GLASS LEWIS

Proxy Access

In-Depth Report

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Introduction

Shareholder proposals regarding shareholders' ability to nominate director candidates to management's proxy (proxy access) became a feature of U.S. proxies 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 also upheld shareholders' ability to submit shareholder proposals requesting that companies adopt proxy access, investors began to employ various approaches to ensure this important right.

While there were only a handful of shareholder proposals requesting that companies adopt this provision prior to 2012, the right to proxy access has risen to the forefront of governance issues and has consistently been one of the most popular proposals at annual meetings. By 2017, the number of shareholder proposals regarding proxy access was second only to corporate political spending proposals.

However, as more and more companies have begun to adopt this provision, the number of proposals submitted to companies dropped precipitously. In 2018, there were only 12 proposals requesting that companies adopt a proxy access right, and that number further halved in 2019. In 2020, no proposals requesting that companies adopt proxy access went to a vote, in their place were proposals asking for companies to make adjustments to their existing proxy access bylaws.

History of Proxy Access in the U.S.

Shareholders have consistently sought mechanisms through which they can secure a meaningful voice in director elections, including majority voting to elect directors and the right 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.

The battle over proxy access began in 2003 when 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 if either: (i) a director nominee received higher than 35% withhold vote; or (ii) a shareholder proposal regarding proxy access received majority shareholder support. After facing widespread opposition, the SEC did not adopt any proxy access rule. However, there was a brief window in 2007 during which shareholder proposals requesting proxy access were still allowable under SEC rules. During that 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, allowing the firm 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 that a company could not exclude proxy access shareholder resolutions. The court's ruling was based on the fact that these proposals dealt with election procedures rather than with a specific election as, while specific elections were subject to exclusion, election procedures were not.[1] In response to the court ruling, the SEC in 2007 codified rules that specified that proxy access shareholder proposals were, indeed, subject to exclusion, effectively overruling the court decision.[2]

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"), providing the SEC with the authority to adopt rules permitting shareholders to use issuer proxy solicitation materials to nominate director 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. However, change was far from immediate; In a progress report published six years later, only 274 of the 390 total rulemaking requirements had been met with finalized rules.

[1] Robert K. Morris. "Reacting to Shareholder Proxy Access Proposals." Harvard Law School Forum on Corporate Governance and Financial Regulation. November 5, 2011.

[2] Peter Atkins. "Shareholder Proxy Access for Director Elections." Harvard Law School Forum on Corporate Governance and Financial Regulation. April 26, 2009.

After issuing its proposed proxy access rule, the SEC received more than 500 comment letters, some of which questioned the agency's authority to adopt such a rule.[3] Nonetheless, in August 2010, the SEC finalized and 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 "the 3% ownership threshold— combined with the other requirements of the rule — properly addresses the potential practical difficulties of requiring inclusion of shareholder director nominations in a company's proxy materials."

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 the 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.[4] In September 2011, the SEC said it would not be seeking rehearing of the decision, but SEC chair 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." 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."[5]

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. This ultimately opened the door to a flurry of shareholder proposals that, since this time, have gone to a vote at companies' annual meetings.

[3] James McRitchie. "Proxy Access: Upcoming Votes at FRX, MDT and HRB." Harvard Law School Forum on Corporate Governance and Financial Regulation. August 13, 2012.
[4] Sarah N. Lynch. "Court Shoots Down SEC Shareholder Election Rule." *Reuters*. July 22, 2011.
[5] Sarah N. Lynch. "SEC's Schapiro: Won't Revisit Proxy Access Rule Soon." *Reuters*. April 25, 2012.

Recent Developments

The private ordering of proxy access had a slow and steady start with a handful 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 Comptroller and New York City Pension Funds announced they would be submitting proxy access shareholder proposals (also modeled after the SEC's original proxy access rules) at 75 companies as part of their Boardroom Accountability Project. That year, 85 proxy access shareholder proposals were put to vote, a significant increase from the 14 proxy access proposals voted on in 2014. The total number of proposals stayed relatively consistent in 2016, with investors voting on 81 proxy access shareholder proposals during the proxy season. By 2017, the number of proxy access shareholder proposals that went to vote dropped substantially to 51,[6] further dropping to 35 in 2018 and 30 in 2019. In 2020, 13 such proposals were voted on. After having already been adopted at roughly 73% of S&P 500 companies, the lead sponsor of such resolutions, the New York City Comptroller, shifted his focus to other topics. Most (and in 2020, all) proxy access proposals are now "fix-it" proposals, which aim to alter existing proxy access bylaws, but these proposals have not seen the same shareholder support as those seeking to institute proxy access.[7]

Adding fuel to the fire, around the time that the Boardroom Accountability Project campaign was launched, Whole Foods (prior to it being acquired by Amazon.com Inc.) attempted to exclude a shareholder proposal requesting proxy access for a group of shareholders of unlimited size owning 3% of its shares for 3 years. Whole Foods petitioned the SEC and was granted no action relief on the basis that it 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.[8]

Although investors quickly rallied 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 was willing to risk investor backlash through the exclusion of a 3%/3 year shareholder proposal in favor of those using a higher ownership threshold.

Prior to the 2016 proxy season, the SEC determined what constitutes 'substantial similarity' between management and shareholder proposals. 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. This leaves significant room for interpretation. It appears, however, from the subsequent SEC no-action letters, that

[6] Shirley Westcott. "Surprises from the 2018 Proxy Season." Harvard Law School Forum on Corporate Governance and Financial Regulation. June 27, 2018.
[7] Marc Treviño. "2019 Proxy Season Review: Part 1—Rule 14a-8 Shareholder Proposals." Harvard Law School Forum on Corporate Governance and Financial Regulation. July 26, 2019.
[8] Kaja Whitehouse. "Shareholders Threaten Boards over 'Proxy Access'." *USA Today.* January 27, 2015.

it will largely base its determination on this matter on the difference between the ownership thresholds specified in management and shareholder proposals. For example, in 2016, Cisco and WD-40 amended their existing bylaws to allow proxy access at the 3%/3-year threshold, however they did not implement each element listed in their shareholder proposals (requesting an “unlimited number of shareholders” who can aggregate into a group, among others). The SEC granted their no-action relief requests, agreeing with their explanation that “a proposal is substantially implemented when its essential objective is satisfied, even if the proposal has not been implemented exactly as proposed.”[9]

Although approximately 67% of S&P 500 companies had adopted proxy access bylaws by 2018,[10] either proactively or following a shareholder proposal, there has still been debate over what qualifications are necessary to nominate a director and other issues concerning proxy access bylaws. In 2016, GAMCO, which had beneficially owned more than 5% of National Fuel Gas since 2010 and had taken an activist role, attempted to nominate a director for the first time under proxy access bylaws. They were promptly declined by National Fuel Gas, which claimed that GAMCO was not eligible because it had not acquired those shares in the ordinary course of business but rather “with the intent to change or influence control.”[11]

Though it has waned since 2015, proxy access has remained a prominent issue for both shareholders and management. By the end of 2019, 76% of S&P 500 companies and just over half of the companies in the Russell 1000 had adopted proxy access.[12] Although shareholder proposals seeking the addition of a proxy access bylaw have consistently achieved majority support from shareholders, proposals to amend existing proxy access bylaws have not garnered such support. For example, during the 2020 proxy season, while no proposals to adopt proxy access bylaws even went to a vote, “fix it” proposals to amend bylaws received 29% average support with none receiving majority support. In 2017 and 2018, these “fix-it” proposals received only slightly less support at 28%.[13]

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[9] Yafit Cohn. “SEC’s ‘Substantial Implementation’ Approach to Proxy Access.” Harvard Law School Forum on Corporate Governance and Financial Regulation. November 8, 2016.
[10] Era Anagnosti et al. “Reminders for US Public Companies for the 2019 Annual Reporting and Proxy Season.” White & Case LLP. December 5, 2018.
[11] Cydney Posner. “Proxy Access Test Drive Hits a Wall.” Harvard Law School Forum on Corporate Governance and Financial Regulation. December 2, 2016.
[12] “Proxy Access: A Five-Year Review.” Sidley. January 16, 2020.
[13] Marc S. Gerber, “Proxy Access: Highlights of the 2017 Proxy Season.” Harvard Law School Forum on Corporate Governance and Financial Regulation. July 1, 2017.

Empirical Evidence

It is unclear how investors' access to the proxy is likely to impact shareholder returns given that it has yet to be successfully 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 divergent 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 marginal shareholders. 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. Researchers found that the abnormal returns were increasingly negative for firms with greater numbers of large institutional blockholders. This is consistent with the criticism that blockholders or share coalitions may be able to nominate their own slate that would benefit their own interests, and not necessarily all shareholders. The abnormal negative returns decreased, however, in cases where small institutional advisors have proxy access. As the study notes, shareholders' interests may be best protected by voluntary proxy access rules (as opposed to governmental regulation) that would allow them to design proxy those rules on a case-by-case basis, particularly given the differing costs and benefits of such rules across firms.

Conversely, a 2010 study found that, on the day the SEC announced the delay in implementing its proxy access rule, the stock prices of companies that would have been most exposed to shareholder access declined, on average, approximately 44 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).[14] 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."[15] This finding was supported by another Harvard study conducted in 2003 which asserted 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. A 2012 study in 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 those with larger market capitalization.

[14] Michael Connor. "Study: Delay in SEC's Proxy Access Rule Proves Its Value." *Business Ethics*. January 10, 2011.

[15] Carmen Nobel. "Activist Board Members Increase Firm's Market Value." *Harvard Business School-Working Knowledge*. January 19, 2011.

The *Stanford Law Review* 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.

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 marketplace.

Finally, a 2017 review of previous studies shows that so far, the empirical evidence provides weak and conflicting evidence on the value of universal proxy access. Some studies support the value of proxy access while others do not. The results are not consistent between studies and across points in time. Moreover, contradictions between studies have yet to be reconciled.

Conclusion

Since the SEC proxy access rule was not implemented, shareholders have resorted to private ordering, using a variety of shareholder proposals to push companies to adopt proxy access. Under the current regulatory scheme, companies are free to design an approach that best aligns with their circumstances, governance provisions, and shareholder structures. Nevertheless, few companies have pursued such a tailored approach, the majority having implemented access rules similar to those originally endorsed by the SEC. Furthermore, while empirical evidence suggests that a one-size-fits-all rule may be detrimental to some companies, primarily those with smaller market caps, certain best practices have developed because of the recent private ordering.

As with all shareholder 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 the view of Glass Lewis 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 a 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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