Cornish F. Hitchcock

ATTORNEY AT LAW
1200 G STREET, NW ● SUITE 800
WASHINGTON, D.C. 20005
(202) 489-4813 ● FAX: (202) 315-3552
CONH@HITCHLAW.COM

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MEMORANDUM ON SEC PROXY ACCESS PROPOSALS

The SEC has requested comment by October 2, 2007 on two competing proposals involving "proxy access" shareholder resolutions. Proxy access is an issue of considerable interest to the Council of Institutional Investors, which has a policy in favor of allowing shareholders with a long-term interest in a company to nominate candidates for the board of directors and to have those candidates included in the company's proxy materials.

The first of the proposals would bar proxy access proposals under the SEC's shareholder proposal rule, Rule 14a-8. The second proposal would allow proxy access bylaws to be offered, but only under strict circumstances. This memorandum will summarize for Council members the major elements of each proposal; outline areas of concern to institutional pension fund investors; and highlight issues that Council members may wish to address in their individual comments to the SEC.

PROPOSAL ONE: ELIMINATING PROXY ACCESS PROPOSALS UNDER THE CURRENT SEC SHAREHOLDER PROPOSAL RULE

The first proposal (Release 34-56161) would overrule the 2006 *AFSCME Pension Plan v. AIG* court decision and clarify that a company may exclude a proxy access proposal from its proxy materials. This proposal would clarify the so-called "director election" exclusion in SEC Rule 14a-8(i)(8), which the *AIG* court had construed as allowing such proposals.

Comment:

This first proposal does two things. First, it explains why the SEC disagrees with the *AIG* court's reading of the director election exclusion. The *AIG* court construed the director election exclusion based on limited evidence as to how the Commission and its staff had read that provision. The proposed rule weaves these various precedents together in an effort to indicate that the SEC now reads this (i)(8) exclusion as barring proxy access resolutions.

Second, the SEC proposes amending the (i)(8) exclusion to clarify that proxy access proposals would be barred in the future. That much is clear. What is less clear is whether shareholders may offer proxy access proposals during the coming year, as they did last year. When the SEC voted to propose this rule change in July, there were indications that the SEC would not change the legal *status quo* while the proposed rule changes were being considered. If so, that would mean that companies could not obtain no-action relief if they try to exclude a proxy access proposal.

However, there is a competing school of thought, which notes that courts give considerable deference to an agency's interpretation of its own rules. Now that the SEC has clarified its views, the argument goes, the SEC staff could and should exclude such proposals. If that were to happen, it is unlikely that a court would rule in favor of allowing a proxy access proposal. The Council has written to the Commission requesting clarification.

Issues of interest to investors:

1. This first proposal could be moot if the SEC should adopt a new rule along the lines of the SEC's second proposal, which expressly permits proxy access proposals under certain conditions. Comments could address the value of proxy access and urge the Commission to reconsider its views on the issue. What is striking about both of the SEC proposals is their failure to discuss shareholder support for proxy access, *e.g.*, the approval of a non-binding access proposal at Cryo-Cell, and the over 40 percent "yes" votes for such proposals at Hewlett Packard and UnitedHealth Group in 2007.

2. Investors may also wish to comment on the value of non-binding proxy access proposals, as opposed to bylaws, which would be allowed under the SEC's second proposal. Precatory proposals do not raise the same concerns as bylaw proposals in terms of setting up a possible contested election for the board of directors; thus, the arguments for limiting the right to offer precatory proposals are not as compelling.

Proposal Two: Proxy Access Proposals Offered By Holders of 5% of a Company's Shares

The second proposal (Release No. 34-56160) would amend Rule 14a-8 to permit shareholders under certain circumstances to offer a bylaw under which shareholder nominees for election to a company's board would be included in the company's proxy materials. Unlike a 2003 rulemaking on this topic, the SEC is not proposing specific criteria for a proxy access proposal; however, the proposed rule contains a number of conditions and requirements upon which the SEC has requested comment.

A. ELIGIBILITY ISSUES

The SEC is proposing to rewrite Rule 14a-8(i)(8) to permit shareholders or a group of shareholders to offer a proxy access bylaw if they:

(1) have collectively and beneficially owned more than 5% of shares for at least a year before submitting the proposal;

(2) are eligible to file a Schedule 13G as an institutional investor or passive investor (pension funds, banks and insurance companies are normally eligible; open-end mutual funds are not eligible to file); and

(3) have in fact filed a Schedule 13G or an amendment thereto containing all the information required under a rule.

These eligibility requirements would also apply if a company should adopt a proxy access bylaw and if shareholders subsequently nominate a candidate for inclusion in the company's proxy materials. The SEC has proposed a new rule 14a-17 dealing expressly with that situation.

The model here is Schedule 13G, which must be filed by shareholders or a group of shareholders who beneficially own more than 5% of a company's shares, but who lack an intent to change or influence control of the company. (Investors who do not lack such an intent must file a Schedule 13D).

Comment:

Although the SEC contemplates that a proxy access bylaw may be offered by a group of shareholders (hereinafter a "Shareholder Group"), the proposed rule does not reflect a practical understanding of the ways that institutional investors might approach this issue. As a result, the Commission appears to have severely underestimated the cost burdens and workability of some of the proposals. The discussion below will highlight issues of concern.

The SEC has requested comment on a number of specifics, including some topics not addressed by the proposal. The following section lists issues that are of particular concern on which Council members may wish to comment based on their own policies and experience.

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Issues of interest to investors:

1. Is "more than 5%" too high a threshold for the right to offer a proxy access shareholder proposal? Although the Schedule 13G filing regime is familiar to the Commission, it may not be a good fit when transferred to the proxy access arena.

The SEC has invited comment on what would be an appropriate level other than 5%. (The proposal in the *AIG* case was 3%.) Funds may wish to discuss some of the practical difficulties in achieving a 5% threshold, including such factors as investment guidelines that limit their ability to hold more than a small percentage of a company's stock (*e.g.*, 0.5%). Such limitations, which are not acknowledged in the SEC's selection of a 5% figure, relate to whether a 5% figure is workable.

2. Is a one-year holding period long enough? As is discussed below, the SEC is proposing a number of detailed disclosures that go beyond what would be required if one had to file a Schedule 13D. A longer holding period (*e.g.*, two years) might limit bylaws to investors with a long-term commitment to a company, which level of commitment might be viewed by some as an adequate trade-off for overly detailed disclosure requirements in the current proposal.

3. Can funds talk to each other about whether it is possible to reach a 5% threshold without triggering EDGAR filing requirements and the like under the SEC's "shareholder communication" rule? This is an issue on which the SEC has invited comment. Given the difficulty in any effort to assemble a Shareholder Group, whatever the threshold, any proxy access rule should clarify that attempts to reach the requisite threshold are exempt from mandatory "shareholder communication" requirements until the group is formed. The "investor protection" concerns that underlie current shareholder communication rules are really not applicable in this situation. A shareholder who is solicited to join a Shareholder Group will render itself subject to various disclosure requirements once it is clear that there is enough support to proffer a proxy access bylaw and once the bylaw is proffered. Thus, a shareholder who contemplates whether to take part in a Shareholder Group will have to engage in enough due diligence to make a knowledgeable decision about whether to participate in that Group.

4. Why not allow precatory proxy access proposals? The SEC's proposal covers only bylaws of the sort proposed in the *AIG* case. There may be times, however, when a shareholder may wish to offer a precatory proposal, for example, if the company requires a supermajority vote to adopt bylaws proposed by shareholders.

5. Is a limit of 500 words for a bylaw too limited? Drafting a bylaw that fits within the 500-word limit in Rule 14a-8 can be difficult, given the level of detail that may be necessary. If investors need to jump through hoops to achieve a certain eligibility threshold, shouldn't there be a higher limit, say, 3000 words?

6. Should the SEC rethink the Schedule 13G model? The proposed rule creates confusion as to an institution's filing requirements because the proposal does not mesh with current deadlines for Schedule 13G filings. Under the current rule governing Schedule 13G filings, passive investors such as pension funds must file an initial Schedule 13G within 45 days after the close of the year when those passive investors acquired a 5% holding. The proposed rule does not explicitly amend this rule. The proposed new text for Rule 14a-8(i)(8) does suggest that a Shareholder Group filing a proxy access bylaw must file an initial Schedule 13G no later than the time the Group submits its bylaw, but the exact timing for such a filing is never specified.

In reading the proposed rule, it is not possible to understand what kind of filing requirement the SEC has in mind or what would trigger the need to file an amendment to Schedule 13G. Is there a materiality requirement? Is a single incident a triggering event, *e.g.*, would a meeting with a proxy adviser such as ISS trigger an obligation to file? If so, within what period of time?

Because the proposal does not address these issues in a concrete way, shareholders are not able to comment in a meaningful fashion, nor is the SEC able to estimate the paperwork obligations that it may be imposing. The analysis in the SEC's Paperwork Reduction Act discussion does not address these points. The SEC should issue a Supplemental Notice spelling out exactly what it has in mind, and the costs thereof, so that the public may file comments directed to that proposal.

B. DISCLOSURE ISSUES

The SEC would require proponents of a proxy access bylaw to file additional categories of information on Schedule 13G as to any group that "has formed any plans or proposals" regarding a proxy access bylaw. These disclosure requirements would apply to each and every investor who is a member of the group:

(1) any "direct or indirect" interest in any contract with the company or an affiliate, including a collective bargaining agreement, consulting agreement, or employment agreement;

(2) any pending or threatened litigation in which one is a party or material participant that involves the company, any officer or director or corporate affiliate;

(3) any other "material relationship" with the company and an affiliate, such as a past employment relationship;

(4) one's dealings with the company and the company's competitors during (a) the 12-month period before plans were formed to submit the proposal and (b) the time that a proposal is pending. That would include:

- (i) Any "material transaction" with the company or an affiliate;
- (ii) Any discussions about the proposal with a proxy advisor, such as ISS or Glass Lewis; and
- (iii) Any holdings of more than 5% of any competitor (*i.e.*, any company in the same "Standard Industrial Classification Code"), as well as any "material relationship" with a competitor, other than the relationship as shareholder; and

(5) disclosures of "any" meetings or contacts with the management or directors of the company during the 12 months before the plan to submit a proposal was made, as well as while the proposal is pending.

For non-individual investors, there is an additional category of disclosures of the “natural person or persons” who is responsible for the proposal. The proposal is vague as to whether the SEC is seeking disclosure as to a fund’s trustees, staff, or someone else. Here are the elements that would have to be filed by each participant in the Shareholder Group:

(1) the person responsible for the formation of any plan or proposal involving a proxy access bylaw;

(2) the manner in which that person was selected, including a discussion of whether the equity holders or other beneficiaries of the fund played any role in selecting that person;

(3) whether the person has “in forming such plans or proposals, a fiduciary duty to the equity holders or other beneficiaries of the entity”;

(4) the qualifications and background of that person that is relevant to the proposal; and

(5) any interest or relationship of that person and the institution that is “not shared generally by the other shareholders” and that “could have influenced the decision” by that person and the investor “to submit” a proposal or nomination.

These requirements would apply to members of a Shareholder Group sponsoring a proxy access bylaw. The SEC is proposing to impose similar requirements on companies and their directors, who would have to disclose in their proxy materials their relationships, meetings and contacts with the members or representatives of the Shareholder Group. As a result, if the company makes certain disclosures in its proxy statement, and there is a discrepancy in the Schedule 13G filed by the Shareholder Group, the SEC may ask “Why?” There may thus be liability concerns.

Comment:

The disclosure requirements are striking for a number of reasons. First, they do not appear to consider the practical aspects of pension funds forming a Shareholder Group. Second, the requests for information to be disclosed in a Schedule 13G are extensive, intrusive, vague and often not limited by a “materiality” or similar requirement. Third, the proposals would require more extensive recordkeeping than is now the case. Finally, there may be liability if information in a Schedule 13G is not complete or accurate.

The items of concern set forth below focus on practical issues that commentators may wish to address based on their own experience and would be most useful if they addressed not merely the policy concerns, but also the costs and burdens that specific proposals would place on their individual fund.

Issues of interest to investors:

1. The proposal would require disclosure from each and every investor in a Shareholder Group. Thus, if the Shareholder Group consisted of ten funds, each with a 0.5% holding, considerable effort will be required to file a Schedule 13G, regardless of the level of detail that is ultimately required. The Commission does not acknowledge that fact in its discussion of the proposal or the costs that would be imposed in preparing the requisite filings.

It is one thing to require individual members of a 5% group to disclose information about each member's involvement with the company in terms of litigation, contracts or other "material relationships." Those are the sorts of things that would be disclosed if a shareholder were making an independent proxy solicitation and thus had to file a Schedule 14A. However, the SEC proposal goes far beyond the level of detail that would be required of shareholders in that situation. Indeed, it goes beyond what would be required of shareholders who would have to file a Schedule 13D because they had acquired over 5% of the shares, but not with the intent of being merely passive investors.

2. The proposed disclosures are sweeping in nature and are not limited to "material" items, but appear to allow no exception, *e.g.*, the proposal to require disclosure in "[r]easonable detail" of "any meetings or contacts, including direct or indirect communication" with management or a director.

3. The proposal would require extensive recordkeeping duties. For example, suppose that a pension fund representative speaks with a director of Company A in May 2007 about matters affecting Company A. Suppose too that this director serves on the board of Company B. In March 2008, ten months after the encounter, the fund in question helps file a proxy access proposal at Company B in time for that company's September 2008 annual meeting.[1]

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[1] This example is far from theoretical, as a number of companies (*e.g.*, CA, FedEx, Nike), hold third quarter meetings, with a spring deadline for filing shareholder proposals.

Under the SEC proposal, the following disclosure obligations would be triggered: (a) The pension fund would have to disclose the conversation with the director in "reasonable detail" in a Schedule 13G, which is filed ten months after the conversation took place. The director would have to recall the conversation in order to assist Company B in preparing its proxy in August 2008 – even though the conversation had nothing to do with Company B. (One wonders whether companies would welcome this level of micromanagement any more than shareholders.)

Or to take another example, every participant in a Shareholder Group would have to calculate not only its holdings in the company being considered, but also every other enterprise in the same SICC and add up those figures; if the total exceeds 5% (or whatever threshold is determined) on the date the plan to submit a bylaw is formulated, that holding would have to be reported.

4. Along that line, the proposal is vague about when certain disclosure obligations would be triggered. The SEC's focus is when the person or group "formed any plans or proposals" about a proxy access bylaw. That phrase may include – but is not limited to – the time that a bylaw proposal is actually submitted, as well as dates that a shareholder proponent indicates to management that the proponent (a) intends to submit a proxy access bylaw or (b) will refrain from submitting a proxy access bylaw if the company does something (unspecified) in return.

This "plan or proposals" date (whenever it may be) is central to the proposal, for the SEC would require reporting of any contacts with a director up to 12 months prior to the date the "plan or proposals" were formed. Similarly, the 5% holding of companies in the same SICC as the focus company would be measured on the date the proponent "first formed" the proxy access "plan or proposals." The reporting requirements for fund representatives, companies and directors also reach back 12 months before the "formation" date.

This proposal is impermissibly vague and does not adequately address the situation faced by a Shareholder Group that includes pension funds. For example, is the date a plan is "formed" the first date that a representative of a single fund advises management of an intent to file a proxy access proposal? That would not seem to be realistic, given that the actual filing of a proposal will occur only if one is successful in enlisting holders with enough shares to meet the 5% threshold (or whatever figure the SEC may select).

If that is the interpretation, then take the example in section 3 above, but assume that a fund representative did mention the possibility of a proxy access bylaw at Company B when speaking to a director in May 2007. A May 2007 "formation" date for a March 2008 filing for a September 2008 meeting would require all funds in the Shareholder Group, as well as the company and all of the company's directors to make disclosures of every phone call, letter, e-mail or other contact going back 12 months before the formation date, *i.e.*, to May 2006.

Moreover, there may be multiple "formation" dates for a single proposal. The provision requiring background information on responsible individuals at a fund requires disclosure of the identity of the person at a fund "responsible for the formation of any plan or proposals." That is presumably a different person at each fund. Is the "formation" date the earliest date upon which any fund representative had a conversation with a company official? Would it not make more sense to key any "formation" date to the date that a Shareholder Group obtains enough participants to exceed the 5% threshold and definitively resolves to move forward?

The confusion is compounded by references to the "formation" date including the date upon which a shareholder or Shareholder Group says that it will *not* submit a proxy access bylaw if the company takes certain action. Suppose that a shareholder not owning the required threshold makes such a statement to a company, *e.g.*, "If this company does not adopt a policy on golden parachutes, then we'll try to round up enough support to submit a proxy access bylaw." Presumably there is no need to file a Schedule 13G if no proxy access bylaw is ultimately filed. Or is there? Or suppose that the shareholder makes this statement, but cannot find enough support until two years later. Are shareholders – and directors – required to search their memories and records going back that far?

This vagueness makes it difficult, if not impossible, for affected parties to submit comments that do more than point out the inconsistencies and ambiguities. Part of the problem may be the fact that the SEC is trying to use Schedule 13G in a manner that it has not previously been used, at least not for institutional investors, who are asked to file a relatively limited and objectively verifiable set of data and to do so after the requisite holding has been acquired. Given the problems identified here, commentators may want to urge the SEC to issue a revised and more coherent proposal that acknowledges these issues, rather than try to proceed to a final rule on the basis of a flawed proposal.

5. The proposed disclosures for background information on individuals offering proxy access proposals are also vague and unworkable, particularly when dealing with pension fund proponents. Suppose that a fund's governance staff identifies a poorly performing company that the staff believes might benefit from a proxy access proposal; the proposal is developed and presented to the fund's board of trustees; the trustees authorize the staff to take steps to identify other investors who might be interested in achieving the requisite ownership threshold.

This fairly typical scenario is rife with questions that the SEC proposal never answers, for example: Who are the "person or persons" about whom each of the five enumerated categories of information must be disclosed? The staff person who first formulated the idea? All the members of a fund's board of trustees? Or only those who voted to undertake the action? Regardless of what individuals may have to report, what does the SEC mean when it says that there must be disclosure of the "qualifications and background" of these individuals that is "relevant to the plans or proposals"? Is election to a fund's board of trustees by fund participants a "qualification"? Does that confer the relevant "background" necessary for a trustee to endorse a proxy access proposal? If not, what does?

6. Questions of this sort are far from theoretical. SEC rules require that a person signing a Schedule 13G certify as to the accuracy of its contents. That is relatively straight-forward when a shareholder is asked to disclose objective information such as the number of one's shares and whether one has a contract or other material relationship with a company. The task becomes more difficult, however, when one is asked to certify to such vague standards as the "qualifications and background" of one's staff or governing board.

7. The SEC proposal appears to justify these detailed and intrusive inquiries on the premise that a company's directors have fiduciary obligations to the shareholders; thus, if a small group of shareholders seeks, at relatively low cost to themselves, to set up a possible challenge to directors, the shareholders as a whole are entitled to greater "transparency" about the Shareholder Group and its members. A major problem with this premise is that the SEC does not discuss the fact that pension funds *themselves* have fiduciary obligations to participants and beneficiaries and that offering a proxy access proposal may be an action in furtherance of that fiduciary obligation.

Commentators may wish to argue that although additional disclosures may be appropriate, a sponsor of a proxy access bylaw who is acting in its fiduciary capacity should be required to only disclose matters comparable to that of a participant in an independent proxy solicitation under Schedule 14A, which governs the contents of proxy statements, both those issued by a company and those by independent shareholders. Schedule 14A requires, *inter alia*, that shareholders be given information about the participants, the nominees, holdings in the company, and any material interests that the participants or nominees may have with respect to the company.

C. ELECTRONIC SHAREHOLDER FORUMS

The SEC is proposing to allow companies or individual shareholders to use the Internet to set up electronic shareholder forums, provided that such forums comply with federal and state law. The goal is to remove legal ambiguity that might inhibit shareholders and companies from using this technology to enhance communications between each other.

The SEC would encourage use of such forums by providing that there would be no liability under federal securities laws for any statements made by a third party on such an electronic forum, in the same way that Congress decided in 1996 to protect interactive computer services from liability for third-party comments.

Prohibitions in anti-fraud laws and regulations would continue to apply. However, participants in an electronic forum would not be subject to the disclosure requirements governing independent proxy solicitations if they are not soliciting proxies on their own behalf, provided that any solicitation stops 60 days before the annual meeting or, if the meeting date is announced less than 60 days before the meeting, within two days of the announcement.

Comment:

It is not clear whether companies would find value in creating such a site. Many institutional investors would support greater use of electronic shareowner forums; but as a supplement to, rather than as a replacement of, meaningful proxy access reform. Comments during SEC roundtables in May 2007 raised questions whether this would do anything more than generate new corporate "chat rooms," which were not seen as producing significant communications on governance or other issues. The SEC invites comment on whether and how shareholders would see these forums as having value to them.

Issues of interest to investors:

1. Would you see value in electronic forums, whether sponsored by a company or an independent shareholder? Would funds be interested in sponsoring such a forum themselves if they believed that there was a company worthy of such targeting?

2. Suppose that a Council member was attempting to solicit support from enough shareholders to submit a proxy access bylaw at a given company. Would the ability to set up an electronic forum be helpful in that regard? Or would the various disclosure and other requirements being proposed by the SEC make the value of such a forum too limited to be worth the effort?

3. The SEC has suggested that as electronic forums are created, they might be a valuable substitute for non-binding shareholder proposals. The theory appears to be that there is only limited value in voting non-binding resolutions at a company's annual meeting, and if shareholders want to communicate their concerns about a given issue by means other than submitting a bylaw proposal, electronic forums might be an adequate substitute. Do you agree?

D. PRECATORY PROPOSALS

This topic is a logical outgrowth of the preceding discussion. Apart from proposals dealing specifically with proxy access bylaws, the SEC requests comments on an open-ended inquiry into whether the SEC should adopt rules under which a company could propose – and its shareholders could adopt – a bylaw restricting the ability of shareholders to offer non-binding shareholder resolutions.

The SEC proposal notes that this same idea was floated in a 1982 rulemaking, but was withdrawn after significant opposition from across the spectrum. The SEC is asking whether it is time to take another look at the concept, given developments since 1982 that "diminished the concerns about shareholders' ability to act as a group." The SEC cites the "increasing importance of institutional investors in contemporary capital markets," the significant role of proxy advisors such as ISS, the prevalence of voting guidelines for market participants, and enhanced opportunities for collaborative discussion between companies and their shareholders.

Comment:

It is a bit surprising seeing this issue resurface, given the overwhelming opposition in the 1982 proceeding, as well as the SEC's decision in 1998 to leave Rule 14a-8 essentially intact after a rulemaking that proposed sweeping changes.

The SEC has not actually proposed amending the text of Rule 14a-8 in order to permit such "opt-out" bylaw proposals, so this is probably only a preliminary inquiry. However, if the SEC receives enough favorable comments on this opt-out concept, it is possible that they could attempt to include such a concept in any final rule.

The May 2007 SEC roundtables saw support for the current system, on the theory that non-binding shareholder proposals play a useful role in letting shareholders communicate with management and the board. The SEC has invited comment on this issue. It has also posed a number of detailed questions about how opt-out bylaws should be drafted, what disclosures should be required of the proponents, whether the standards should be different if a company proposes such a bylaw, as opposed to shareholders, what kind of dispute resolution should exist, whether companies and shareholders should be forced to rely on state court remedies, etc. Some of the broader policy issues are listed below.

Issues of interest to investors:

1. Have things changed that much since 1982 in terms of the ability of shareholders to "act as a group"? Is that really the issue? Is it not true that the biggest change since 1982 is the fact that non-binding proposals are far more likely to be adopted these days than 25 years ago? Is that a reason to change the rules?

2. Do investors find value in being able to vote on non-binding shareholder resolutions as a means of having a dialogue with management and the board?

3. Concern has been expressed about shareholders offering non-binding resolutions that become the subject of "backroom" negotiations with management and that may be withdrawn in return for concessions that benefit the proponent, but not shareholders as a whole. If funds have had experience offering shareholder resolutions, the SEC would find it helpful to receive comments delineating that experience and the outcome of any negotiations that affected governance at a company.

4. If a company decides that it will not entertain non-binding resolutions, there is nothing to prevent a proponent from rewriting a precatory resolution into bylaw form. Thus, there may be no reduction in the number of proposals received each year or the number of items being voted at a given meeting.

Also, as a practical matter, some issues might be more suitable for discussion among shareholders if they are phrased as a recommendation, rather than as a bylaw. For example, a proposal urging a company to take more aggressive action on global warming concerns may strike some as an unlikely target for a bylaw, but if that is the only way to raise the issue, proponents may take that tack.

5. Are electronic shareholder forums an adequate substitute for letting all shareholders use the annual meeting as a forum for voting on shareholder resolutions, even if the proposals are not binding?