Circuit Court of Appeals found that the current Rule 14a-8(i)(8) exclusion could not be used to exclude a shareholder proposal that would seek to amend a company's bylaws to allow shareholder nominees to be included in the company's proxy statement. The Second Circuit's decision noted that the SEC could change its interpretation of the Rule 14a-8(i)(8) exclusion, "provided that it explains its reasons for doing so." Accordingly, in the release, the SEC provides an extensive explanation of the rationale for excluding shareholder proposals that would permit shareholder nominees in company proxy statements, and states that "we are issuing this release to confirm the Commission's position that shareholder proposals that could result in an election contest may be excluded under Rule 14a-8(i)(8)." While the release goes on to propose clarifying amendments to Rule 14a-8(i)(8), the intent of the release may be in part to respond to the objections raised by the Second Circuit in *AFSCME v. AIG*, and thereby allow the

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staff to resume issuing no-action letters permitting the exclusion of shareholder proposals on proxy statement access for board nominations, even if neither of the two proposals is ultimately adopted.

In the second release, the SEC sets forth an alternative proposal that would permit certain shareholders to include in company proxy materials proposals for amendments to bylaws that would mandate procedures to allow shareholders to nominate board of director candidates. The release states that the SEC "has sought to use its authority in a manner that does not conflict with the primary role of the states in establishing corporate governance rights." In doing so, the SEC is trying to steer clear of the problems inherent in the SEC's 2003 shareholder access proposal that would have trumped state law by federally mandating, through the proxy rules, that shareholders have the ability to nominate candidates in a company's proxy statement. Instead, the release states that "the Commission is proposing that the current proxy rules and related disclosure requirements be revised and updated to more effectively serve the essential purpose of facilitating the exercise of shareholder rights under state law." The release also notes that any shareholder proposals would need to be "consistent with applicable state law and the company's charter and existing bylaw provisions." This raises the possibility that, even if the proposal is adopted, a company could proactively adopt bylaw provisions that would create parameters for any subsequent shareholder proposal, such as the director qualification requirements that we have recently suggested in the context of a majority voting bylaw. See our memo of May 12, 2006, Majority Voting and Director Qualifications.

The second release proposes comprehensive amendments to the Rule 14a-8(i)(8) exclusion as well as changes to Schedule 13G and other proxy disclosure requirements. The right to submit binding bylaw proposals that would mandate shareholder access to the proxy statement is limited under the SEC proposal to shareholders (or groups of shareholders) that hold 5% or more of a company's voting securities for at least one year and are eligible to file a Schedule 13G as either an institutional shareholder or a passive shareholder. In other words, eligible shareholders cannot have acquired or held their shares "for the purpose of or with the effect of changing or influencing control of the company." The release goes on to solicit comments on a number of technical questions, including whether a shareholder who acquires shares with the intent to propose a bylaw amendment would be barred from filing on Schedule 13G, and whether a shareholder seeking to form a group of shareholders to satisfy the 5% threshold would thereby trigger the proxy rules as a result of solicitations to join such a group. The release also seeks comments with respect to a proposal to facilitate the use of electronic shareholder forums, including whether shareholders should be able to use electronic shareholder forums to solicit other shareholders to form a 5% group to make a binding bylaw proposal on shareholder access.

We continue to believe that allowing shareholders to use a company's proxy statement for director nominations would be a mistake.<sup>1</sup> Many rivers of ink have been spilled discussing and debating whether the "director-centric"/advisory board model of the modern American corporation is still best suited to advancing the economic interests of our nation, or whether a change is required to avoid recurrence of the Enron-Worldcom sort of debacles or otherwise to take account of current conditions. Our own views on this topic are well known, and we continue to believe the reactive pendulum has swung too far in both tarring public company directors as suspect, and disempowering directors from acting autonomously to pursue shareholder

<sup>&</sup>lt;sup>1</sup> See Lipton and Rosenblum, <u>Election Contests In the Company's Proxy: An Idea Whose Time Has Not Come</u>, 59 Bus. Law. 67 (Nov. 2003).

interests.<sup>2</sup> For these reasons, we support the SEC's first proposal codifying the exclusion under Rule 14a-8 for proposals seeking access to a company's proxy statement for director nominations made by shareholders, and oppose the second.

While a contested election may on rare occasion be a necessary last resort, proxy contests entail a number of potential negative effects and risks. They are disruptive to a company's operations, diverting huge amounts of time, energy and resources away from running the business. The short-slate proxy contests most likely to be facilitated by access proposals in particular can be used by special interests to promote agendas that are not in the long-term best interests of a company and all shareholders. It is no coincidence that the most vocal supporters of proxy access proposals tend to be political or union shareholder activists. Moreover, a successful proxy contest putting dissident directors in a boardroom can create a divisive boardroom environment that undermines the effectiveness of board governance and board-management relationships. There is no evidence to suggest that facilitating and increasing the number of election contests would produce positive results. Indeed, it is far more likely that the results would be negative.

At the same time, the frequency of contested elections under the current rules continues to increase. The irony of the SEC's second proposal is that it comes at a time when proxy fights are more prevalent than ever and are about to be made easier than ever through the new SEC rules relating to electronic dissemination of proxy materials. Hedge funds and other activists have been successful in running short-slate election contests in which one or more dissident nominees, but less than a majority of the board, seek election. There have also been a number of high profile, full-slate election contests in the past couple of years. With the increasing prominence of hedge funds, the implementation of the SEC's rules for the electronic dissemination of proxy materials, which will significantly reduce the costs for dissident shareholders who wish to engage in contested solicitations, and the elimination of broker discretion to vote in uncontested elections where the brokers do not receive direction from their clients, the ability to run an election contest will only get easier in the upcoming proxy season without any further rules changes.

In addition, shareholders have an increasing number of ways to communicate with and provide input to companies, managers and directors short of a proxy contest. Well advised companies are generally very receptive and sensitive to shareholder views and concerns. These avenues of communication tend to be more constructive than an election contest, and are almost always less disruptive. Changes in the SEC's rules that would facilitate more election contests at this time are both unwise and unnecessary, and indeed might only serve to channel the evolving dialogue between companies and their shareholders into a less cooperative and productive framework.

We intend to express our views again to the SEC by providing comments on the SEC's two alternative rules proposals well in advance of the October 2 comment deadline. We encourage others to do the same.

Martin Lipton Andrew R. Brownstein Steven A. Rosenblum Adam O. Emmerich David A. Katz

<sup>&</sup>lt;sup>2</sup> See Lipton and Savitt, <u>The Many Myths of Lucian Bebchuk</u>, 93 U. Va. L. Rev. 733 (May 2007).