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CORPORATE GOVERNANCE

Uptick in Proposals to Change How Directors Are Nominated

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Special to the Legal

Activist shareholders are looking to have a greater say about the composition of the boards of U.S. public companies. The ultimate goal of these shareholders is to reshape how public company directors are traditionally selected. This movement has been caused, in part, by widely publicized corporate governance and senior management failures. Such scandals, including the recent Wells Fargo fraud scheme, have prompted a higher level of scrutiny not only on the oversight role of directors, but also, more fundamentally, on how qualified directors are nominated. This movement has created what is becoming a new "norm" regarding shareholder proxy access that many public companies have adopted.

Over the past couple years, there has been an uptick in shareholders proposing amendments to company bylaws to facilitate the addition of, or changes to, proxy access rules. Proxy access gives long-term shareholders the right to place board nominees of the shareholders' choosing on the company ballot during annual reporting and proxy season. The shareholders' board nominees will then be voted on by all shareholders, alongside directors recommended by the board. The phenomenon of proxy access shareholder proposals is relatively new, and has been met with differing approaches by issuers.

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Some public companies faced with such proposals sought to omit them from their proxy materials, by requesting no-action relief from the Securities Exchange Commission (SEC), with varied success. As an alternative approach, some companies, even in the absence of a proxy access shareholder proposal, have proactively adopted bylaw amendments to add proxy access provisions that comport with the trending practice of granting proxy access to long-term shareholders when certain conditions are met.

According to the latest MSCI research report on proxy access, over the past two years the percentage of public companies with proxy access provisions has risen dramatically from single to double-digits. This increase was due, in part, to the targeted efforts of shareholders such as the New York City Comptroller and New York City Pension funds' 2015 Boardroom Accountability Project, and individual shareholder proposals. However, U.S. standards are still well behind global proxy access norms.

It remains to be seen what impact this movement will ultimately have on the face of public company boards in the U.S., particularly on those with traditionally entrenched boards. However, it is useful to examine: how some large-scale institutions have responded to the increase in shareholder proposals regarding proxy access; how the SEC has evaluated public companies' attempts to thwart shareholder proxy access proposals; and the most common terms of adopted proxy access rules in the United States.

NOTABLE PUBLIC COMPANIES HAVE RECENTLY ADOPTED PROXY ACCESS BYLAW PROVISIONS

Many public companies have adopted proxy access rules, as either a direct or indirect result of shareholder proxy access proposals.

In December 2015, in the midst of its fraud scandal, Wells Fargo amended its bylaws to make it easier for shareholders to nominate directors. Proxy access rights were granted to an individual investor or groups of as many as 20 shareholders with continuous ownership of at least 3 percent of the bank's stock for three years. Shareholders who met these requirements were granted the right to nominate and include in the firm's proxy statement the greater of two directors, or 20 percent of the board.

After discussion with three major pension funds, Bank of America's board adopted similar bylaw amendments in 2015. In October 2015, the board of McDonald's amended its bylaws to provide shareholders with new proxy access rights for director nominations, with the same conditions and ownership thresholds that were adopted by Wells Fargo and Bank of America.

To date, there has been only one case where an activist shareholder attempted to use proxy access rules to nominate a director. In November 2016, GAMCO Asset Management Inc. (GAMCO), a hedge fund and shareholder of the National Fuel Gas Company (NFG), attempted to use proxy access bylaw provisions to nominate a director. A dispute ensued between GAMCO and NFG. NFG rejected GAMCO's proxy access nominee from inclusion in NFG's proxy statement, accusing GAMCO of violating an ancillary condition in the bylaws that required that nominating shareholders acquired their threshold shares "in the ordinary course of business and not with the intent to change or influence control of the Corporation, and does not presently have such intent." NFG accused GAMCO of possessing intent to change or influence control of NFG, based on GAMCO's prior shareholder proposal for NFG's 2015 annual meeting, where GAMCO requested that the NFG board spin off NFG's utility segment. This proposal was rejected by a majority of NFG shareholders. NFG alleged that this was the underlying reason for GAMCO's proxy access attempt. GAMCO did not challenge NFG's accusations, but instead released a statement shortly thereafter, reporting that its nominee decided to withdraw as a board candidate.

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SEC'S POSITION ON NO-ACTION REQUESTS

The staff of the SEC's Division of Corporation Finance conducts a fact-specific analysis when issuing informal no-action letters to determine whether it would recommend enforcement action if a company takes the course of action outlined in its inquiry to the SEC. Companies should be aware of the following prevalent arguments recently considered, and the SEC staff's guidance on applicable rules that may be appropriately used to challenge shareholder proxy access proposals:

- Under Rule 14a-8(i)(10), substantial implementation has been successfully argued by companies seeking to exclude shareholder proxy access proposals. When relying on this rule, companies contend that the difference between the proposed bylaw amendments and the company's previously adopted proxy access bylaw provisions are relatively insignificant to shareholder proxy access, and thus the company should be permitted to exclude such shareholder-proposed amendments. In the 2016 proxy season, the SEC concurred with 36 companies that the shareholder proxy access proposals they received could be excluded from their annual proxy materials based on this rule. However, SEC staff denied the attempts of three companies that asserted substantial implementation, where the bylaws contained ownership thresholds for proxy access that were higher than those requested in the shareholder proposals.

• Under Rule 14a-8(c), companies including Walgreens, Walt Disney and Whole Foods argued that multiple provisions proposed in shareholder proxy access proposals constituted more than a single proposal, and were unrelated to a "single well-defined unifying concept." The SEC staff disagreed in all three cases, and declined to accept this argument.

• Rule 14a-8(i)(9) should not be used to exclude a shareholder proxy access proposal. The SEC Staff Legal Bulletin 14H provides clear guidance that a shareholder and management proposal, each with differing eligibility thresholds concerning proxy access, will not be considered "directly conflicting," as required by Rule 14a-8(i)(9).

MOST COMMONLY ADOPTED PROXY ACCESS RULES BY U.S. PUBLIC COMPANIES

• Shareholders hold a minimum 3 percent stake, for a minimum of three years.

• Shareholders may aggregate their shares to fulfill the minimum 3 percent stake requirement.

• If shareholder ownership percentage and duration requirements are met, shareholders many nominate the greater of two directors, or 20 percent of the board.

Many shareholder proposals and adopted proxy bylaw provisions address additional, ancillary conditions, such as the maximum number of shareholders that may aggregate their shares to meet the 3 percent total minimum stake, the source and purpose for use of shares acquired to meet the ownership threshold, the treatment of "loaned shares", notice deadlines, and restrictions on the individual being nominated by shareholders. However, the SEC has generally found that where the company has adopted proxy access bylaw provisions that include the 3 percent stake, three-year ownership thresholds, a shareholder proposal containing these same standard thresholds, albeit with requests for different ancillary terms, may be excluded from the company proxy statement under Rule 14a-8(i)(10) because the company's existing proxy access bylaws will be deemed to have met the "proposal's essential objective".

CONCLUSION

The practical implications of shareholders' push for proxy access may change due to the recent shift in U.S. administration. President Donald J. Trump's stated goal and actions to deregulate the financial industry will likely impact the SEC's priorities, as well as its position on when and how public companies may use existing rules to support their refusal to take action on shareholder proxy access proposals. Also, as only one activist shareholder has attempted, unsuccessfully, to use newly adopted proxy access rules to nominate a director, it is improbable that this movement will result in shareholder nominees being routinely included on company ballots during proxy season. Accordingly, an immediate shake-up of entrenched boards is not likely imminent. However, as with any major movement, one step at a time—despite what activist shareholders have failed to achieve in the short-term concerning director nominations, they have managed to create a new U.S. standard causing many public companies to adopt proxy access bylaw provisions. This is a start toward securing shareholders' right to attempt to reform the composition of public company boards. •