INTRODUCTION

Shareholder proposals regarding shareholders’ ability to nominate director candidates to management’s proxy (“proxy access”) took center stage during the 2012 proxy season. As a result of a 2011 court ruling that overturned Securities and Exchange Commission (“SEC”) rules mandating universal proxy access, but that upheld shareholders’ ability to submit shareholder proposals requesting that companies adopt proxy access, investors began to adopt various approaches to ensuring this important right. While there were only a handful of shareholder proposals requesting this provision in the past year, proxy access has come to the forefront of governance issues and investors must begin to deal with this complex issue.

HISTORY OF PROXY ACCESS IN THE UNITED STATES

Shareholders have consistently sought mechanisms through which they could secure a meaningful voice in director elections, including majority voting to elect directors and the ability to nominate their own candidates. Regulatory agencies have also considered the most appropriate mechanisms for shareholders to secure this voice. In fact, the SEC has been considering allowing shareholders to place director nominees on a company’s proxy materials, eliminating the requirement to file an alternative proxy, i.e. a contested proxy, for more than 60 years.¹

The current battle over proxy access has its roots in 2003. At that time, the SEC proposed a rule that would allow shareholders owning 5% of a company’s securities for two years the ability to require the company to include the shareholders’ director candidates on management’s proxy materials, eliminating the requirement to file an alternative proxy, i.e. a contested proxy, for more than 60 years.¹

The SEC did not adopt any proxy access rule.² However, there was a brief window in 2007 during which shareholder proposals requesting proxy access were still allowable under SEC rules. During this time, shareholder proposals were filed at Hewlett Packard, United Health and Cryo-Cell International, garnering significant shareholder support: 43% at Hewlett Packard, 45% at United Health and passing with 53% of the vote at Cryo-Cell International.

Shortly after withdrawing its proposed rule, the SEC granted no action relief to AIG to exclude a shareholder proposal seeking proxy access put forth by AFSCME. The SEC allowed AIG to exclude the proposal on the basis that it involved matters related to the election of directors. On appeal, the Second Circuit court overruled the SEC’s interpretation of its rule allowing the exclusion of such proposals and held a company could not exclude proxy access proposals. The court’s ruling was based on the fact that these proposals dealt with election procedures, rather than with a specific election. While specific elections were subject to exclusion, election procedures were not.³ In response to the court ruling, the SEC in 2008 codified rules that specified that proxy access shareholder proposals were, indeed, subject to exclusion, effectively overruling the court decision.⁴

Following the 2008 financial crisis, proxy access resurfaced as a means to hold boards accountable by replacing poorly performing directors with shareholder-nominated directors. In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). This act provided the SEC with the authority to adopt rules permitting shareholders to use issuer proxy solicitation materials to nominate director candidates.²

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candidates. While the SEC had considered adopting proxy access provisions before the adoption of Dodd-Frank, the act allowed Congress to preempt expected challenges to the SEC’s regulation of proxy access.\(^5\)

After issuing its proposed proxy access rule, the SEC received more than 500 comments, some of which questioned the agency’s authority to adopt such a rule.\(^6\) Nonetheless, in August 2010, the SEC adopted final Rule 14a-11, which, under certain circumstances, gave shareholders (and shareholder groups) who collectively held at least 3% of the voting power of a company’s securities continuously for at least three years, the right to nominate up to 25% of a board’s directors and have these nominees included on a company’s ballot and described in its proxy statement. At the time of its adoption, the SEC stated that it believed that “the 3% ownership threshold — combined with the other requirements of the rule — properly address the potential practical difficulties of requiring inclusion of shareholder director nominations in a company’s proxy materials.”\(^7\)

Rule 14a-11 was scheduled to take effect on November 15, 2010, but on October 4, 2010, the SEC announced that it would delay implementation as a result of a lawsuit by the U.S. Chamber of Commerce and the Business Roundtable. In July 2011, the United States Court of Appeals for the District of Columbia ruled against the SEC based on what it perceived to be the SEC’s failure to fully consider the costs and benefits of the proxy access rules. The majority opinion, written by Justice Douglas Ginsburg, stated that the SEC “inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments,” and “contradicted itself,” among other things.\(^8\) In September 2011, the SEC said it would not be seeking rehearing of the decision,\(^9\) but SEC chairman Mary Schapiro maintained that the commission was still “committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.”\(^10\) However, in April 2012, Schapiro stated that, “[i]n terms of proposing a proxy access rule and putting it on the commission agenda, we just don’t have the capacity right now. We are just not going to be able to get to it.”\(^11\)

Although rule 14a-11 was vacated, the U.S. Court of Appeals issued a stay on the “private ordering” amendments to Rule 14a-8, meaning that companies were no longer able to exclude shareholder proposals requesting that they adopt procedures to allow for shareholder nominees to be included in proxy statements.\(^12\)

**RECENT DEVELOPMENTS**

The private ordering of proxy access had a slow and steady start, with a number of proxy access proposals requesting that companies adopt proxy access modeled after the rules originally promulgated by the SEC (with a threshold of 3% of shareholders for 3 years) receiving majority shareholder support. Proxy access became the major focal point of the 2015 proxy season, however, when the New York City pension funds announced that it would be submitting proxy access shareholder proposals (also modeled after the SEC’s original proxy access rules) at 75 companies. Ultimately, 85 shareholder proposals went to a vote, a significant departure from 2014, when only 14 such proposals went to a vote.

Adding fuel to the fire, around the same time as the New York City pension fund announcement, Whole Foods attempted to exclude a shareholder proposal requesting

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proxy access for an unlimited group of shareholders owning 3% of its shares for 3 years. Whole Foods petitioned the SEC and was granted no action relief on the basis that Whole Foods had a substantially similar management proposal on its ballot. However, the management proposal would allow proxy access for a single shareholder owning 9% of the company’s shares for 5 years. The SEC quickly backtracked on its decision following significant investor opposition. The regulator ultimately determined that it would make no decisions as to whether companies could exclude shareholder proposals on the basis that management had proposed similar measures, opening up a range of potential paths for corporate boards to explore when faced with a proxy access shareholder proposal.

Although investors quickly galvanized around a 3% for 3 year proxy access threshold (“3%/3 year”), during the 2015 proxy season, over a dozen companies originally signaled their intent to exclude shareholder initiatives in favor of management-sponsored proxy access proposals allowing the right for shareholders owning 5% of shares for 3 years in preliminary letters to the SEC. Ultimately, however, no company risked investor backlash through the exclusion of a 3%/3 year shareholder proposal in favor of those using a higher ownership threshold and the shareholder proposals put forth during the 2015 season received significant shareholder support; on average, these proposals received shareholder support of 58.5%.

Prior to the 2016 proxy season, the SEC made a determination concerning its view on whether management and shareholder proposals are substantially similar. The SEC determined that it would not consider a shareholder proposal to directly conflict with a management proposal if a reasonable shareholder could logically vote for both. Though, this leaves significant room for interpretation. It appears, however, from the subsequent SEC no-action letters that it will largely base their determination on this matter on the difference between the ownership thresholds specified in management and shareholder proposals.

**EMPIRICAL EVIDENCE REGARDING PROXY ACCESS**

It is unclear how investors’ access to the proxy is likely to impact shareholder returns, given that very few U.S. companies afford shareholders proxy access and that it has yet to be utilized by an eligible shareholder. However, in recent years, there have been several studies that have examined the effects of proxy access on firm value that have come to differing conclusions.

A 2010 study found negative abnormal returns for firms around events that increased the probability of the implementation of a proxy access rule and positive abnormal returns when the probability of such a rule decreased. This suggests that proxy access was perceived as costly by the marginal shareholder. The study concluded that its findings “indicate that increasing shareholder rights, specifically by facilitating director nominations by shareholders, may actually be detrimental to shareholder wealth.”

Another 2010 study that analyzed the market reaction to actions pertaining to proxy access regulation also found that firm value decreased in response to regulatory actions that would strengthen investors’ ability to nominate director candidates. However, the study did note that “[b]ecause the costs and benefits of proxy access vary significantly across firms, our results suggests that shareholders may be best served by voluntary proxy access in which shareholders themselves (rather than the government) to determine the rules that govern proxy access on a company-by-company basis [sic].”

Conversely, a 2010 Harvard study found that the day the SEC announced the delay

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of the implementation of its proxy access rule, stock prices of companies that would have been most exposed to shareholder access declined, on average, approximately 42 basis points, when compared to share prices of companies that would have been most insulated by the rule. The researchers note that their findings suggest “that proxy access was assigned a positive value by the stock market and that this value was associated with both the presence of the large active owners (who are plausible users of proxy access) and with poor firm track records (indicating possible room for improvement).” Ultimately, this study found that “allowing owners to have more power and influence with corporate decision making, on balance, seems to be valuable in the eyes of the stock market.” Additionally, a 2003 Harvard study concluded that “providing shareholder access would be a moderate step toward improving board accountability” and that “it would be desirable to supplement shareholder access with additional measures to invigorate corporate elections.”

At least one analysis suggests that proxy access might not be beneficial for all firms, particularly those with smaller market capitalization. The recent study for the Stanford Law Review noted that, for many small companies, a 3% ownership threshold could make it easy for any one shareholder, or a group of smaller shareholders, to run a contest. Further, proxy contests typically occur in small publicly held firms rather than firms with larger market capitalization. The study’s authors examined the returns of 1,000 small companies following the SEC’s announcement of its most recent proxy access rule, which only provided a temporary exemption (rather than a full exemption, as anticipated under the SEC’s initial proxy access rules) for firms with under $75 million in market capitalization. The authors found that the unanticipated application of proxy access rules, particularly when firms had investors with at least 3% interest, resulted in negative abnormal returns.

Most recently, however, in August 2014, the CFA Institute released a report suggesting that proxy access had the potential to enhance board performance and raise overall U.S. market capitalization by between $3.5 billion and $140.3 billion. Additionally, the report concluded that there is limited evidence to suggest that special interest groups could use proxy access to hijack the election process or to pursue special interest agendas. The CFA Institute ultimately concluded that proxy access would serve as a useful tool for shareholders in the U.S. and that it would ultimately benefit both the markets and corporate boardrooms, with little cost or disruption to companies and the markets as a whole.

CONCLUSION

Since the SEC proxy access rule was not implemented, shareholders have resorted to pushing companies to adopt proxy access through a variety of shareholder proposals. As previously mentioned, empirical evidence suggests that a one-size-fits-all rule may be to the detriment of some, mainly smaller market cap companies. While companies can design an approach that meets their own unique circumstances, governance provisions and shareholders, very few companies have taken such a step.

As with all proposals, investors must weigh several factors when determining what proxy access provisions would be in the best long-term interests of the company. It is generally our view that granting shareholders proxy access is beneficial, as it provides a means for shareholders to have

meaningful input into director elections. Further, when shareholders exercise this right, a majority (or plurality, if contested) of shareholders must then elect the nominee that is put forth by qualifying shareholders, providing a sufficient safeguard against the election of directors not supported by most shareholders. We believe that appropriate ownership thresholds in both percentage of shares and length of ownership, combined with the protection afforded by the shareholder election process itself, act as safeguards from potentially disruptive proxy contests.
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