Proxy Access: A Sheep, or Wolf in Sheep’s Clothing?

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**PROXY ACCESS**

At most companies, the board of directors has sole authority to nominate candidates for election to the board and include their names on the company proxy. Much of this work is handed by the nominating and governance committee, which is composed of independent directors. Although Delaware law allows companies on a voluntary basis to allow shareholder-sponsored nominees to appear on the proxy, few have elected to do so. As a result, a shareholder wishing to nominate candidates to the board generally must do so through a proxy contest. In a proxy contest, the shareholder sponsors a dissident slate of directors whose names appear on a separate proxy. The shareholder must bear the full cost of preparing and distributing this set of materials, obtaining the list of shareholders, and soliciting support for its candidates. Because of the considerable cost involved, proxy contests occur infrequently and in many cases are not successful.

In recent years, some governance experts have advocated rules allowing for greater proxy access by shareholders, a movement referred to as “shareholder democracy”. They argue that, because directors are the representatives of shareholders, shareholders should have the right to nominate qualified individuals to serve on their behalf. For the most part, corporations have resisted this movement, and few shareholder-referred candidates make it through the nominating and governance committee. Corporate officials argue that shareholders lack firm-specific knowledge about the qualifications necessary to fill a board vacancy. In addition, they argue that proxy access will open director elections to special interests that may use their position to advance a private agenda that is not in the interest of shareholders broadly. Until recently, the Securities and Exchange Commission has tended to side against proxy access, although there was some equivocation during Christopher Cox’s tenure as SEC chairman. The most recent version of the Dodd-Frank financial reform bill has handed the SEC the authority and responsibility to determine rules for proxy access.

**THE BATTLE FOR PROXY ACCESS**

In 2005, the pension plan of the American Federation of State, County, and Municipal Employees (AFSCME) filed a proposal with AIG, calling for a bylaw amendment allowing shareholders to nominate directors on the proxy alongside those nominated by the company. AIG excluded the proposal citing Rule 14a-8(i)(8), which allows a company to exclude a proposal that “relates to a nomination or an election for membership on the company’s board of directors or analogous governing body.” The SEC supported AIG’s exclusion on this basis. The pension plan sued AIG in district court, arguing that while the rule did not permit shareholders to nominate a specific director, it also did not prohibit shareholders from proposing amendments to the procedures by which elections take place. Although the AFSCME initially lost the lawsuit, it won on appeal. Following the successful appeal, SEC Chairman Christopher Cox announced that the commission would review the provisions of Rule 14a-8 to determine whether changes should be made to grant increased proxy access to shareholders.

In the meantime, advocates moved ahead with shareholder proposals that would achieve this end. For example, in 2007, the AFSCME filed a proposal with Hewlett Packard that would allow a
shareholder or group of shareholders owning 3 percent or more of the company’s shares for at least two years to nominate up to two directors in any election. Hewlett Packard included the proposal on its proxy but asked shareholders to reject it. The company cited four reasons: shareholders were already eligible to make director recommendations through the board’s nominating committee; the proposal could lead to the election of special interest groups to the board; the proposal could lead to expensive proxy contests over directors that would have to be funded by the company; and the SEC was currently reviewing rules that would clarify proxy access rights (see Exhibit 1). The proposal was defeated, with 39 percent support.3

In the summer of 2007, the SEC released two draft rules for public comment. The situation was unique in that the draft rules directly contradicted one another, such that only one could be adopted. Under one, Rule 14a-8 would be amended so that shareholders owning 5 percent of a company’s stock continuously for one year would be eligible to propose changes to the director election process. Under the other draft rule, Rule 14a-8 would be clarified to explicitly exclude shareholder proposals dealing with director election processes (see Exhibit 2). The SEC ultimately adopted the second draft rule, and Rule 14a-8(i)(8) was amended to allow exclusion of a proposal that “relates to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election.”4

The decision raised considerable controversy. SEC Commissioner Annette Nazareth opposed the rule, stating that it “stands in the way of shareholders’ rights to elect directors.” CalPERS accused the SEC of “turning back the clock on corporate democracy.”5 The AFSCME claimed that Cox’s decision “will tar his legacy as an anti-shareholder chairman.”6

In 2009, newly appointed SEC Chairman Mary Schapiro announced that the SEC would reconsider proxy access. The commission released a draft rule that would allow shareholders to nominate directors, provided they own at least 1 percent of the company’s shares for a period of one year (see Exhibit 3).7 Business groups continued to oppose the measure. At a minimum, they called for stricter limitations, including an ownership threshold of 3 to 5 percent and a holding period as long as two years. While the issue is not resolved as of 2010, the Dodd-Frank financial reform bill makes clear that the SEC has the authority to prescribe rules relating to director elections.

WHY THIS MATTERS

1. Proxy access reduces the cost of contested elections, thereby increasing the likelihood they will occur. What is the agenda of the investor groups who support proxy access? Are they strictly shareholder-centric, or do they have alternative agendas that may conflict with broad shareholder interests?

2. A director is selected by the nominating and governance committee to satisfy a specific corporate need for functional, geographic, industry, or regulatory experience. S/he must also be compatible with fellow directors and management. How will shareholders make an informed decision about the relative qualifications of two directors in a contested election? Will elections become “politicized?”

3. Proxy access is the first serious attempt to legislate corporate governance at a national level in the U.S. Academic research suggests that regulation of corporate governance is viewed negatively by shareholders. Why mandate proxy access, when shareholders may best be served by voluntary proxy access in which shareholders themselves (rather than the government) determine the rules for director election on a company-specific basis?8

1 North Dakota law, passed in 2007, grants proxy access to shareholders holding at least 5 percent of the company’s stock for at least two years.
This limit applied to companies with a market capitalization of $700 million or more. Proposed thresholds were higher for smaller companies: 3 percent for companies with a market value between $75 million and $700 million, and 5 percent for companies with a market value less than $75 million. SEC Press Release, “SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors,” May 20, 2009. Available at: http://www.sec.gov/news/press/2009/2009-116.htm.


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EXHIBIT 1 — HEWLETT PACKARD: PROPOSAL FOR SHAREHOLDER NOMINATION OF DIRECTORS

Dear Fellow Stockholder:

Recently we mailed to you proxy materials in connection with our annual stockholder meeting to be held on March 14, 2007. I am writing to request your support in voting AGAINST Proposal No. 3 relating to stockholder nominees for election to HP’s Board of Directors.

If approved, Proposal No. 3 will amend HP’s Bylaws to permit investors meeting certain criteria (ownership of 3% or more of HP’s common stock continuously for at least two years) to nominate candidates for the HP Board and include those nominees in HP’s proxy materials.

We believe that this proposal is NOT in HP stockholders’ best interests and urge you to vote against it for four important reasons....

All stockholders already may recommend candidates for HP’s Board.

As noted in our proxy statement, all stockholders may recommend potential director candidates to the HP Board. HP actively seeks directors who have the highest professional and personal ethics and values, who have broad experience at the policy making level in business, government, education, technology or public service, and who are committed to enhancing stockholder value. With these qualifications in mind, the Board’s Nominating and Governance Committee considers all properly submitted director recommendations from all stockholders. The proponents of Proposal No. 3 have not used this existing mechanism to recommend director candidates for consideration by the Board.

Proposal No. 3 could lead to the election of special interest directors.

If approved, Proposal No. 3 could lead to the election of “special interest” directors nominated by stockholders with goals and objectives that may differ markedly from those of other HP stockholders. In addition, the cumulative voting provisions in HP’s Certificate of Incorporation allow stockholders to aggregate their votes in the election of directors, which makes it easier for a minority stockholder to elect a particular special interest candidate.

Proposal No. 3 will lead to divisive and expensive proxy contests that will discourage qualified directors from serving on HP’s Board.

Allowing certain stockholders to include their director nominees in HP’s proxy materials will enable those stockholders to wage proxy contests at the expense of all stockholders. This could lead to repeated, costly, distracting and divisive proxy contests, as the Board’s fiduciary duties require that it oppose any unqualified nominees. In addition, numerous stockholder activists have special interest agendas that could be publicized and promoted at the expense of HP stockholders by nominating a director for the HP Board. This situation also would discourage qualified directors from serving on the Board.

The SEC is the appropriate forum for establishing regulations for all public companies on this issue.

The SEC has said that it is carefully considering the shareholder access issue to see that “there is one clear rule to protect investors’ interests.” We believe that the broader issue of proxy access should be resolved by the SEC, which is more qualified than a small group of stockholders to set policy and regulations for public companies.

... We appreciate your time and attention to these matters, which could significantly impact your company. Thank you for your continued support.

Mark V. Hurd, Chairman, Chief Executive Officer and President

EXHIBIT 2 — SEC: DRAFT RULES FOR AMENDMENT TO RULE 14A-8 (2007)

SEC PROPOSED RULE: ALLOWING PROXY ACCESS
As amended, Rule 14a-8 would allow proponents of bylaw proposals to offer shareholder nomination procedures as they see fit. The only substantive limitations on such procedures would be those imposed by state law or the company’s charter and bylaws. For example, the procedure could specify a minimum level of share ownership for those making director nominations that would be included in the company’s proxy materials; it could specify the number of director slots subject to the procedure; or it could prescribe a method for the allocation of any costs—so long as both the form and substance of any such requirements were consistent with applicable state law and the company’s charter and existing bylaw provisions.

SEC PROPOSED RULE: DISALLOWING PROXY ACCESS
The Commission stated clearly when it proposed amendments to Rule 14a-8 in 1976 that “Rule 14a-8 is not the proper means for conducting campaigns or effecting reforms in elections of that nature, since other proxy rules, including Rule 14a-11, are applicable thereto.”* Thus, Rule 14a-8 expressly was not intended to be a substitute, or additional, mechanism for conducting contested elections. Based on the foregoing, it is the Commission’s view that a proposal may be excluded under Rule 14a-8(i)(8) if it would result in an immediate election contest … or would set up a process for shareholders to conduct an election contest in the future by requiring the company to include shareholders’ director nominees in the company’s proxy materials for subsequent meetings.


* The SEC rescinded Rule 14a-11 in 1999 and moved many of the requirements to current Rule 14a-12, which outlined the process for issuing a full and separate proxy contest.
EXHIBIT 3 — SEC: DRAFT RULE AMENDMENTS TO FACILITATE PROXY ACCESS (2009)

OVERVIEW
The nation and the markets are experiencing one of the most serious economic crises of the past century. This crisis has led many to question whether boards of directors are truly being held accountable for the decisions that they make. These concerns include questions about whether boards are exercising appropriate oversight of management, whether boards are appropriately focused on shareholder interests, and whether boards need to be held more responsible for their decisions regarding such issues as compensation structures and risk management. Because of these concerns, the Commission has decided to revisit whether and how the federal proxy rules may be impeding the ability of shareholders to exercise their fundamental right under state law to nominate and elect members to company boards of directors.

BACKGROUND
Today, public companies across the country hold elections to select members of their boards of directors, which oversee the management of the company. In most cases, the existing directors nominate the slate of candidates and the company sends information to the shareholders, through so-called proxy materials, so those shareholders have information to vote their shares.

But, because the shareholders rarely have any input into the slate of candidates, they are not always able to vote for the person they believe may be best suited to fill the post.

In many situations, companies permit shareholders to show up to the annual shareholder meeting where the election occurs and nominate different candidates than the ones on the ballot. But, by then it is too late to be meaningful because the proxy votes will have already been cast.

As a result, shareholders who wish to nominate their own candidates today must launch a proxy fight in which they mail out their own ballots — an extremely costly process.

Congress gave the Commission authority over the corporate proxy process as a means of ensuring that it functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders. Refining the proxy process so that it replicates, as nearly as possible, the annual meeting is particularly important given that the proxy process has become the primary way for shareholders to know about the matters to be decided by the shareholder and to make their views known to company management.

To address this situation, the Commission is proposing rule amendments that would provide shareholders with a meaningful ability to exercise their state law rights to nominate the directors of the companies that they own. Under the proposal, shareholders who otherwise are provided the opportunity to nominate directors at a shareholder meeting would be able to have their nominees included in the company proxy ballot that is sent to all voters. Shareholders would also have the ability to use shareholder proposals to modify the company’s nomination procedures or disclosure about elections, so long as those proposals do not conflict with state law or Commission rules.