Legal Backgrounder

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SEC PROXY REFORM INITIATIVE COULD HAVE SIGNIFICANT IMPACT ON CORPORATE GOVERNANCE

by

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You may not have noticed that the Securities and Exchange Commission (SEC) announced a new initiative on April 14 of this year. If you missed it, rest assured that it was easy to miss, as it was unexpected.

This would not seem a likely time for new initiatives from the SEC. The Sarbanes-Oxley Act of 2002, and the overall "reform atmosphere," following Enron, Worldcom, and the other corporate scandals, has meant late nights for the staff at the SEC. Sarbanes-Oxley imposed deadlines for proposing and adopting a series of new rules, and for completing a number of studies, none of which directly involves the proxy rules. In line behind those efforts are other disclosure reforms that the SEC has proposed on its own.

Despite this heavy agenda, on April 14, 2003 the SEC announced that it had directed its Division of Corporation Finance "to examine current proxy regulations and develop possible changes to those regulations to improve corporate democracy." The SEC asked its staff to consult with interested parties, and the staff, in turn, asked for public comment by June 13. (The staff normally will consider comments received after the deadline to the extent possible.)

The Proxy Rules. Although large, public companies continue to hold annual meetings, the solicitation of written proxies has replaced the shareholder meeting as the true forum for shareholder voting for the thousands or hundreds of thousands of shareholders scattered around the country or around the world. Many of us who invest in public companies receive envelopes each spring wrapped in blue plastic containing the proxy statement, annual report, and a card upon which to mark our votes.

Because of a number of abuses where some companies attempted to obtain shareholder approval without full and complete disclosure, in 1934 Congress adopted the first federal regulation of proxy solicitations in the Securities Exchange Act of 1934 (Exchange Act). Section 14(a) of that Act prohibits

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the solicitation of proxies "in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or the protection of investors." Section 14(a) and related rules apply only to those companies whose shares are registered under Section 12 of the Exchange Act. Classes of stock listed on the NYSE, Nasdaq, or the Amex must be registered under Section 12.

The SEC has used its authority under Section 14 to adopt and enforce a number of rules. Consistent with its traditional role as a "disclosure agency," those rules primarily regulate when a communication amounts to a "solicitation" subject to the rules, and the disclosure that companies must make in their proxy materials about their proposals. For example, when seeking shareholder approval of nominees to the board of directors, the company must provide information about the nominees, including their prior business experience and other background information.

Rule 14a-8, the shareholder proposal rule, departs from the rules' overall focus on management proposals. Under that Rule, a shareholder may submit to a public company a proposal and 500-word supporting statement for inclusion in the company's proxy materials. The company's obligation to include the proposal, however, is subject to certain restrictions, including, for instance, that the proposal is a proper matter for shareholder action under state law. Because of this restriction, most proposals must be written as recommendations to the board, so that the proposal, even if approved by the required number of shareholders, is not binding on the company.

The predecessor to Rule 14a-8 originally had a pure "disclosure" basis. If a shareholder notified the company of its intention to present a proposal at a meeting of shareholders, the company incurred an obligation to make a corresponding disclosure, subject to certain exceptions, under the anti-fraud rule. Over the years, Rule 14a-8 has developed more of a corporate governance justification as shareholder activists have used the rule in attempts to gain greater influence over boards and management.

A company may not exclude a Rule 14a-8 proposal from its proxy materials without submitting a written request to the SEC staff seeking its concurrence that the proposal may be omitted. The staff's "no-action letter response" agreeing or disagreeing with the company's position is informal, so that the company may still act inconsistently with the staff's decision, but it then risks legal action brought by the shareholder proponent.

A History of Tension. The balance between corporate control of the proxy process and shareholders' desire for more direct participation in the process has been the subject of tension since adoption of the Exchange Act. Section 14 left in place a system where management would retain control of the company's own proxy materials. With the exception of Rule 14a-8, the company typically chooses which proposals are included in the proxy materials, including the identity of the nominees to the board of directors.

Of course, shareholders have always had the right to prepare their own proxy materials to solicit proxies, including support for an alternative slate of directors, so long as they follow the same proxy rules that companies must follow. However, shareholders cite the time and expense involved, along with other regulatory concerns, in questioning its practicality in most circumstances.

Supporters of the current system contend that more direct shareholder involvement in board and management decisions could be distracting and disruptive. In proposing amendments to Rule 14a-8, the SEC in 1998 acknowledged that "[c]ertain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight."

In addition, as noted earlier, the SEC's role in the proxy process has generally been focused on disclosures in the proxy materials. The substantive regulation of corporate governance has traditionally been the territory of the laws of the state of the company's incorporation. Greater shareholder participation

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mandated by federal regulation, some argue, would be inconsistent with this division of labor, and the underlying principles of federalism. To be sure, the stock exchange listing standards have to some extent already "intruded" on corporate governance matters, and new stock exchange proposals which are consistent with the overall Sarbanes-Oxley reform effort would represent a further intrusion (*e.g.*, by requiring that listed companies have a majority of "independent" directors on their boards).

Advocates of greater shareholder participation question whether shareholder access under the current system is meaningful, pointing to current corporate scandals and the corresponding failure of corporate boards as demonstrating the need for more effective "checks and balances" on management and board discretion. Some advocates would compare the current system (unfavorably) to a democratic political system, and seek more effective "shareholder democracy." Indeed, as noted earlier, in its press release announcing the recent re-examination of the proxy rules, the SEC stated as a goal the development of possible changes to the proxy rules "to improve corporate democracy."

Over the last thirty years, this debate has only grown in intensity. For one thing, institutional shareholders (including employee unions), who have the resources and clout to make themselves heard, have come to hold an increasing percentage of equities, and have become increasingly active in corporate governance matters. The number of households holding equities also has grown, especially during the 1990s. Corporate failures like Enron and Worldcom without a doubt have undermined overall confidence in management and in the "checks and balances" in place to prevent fraud, while also directly hurting the pocketbooks of a growing number of individual investors.

The SEC's Current Focus on Proxy Reform. Ironically, while Sarbanes-Oxley has been responsible for a number of corporate reforms, none of those reforms directly addressed the proxy process. The legislation did not even provide for a study of the proxy rules. It is not clear whether Congress considered and rejected proxy reform, or whether there is some other explanation for its silence.

The SEC, in any case, seems intent on wading into the area on its own. One reason for the SEC's eagerness may be hope of easing the burden posed by having to play the role of "referee," processing hundreds of Rule 14a-8 no-action letter requests each year. As noted above, a company may not exclude a proposal from its proxy materials without submitting such a request. Over the past few years, a steady increase in the overall number of proposals submitted to companies has meant an increase in the number of requests submitted to the SEC staff by companies planning to exclude proposals. Because most companies send out their proxy materials at the same time of the year, this results in a "traffic jam" of requests, which creates a drain on the staff's resources.

So far, the SEC's current study of the proxy rules appears to be focused on two questions.

First, should Rule 14a-8, the "shareholder proposal rule," be fundamentally re-shaped? Rule 14a-8 was last re-examined in 1997 and 1998. While some constructive clean-up changes were made to the rule in 1998, more significant proposed changes were not adopted due to opposition from shareholder and corporate groups.

The second question being addressed is a more significant one: should shareholders be granted greater participation in the *nomination* of directors? Most public companies have nomination procedures whereby a nominating committee of the board of directors reviews the qualifications of potential directors, and many have procedures through which shareholders can suggest nominees. The ultimate decision on nominations is made by the board. Shareholders are then asked to approve the nominees annually, and certain information about each nominee is included in the proxy statement.

The SEC's focus on this second issue appears to have been triggered in part by a proposal submitted this year under Rule 14a-8 that called for a company to permit shareholders or groups of shareholders holding 3% or more of the company's stock to nominate candidates for director in the company's proxy

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materials — bypassing the board and its nominations committee. The SEC staff agreed with the company's view that the proposal could be excluded from its proxy materials, but the shareholder proponent appealed the matter to the Commission. The Commission affirmed the staff's response, but indicated its intent to launch the current re-examination of the proxy rules.

The SEC has considered the question of direct shareholder nominations in the past, most recently in 1979, when it rejected the idea after hearing testimony from interested parties.

The Elements of Reform. What are the elements that might impact proxy reform this time around? In the 1997-98 reexamination of Rule 14a-8, almost every alternative to the current rule was considered. The SEC, for example, proposed in 1997 that the Rule be amended to permit shareholders holding 3% or more of the company's outstanding shares to "override" the most controversial basis upon which a company could exclude proposals, the "ordinary business" exception.

Other ideas considered by the SEC, but not proposed, were to encourage each state to adopt its own shareholder proposal rule, or alternatively to allow companies and their shareholders to adopt their own rules, in each case as an alternative to Rule 14a-8. Another idea was to significantly reduce the number of pre-conditions and other restrictions on a shareholder's ability to have a proposal included in a company's proxy statement, but then place a numerical cap on the number of proposals that a company would be required to include. Proposals would gain space in the company's proxy materials either in a "first-in-time" system, or perhaps by "lottery."

None of these alternatives gained great support just five years ago, as most commentators seemed to prefer the existing system with some refinements. One element of this debate that has changed is an apparent new focus on the use of the Internet as a forum for shareholder communication with boards and management. There is no question that the Internet could provide an accessible and efficient means of gathering shareholder views and communicating them to management. Such a system could also reduce the burden of the SEC staff's role as "referee." The real question is whether such a system could be designed and managed — without undue expense or SEC involvement — to become a truly useful tool for shareholders and the company, such as by sifting through shareholder-generated ideas to identify efficiently those that are most worthy and well-supported. It is equally unclear whether the shareholder community would accept such a system in place of the right accorded by Rule 14a-8 to have a proposal included in the company's proxy materials.

By contrast to Rule 14a-8, the idea of permitting shareholders to nominate directors to the board has not been formally considered by the SEC for 24 years. It is unclear at this point what direction the debate is likely to take. If a decision were reached to move forward, the chief obstacle would be the mechanics. What would happen if multiple shareholder groups made valid director nominations? Would all names be put before shareholders for approval, or would there be a numerical limit to the number of such nominees? Would the shareholder nominees compete with other nominees for a limited number of board seats, or would the company be required to reserve one or more board seats for shareholder nominees? How would all of the new Sarbanes-Oxley and stock exchange requirements for director independence and expertise be monitored and observed under these circumstances?

It is unclear, finally, whether the SEC has the authority to implement such a system directly. It may have to seek the cooperation of the stock exchanges to impose the requirements through amended listing standards, or look to the states to amend their laws governing corporations.

Conclusion. As of July 9, 2003 the SEC had received nearly 600 comment letters on its proxy initiative (not including any letters that may not yet have been posted on its website), and the staff was expected to make its recommendation to the Commission by July 15. On July 10, 2003, *The Wall Street Journal* reported that the SEC staff intends to recommend to the Commission rule proposals providing for greater shareholder involvement in the shareholder nominations process. Perhaps we will learn more before the end of the summer.

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