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SEC Releases Proposed Rules "Facilitating Shareholder Director Nominations"

The Securities and Exchange Commission yesterday released its proposed proxy access rules in a 250-page Release (Securities Act Rel. No. 9046). As expected, the proposed rules are broadly consistent with the SEC's previous announcement: in essence, any shareholder or group of shareholders that has held at least 1% of the stock of a public company (with larger thresholds for small-cap companies) for at least a year can have their proposed nominees for up to 25% of the board included in the company's proxy statement and on its proxy card – as long as they are the first such shareholder to file.

The Release again explains that the Commission's split decision to federalize the director nomination process was based on the premise that board failures played a large role in the current financial crisis and so dramatic changes are needed to "restore investor confidence." As we have previously noted, this premise is highly questionable at best and ignores the greater role in this crisis played by short-term pressures brought about by increased shareholder activism in recent years. The Delaware private-ordering approach to proxy access (supported by company-adopted bylaws like our model access bylaw) is more consistent with shareholder democracy than the SEC's one-size-fits-all federal mandate. Moreover, the SEC's proposal, if adopted, will likely exacerbate rather than mitigate the emphasis on short-term results, and create disruption, distraction and waste as election contests become as common and costless as 14a-8 proposals, with inadequate incentive alignment or controls on the quality of director candidates.

The Release details how the proposal is intended to work in practice, clarifies certain provisions and explains the SEC's rationale for choosing certain alternatives. On some points, it takes a more measured approach than the initial announcement had suggested. For example, it clarifies that even though generally shareholders can use the new Rule 14a-11 to propose up to 25% of the full board, a shareholder nominee previously elected under Rule 14a-11 whose term extends past the meeting will count towards the 25% cap. Without this significant change, the proposed rules could have significantly undermined the integrity of staggered boards.

Importantly, the Release seeks comments on almost five hundred specific questions, reflecting the SEC's appreciation of the complexity of this matter. However, many of the difficult issues that the Commission recognizes are not reflected in the proposed regulations but only in their admirable questions (such as whether shareholders should be able to opt out of this proposal and approve different standards, and whether a simultaneous "full-blown" proxy contest should preempt use of the new proxy access rule).

The Commission wisely notes: "Amending our rules to provide for the inclusion of shareholder nominees for directors in a company's proxy materials is a significant change. Given the novelty of such a change, we believe it is appropriate to take an incremental approach as a first step and reassess at a later time to determine whether additional changes would be appropriate."

That much seems undoubtedly true. With hundreds of important questions to consider, the SEC should not rush to adopt a preemptive one-size-fits-all rule based on a dubious and unproven premise in response to political pressure. It is inconceivable – especially given the breadth of comments sought – that the SEC can do justice to these issues in time for the 2010 proxy season.

Given these questions and the serious issues at stake, we believe that the SEC should adopt Rule 14a-8 amendments this year to facilitate private-ordering on the subject of proxy access (the Model Business Corporation Act and other states are looking to follow the Delaware approach), while continuing to study the merits and demerits of broader changes. Based on recent experience with majority voting, in which a sizable majority of large public companies adopted some form of majority voting within a two-year time frame, it is entirely possible if not likely that private ordering will lead to a reasonable accommodation that gives shareholders enhanced nominating powers, without damaging America's corporations in the process or eliminating shareholder choice through an unprecedented federalization of our corporate law. Based on the results of this type of thoughtful company-specific private ordering, the SEC could then revisit the need for an across-the-board federal proxy access regime in the future.

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