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Shareholder Proxy Access: Time To Get Ready

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As we described in our recent memo, the SEC has adopted rules affording shareholders access to company proxy statements for the nomination of director candidates. The new regime, which includes new access Rule 14a-11 and amendments to Rule 14a-8, is expected to become effective in early November and will be applicable for the 2011 proxy season for most companies. It is now time for companies to take action to prepare for these sweeping changes. We opposed proxy access as an unnecessary and imprudent step. However it is now law and companies need to implement structures and procedures designed to make the proxy access regime work with minimum damage to the ability of boards to build long-term value for all shareholders. This memo highlights some of the major actions companies should consider:

Monitor and Engage with Significant Shareholders. While it has always been important for companies to engage actively with their major shareholders to gain a better understanding of their views and concerns, this takes on a heightened relevance in light of the new proxy access rules. In some cases, the group of shareholders that warrant engagement may have to be expanded. The new rules afford proxy access to shareholder groups who have collectively held at least 3% of the voting power of a company's stock continuously for at least three years. In light of these ownership thresholds, companies should actively monitor their shareholder base, and may wish to engage third parties to help them identify holders, including smaller long-term shareholders, who may be eligible to initiate or participate in nominating groups. Engaging with shareholders in advance of the Rule 14a-11 notice period should afford companies a better view of their shareholders' interests in becoming involved in the nomination process.

In addition, engaging constructively and pro-actively with shareholders may enable companies to anticipate and address investor concerns that could otherwise lead to nominations. While it will not be possible to head off all nominations, particularly from unions, activists and others with

special non-shareholder agendas, a company's ability to resist a special interest access slate will be greatly enhanced if it has fostered good relations with its major shareholders. Of course, companies will need to be reasonable in their allocation of resources, particularly in terms of senior management time and focus, in connection with their investor relations programs, and boards of directors should retain the ultimate decision-making authority and responsibility on issues and concerns that shareholders may raise. However, in light of proxy access, and other recent developments in the corporate governance landscape, boards of directors and management will be well advised to use reasonable efforts to educate shareholders about their company's strategy, encourage long-term investors, and develop their relationships with shareholders and their understanding of their shareholders' perspectives on the company well in advance of any potential proxy contest.

Respond to "Early Warning" Schedule 14N Filings. We expect that, in most cases, a shareholder considering nominating directors under proxy access will first seek to solicit other shareholders to form a nominating group to aggregate their holdings in order to meet the 3% minimum ownership threshold or establish a larger nominating ownership position. A shareholder seeking to form a nominating group will likely use a new exemption from the proxy rules adopted for such solicitations, which will require it to file a notice on new Schedule 14N as soon as it starts communicating with other shareholders, as well as copies of any written communications it makes. These filings will disclose the number of shares held by the soliciting shareholder and may identify potential nominees or the characteristics of nominees that the shareholder intends to propose. Companies should monitor these 14N filings for "early warning" of potential access nominations, and consider engaging with the soliciting shareholder or others who may be solicited to join the nominating group to understand and potentially address their concerns prior to the submission of an actual nomination that may generate its own momentum.

Companies should be aware, however, that if they engage in communications with a shareholder specifically about a nomination prior to the shareholder filing a nomination on Schedule 14N, that nomination will not count against the 25% cap on shareholder access nominees if the company later agrees to recommend the election of that nominee.

Revise Advance Notice Bylaws. Companies should review their advance notice bylaws and consider changes in light of the new proxy access rules (which will apply by law even if not addressed in the bylaws). Our model advance notice bylaws, as updated to reflect proxy access, are attached. The model retains a suggested advance notice period of 90 to 120 days prior to the anniversary of the prior annual meeting for shareholder proposals of new business or for director nominations made outside of Rule 14a-8 and Rule 14a-11, consistent with established practice and case law. New Rule 14a-11, which our revised model bylaws treat as an exception to the

generally applicable advance notice requirements, requires shareholders seeking to include their nominees in the company's proxy statement to file a notice no earlier than 150 days, and no later than 120 days, prior to the anniversary of the *mailing date* of the prior year's proxy statement (that is, 60 to 70 days earlier than under our model advance notice bylaw for proposals made outside the federal rules). Particularly in light of the now-mandatory proxy access route, companies which did not previously have state-of-the-art advance notice bylaws for notice of business and director nominations should adopt or revise such provisions.

Review Director Qualification Bylaws. Companies should review any director qualification provisions in their bylaws. Many companies have adopted standards that all candidates must meet to be eligible to serve as directors (and our model bylaws have long included such provisions). The new access rules do not negate director qualification requirements, which are governed by state law, but operate alongside them. While failure to satisfy the company's director qualification standards will not preclude a properly nominated access nominee from being included in the proxy statement under Rule 14a-11, or from being voted upon, companies may, subject to state law, preclude nominees from serving as directors for failure to satisfy reasonable qualification requirements. In addition, nominating shareholders using Rule 14a-11 must disclose whether, to their knowledge, their nominees meet the company's director qualifications, which may affect both the quality of the nominees that are proposed and the number of votes that non-qualified nominees may receive. We are not proposing any changes to the director qualification provisions of our model bylaws, which are included in the attachment.

Review Corporate Governance Policies and Board Committee Charters. Companies should consider updating their corporate governance policies and board committee charters to take account of the proxy access regime. For example, companies may wish to address in their nominating committee charter the responsibility for reviewing nominees proposed through the proxy access process, as well as regular nominees. Education of new directors, including some who may never before have served on a board, should be considered. Companies should also consider implementing appropriate director policies regarding confidentiality and public statements concerning company matters, especially in light of the possibility of director candidates with ties to shareholders with special interests. Rule 14a-11 mandates that the nominating shareholders disclose relationships between themselves and their candidates as well as relationships between the company and either candidates or their proponents, but does not require that nominees be independent from the nominating shareholders nor that they satisfy subjective independence requirements under exchange rules.

Director Qualifications and Evaluation. The SEC adopted amendments to the proxy rules in December 2009 that require companies to disclose the qualifications, skills and experiences the

board considered in determining that each particular director was qualified to serve on the board. These new disclosure requirements, together with the adoption of proxy access, reinforce the importance of boards engaging in a thorough and candid evaluation of their members, including to ensure that the board's composition remains appropriate in an evolving business environment. Companies should also consider which, if any, board members may be vulnerable to be targeted by proxy advisory services such as ISS during a proxy access or shortslate contest, as well as whether there are any issues on which the company is at risk for a withhold recommendation against some or all nominees.

Review Appropriate Board Size. Boards should periodically review the appropriate size of the board for the company's particular circumstances, taking into account all relevant factors, including having sufficient independent and qualified directors to fill the needs of all board committees. If the calculation of the 25% cap on proxy access nominees does not result in a whole number based on the board's size, the SEC rules provide that the cap rounds down to the closest whole number of nominees below 25% (with a minimum of one nominee). Thus, a company with a seven-member board will face a maximum of one nominee (14.3% of the board) under Rule 14a-11, and, likewise, a company with an eleven-member board will face a maximum of two nominees (18.2% of the board). Companies should be cautious about the timing for implementing any change in board size; consideration of the appropriate board size and any action to change the size of the board is better accomplished outside the context of any potential election contest.

Consider Ways To Minimize Disruption. The new proxy access regime may lead to a higher incidence of proxy contests, as well as "shadow" proxy contests, where nominations are threatened in the context of seeking to change corporate policy or board composition. Activists can also be expected to take advantage of the one-way street created by the SEC, together with the 2009 amendments to Delaware law permitting shareholders to adopt access bylaws, to press for mandatory bylaw amendments providing even more favorable procedures for proxy access, such as reducing the 3% eligibility requirement or the three-year holding period. A game plan to deal with these possibilities should be developed.

Board Stability and Dynamics. Although we have often warned of the potential threats posed by proxy access to board stability and collegiality, and thus effectiveness, much will depend on shareholders' agendas and the quality of candidates put forward by shareholders and groups using – or threatening to use – the access process, as well as the way these candidates choose to conduct themselves. We are hopeful that major institutional shareholders will use their newfound power constructively and responsibly. Accordingly, in the event that candidates nominated through the proxy access process are elected to a board, the board should generally

seek to integrate those new directors constructively, expect them to operate with dedication, diligence and integrity, and only resort to protective structures, such as increasing use of committees, as some have advocated, as a last resort.

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Although there are some actions in light of the new proxy access rules that can and should be taken at this time, as discussed above, many of the effects of the new regime are still to be determined, and a fuller picture of the new environment will only emerge in time. Active monitoring and engagement by boards of directors and management will be required as the new landscape of shareholder-board relationships develops and unfolds.