Will 2015 be the Year of Proxy Access?

IROs should also expect more investor questions on board diversity and tenure during the 2015 proxy season.

By Ted Allen
2015 may be remembered as the year that proxy access finally arrived.

This year, proxy access is a front-burner issue, along with board composition and perennial issues such as executive compensation, corporate political spending, and independent board chairs, according to Francis Byrd, author of the corporate governance blog “ByrdSpeaks,” who has overseen governance issues for TIAA-CREF and Connecticut’s state pension system. “Proxy access is important for a large proportion of the institutional investor community,” he notes, “not just in the United States, but also Europe.”

Currently, the corporate laws of Delaware and most U.S. states permit shareholders to nominate dissonant board slates and distribute their own proxy materials, a costly process that is typically used only by hedge funds and other well-financed activists. However, public pension funds, labor investors, and other governance advocates have argued since the 1980s that investors should have a less expensive way to get alternative board candidates onto corporate ballots.

After years of debate and hundreds of comment letters, the Securities and Exchange Commission adopted a marketwide proxy access rule in 2010 that would have required investor groups to collectively hold at least a 3 percent stake for three years, and capped access nominees at 25 percent of the total board. That mandate (Rule 14a-11) was challenged by corporate groups and struck down by a federal appeals court in 2011.

Corporate advocates did not challenge a separate SEC rule change that permitted shareholders to file company-specific access resolutions. Over the past three proxy seasons, most activists have carefully targeted their access proposals, selecting only a few high-profile companies each year that had lagging performance, accounting issues, frequent CEO turnover, and/or investor complaints over executive pay. Most of these targeted proposals have done well, often winning a majority of votes cast, and prompting several companies to adopt access bylaws based on Rule 14a-11.

However, New York City Comptroller Scott Stringer amplified the debate over proxy access when he announced in November that the city’s employee pension funds had filed proposals at 75 companies. According to his website, the targets of Stringer’s “Boardroom Accountability Project” include: “33 carbon-intensive coal, oil and gas, and utility companies; 24 companies with few or no women directors, and little or no apparent racial or ethnic diversity; and 25 companies that received significant opposition to their 2014 advisory vote on executive compensation.”

The New York City resolutions ask companies to adopt access bylaws based on the overturned Rule 14a-11. In addition, the California Public Employees’ Retirement System, several other public funds, and individual activists have filed another 15 proposals.

In response, some of the targeted companies filed requests with the SEC that ask the agency staff to agree to take “no action” if the company excludes the resolution from its proxy statement. At least 22 issuers argued for omission under SEC Rule 14a-8(i)(9) on the grounds that the shareholder measure would conflict with a planned management proposal that would impose stricter ownership requirements.

In early December, Whole Foods Market obtained permission from the SEC staff to omit a proxy access resolution filed by retail activist James McRitchie. The staff decision prompted outrage among governance advocates, who complained that Whole Foods’ planned management proposal (which would have required a single investor to hold a 9 percent stake for at least five years) would make access impossible, because there are no current investors who could meet that threshold. Whole Foods later reduced that ownership percentage to 5 percent when it filed its proxy statement. Most other companies have proposed bylaws with five-year and 5 percent requirements and various limits on investor groups.

SEC Reversal

McRitchie appealed the staff ruling, while the Council of Institutional Investors sent letters to the SEC and companies to express concern. In a surprising move in mid-January, Chair Mary Jo White directed the SEC staff to undertake a review of Rule 14a-8(i)(9) and to “express no views” on omission requests under that rule during the 2015 proxy season. Consequently, companies face legal uncertainty because they can no longer rely on the protection of a favorable SEC no-action ruling if they are sued for excluding a shareholder proposal.

The SEC review is not limited to proxy access and would apply to corporate requests under Rule 14a-8(i)(9) to exclude investor resolutions seeking special meeting rights and other governance changes. According to the law firm of Gibson Dunn & Crutcher, 49 companies have filed such requests this season.

Based on memos issued by various law firms after the SEC’s suspension of Rule 14a-8(i)(9), these companies appear to have five options: 1) persuade the SEC staff that the shareholder proposal should be omitted on technical grounds, such as insufficient
proof of ownership; 2) ask a federal judge to rule that the shareholder proposal can be excluded; 3) omit the investor proposal without obtaining a federal court order; 4) put the two competing proposals in the proxy statement, which may confuse investors; or 5) drop the management proposal and put the shareholder measure on the ballot and then oppose it.

“I doubt that companies would want to put both the shareholder resolution and a management resolution on the ballot since that would create confusion,” observes Shirley Westcott, a senior vice president at Alliance Advisors, a proxy solicitor. “I suspect that many companies will just leave the shareholder resolution on the ballot and fight it, figuring they’ll deal with the issue next year when there is more clarity from the SEC.”

Companies that opt to exclude proxy access proposals without the blessing of the SEC or a federal court may face a backlash from activists and proxy advisory firms. According to the New York Times, Stringer plans to oppose directors at companies that omit access resolutions. McRitchie has urged proxy advisors and institutions to take a similar stand.

In 2011, the board of San Antonio-based Kinetic Concepts (KCI) received a negative proxy advisor recommendation after omitting a retail activist’s board declassification proposal. KCI argued that the investor had provided insufficient evidence of ownership.

Although the SEC denied the company’s “no action” request, KCI relied on a federal court order obtained by another Texas company to exclude a proposal from that same investor on the same basis, but did not seek its own court order. KCI later reversed course and said it would declassify its board.

As of the publication deadline for this article, it was not known how most companies would respond to the SEC’s action, but it appears likely that IROs will see a record number of proxy access proposals on corporate ballots this spring.

The SEC’s action “really makes proxy access the story of this year,” notes Andrew Letts, a partner with CamberView Partners, a corporate governance advisory firm. “It’s become the biggest issue out there.”

Engaging on Proxy Access

Westcott doesn’t expect that the New York City access proposals will fare as well at companies that were targeted simply because of climate change or board diversity concerns. “Most institutional investors want to see proxy access only at companies with serious board accountability problems, a failed Say-on-Pay vote, or poor financial performance,” she points out.

“With any proposal, it can be hard to tell whether investors will support it or not,” notes Theresa Molloy, director of governance and shareholder services at Prudential Financial. “It depends on the company’s history and how responsive the company has been to shareholders’ views in the past.

“If a company receives a proposal, it would be a good idea to review the company’s overall shareholder base and evaluate the likelihood, in the context of the particular circumstances at the company, that the proposal would prevail if taken to a shareholder vote.”

Westcott expects that many shareholders would be receptive to management proxy access proposals that seek stricter ownership rules than the Rule 14a-11 standard (3 percent for three years) requested by activists, “Most institutional investors don’t want to see access abused,” she says. Westcott also expects that proxy advisors would support management proposals with greater hurdles after concluding that “some access is better than none.”

However, Byrd advises companies to be careful and not propose access bylaws with ownership rules (such as 10 percent or a 10-year holding period) that activists would view as excessively onerous. “If you start with an outrageous number, you are waving a red flag in front of a bull,” Byrd says, observing that such a move could put the company “under the microscope” of other activists in 2016.

“You should talk to your institutional investors to get their feelings on proxy access,” he advises, noting that some large investors may accept a compromise (such as a 5 percent stake for three years).

Board Diversity and Tenure

Another issue that is attracting more attention from investors is board “refreshment,” which includes concerns over diversity, tenure, and skills. The California State Teachers’ Retirement System and other activists have called on U.S. companies to boost gender diversity.

Currently, 19.2 percent of U.S. board seats are held by women, according to Catalyst, an advocacy group that is seeking more female directors. These activists point to the growing number of European nations, several of which have adopted mandatory gender quotas, such as 30 percent (Germany) or 40 percent (France, Norway, and Spain).

Byrd recalls that many activists expected to see a wave of board retirements after the global financial crisis, but that hasn’t really happened. “Companies have moved very slowly, and there is a great deal of frustration among women and people of color who feel they are qualified for board service,” he observes.

Investors also are paying closer attention to board tenure. While it appears unlikely that U.S. activists will embrace specific limits for independent directors (such as nine years in the United Kingdom, or 12 years in continental Europe), IROs should expect more questions about board tenure. In 2014, State Street Global Advisors adopted a new voting policy on
long-serving directors. While U.S. proxy advisors have not adopted maximum tenure guidelines, Institutional Shareholder Services (ISS) has added director tenure to its governance ratings and will “scrutinize” boards with an average tenure of more than 15 years. The average tenure at U.S. companies is 8.6 years, according to ISS data.

“Board refreshment is a critical subject that companies need to be able to talk about,” notes Byrd. “It shouldn’t just be the rolodex of the CEO; companies need to be able to tell shareholders they have a goal of greater board refreshment and explain that in their proxy statements.”

At the same time, most governance observers don’t expect that U.S. institutions will start voting against directors solely because of long tenure. “Investors look at a board holistically and will not vote against a director merely because he or she has been on the board for 20 years,” observes Prudential’s Molloy.

Likewise, Letts doesn’t expect a significant increase in votes against directors, but notes that board tenure could be raised by activists during proxy contests or votes on proxy access proposals. “If an investor is on the fence, it could pull them over the edge,” he says.

Letts, who previously was the head of corporate governance at State Street, also expects that more asset managers will revise their voting policies and engage on this issue. Shareholders likely will focus on outliers (e.g., companies with four or five long-tenured directors), while issuers with one or two long-serving board members should be able to address concerns by explaining their board refreshment practices. “It’s well within a company’s control to make this not an issue,” Letts says, explaining that boards could adopt age-limits and other policies to periodically roll off directors.

Molloy believes that many investors are taking a broader look at board composition. “In general, investors want to evaluate how a board thinks strategically about ‘refreshment,’ including leveraging the expertise of the current directors, and importantly, the type of directors the company needs for the future,” says Molloy. “Do they need directors with industry experience or technology expertise, and what are the trends that will impact the financial and competitive environment five or 10 years out?”

If your company does have long-tenured directors, it should “leverage your proxy to make it easy for investors to realize the value that the director plays by creating a skills matrix box,” Molloy says.

Ronald Schneider, director of corporate governance services at RR Donnelley Financial Services, says he has seen more companies use skills matrices and bullet points, instead of lengthy biographical statements, to highlight their directors’ skills and qualifications and urges companies to be proactive in this area: “Why wait until an activist investor comes calling to tell your best story about the skills and qualifications of your directors?”

Preparing for Another Say-on-Pay Vote

In 2015, most U.S. companies will hold their fifth Say-on-Pay vote, and most IROs are familiar with what they need to do to win investor support for their company’s executive compensation practices. Average support levels have remained above 90 percent over the past four proxy seasons, even after small-cap companies started holding compensation votes in 2013.

While the role of the IRO in this process will vary from company to company, Schneider advises IR professionals to work collaboratively with their company’s corporate secretary, legal, human resources, and corporate communication teams to offer input on the proxy statement, particularly on the compensation discussion and analysis section.

As Schneider observes, many companies now have a year-round Say-on-Pay process that analyzes annual meeting results, gathers input directly from investors, reviews peer company disclosures, and considers potential changes to their compensation and governance practices, as well as stylistic enhancements to the next proxy statement.

“Engagement with investors continues to be important to identify investor informational needs and preferences, as well as develop relationships that may be important during critical votes,” he says. “This engagement then informs clear proxy messaging, which can help companies try to minimize the impact of negative proxy advisor recommendations.”

Schneider has seen more companies adopt improvements in their voluntary proxy disclosures, such as hyperlinked tables of contents, shorter executive summaries, and new or expanded sections on topics including investor engagement, succession planning, or internal pay equity. “Your objective should be to communicate and convince,” he notes.

Also, as performance and pay decisions may change from year to year, the proxy messaging has to reflect these changing circumstances. “You can’t just set it and forget it,” Schneider adds.

If an IRO’s company expects Say-on-Pay opposition from proxy advisors or investors, he or she needs to be “preemptive,” advises Molloy.

“Reach out to investors and explain your compensation plan and the thought process behind its components. If your investors have recommendations, take them seriously, and to the extent that you can incorporate any of the recommendations, do so,” she says. “When investors have concerns, make sure you share these with your senior management team and the board.”

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