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Corporate Governance Update: Preparing Now For Proxy Access in 2011

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Now that the Securities and Exchange Commission (SEC) has approved final rules regarding the inclusion of shareholder nominees in company proxy statements, proxy access is the law for most U.S. public companies.[1] Eligible shareholders (or groups of shareholders) will be able to nominate director candidates without the expense and effort of mailing separate proxy materials. The proxy access rules will become effective on November 15, 2010[2] and will apply to companies (other than small reporting companies) that mailed their 2010 proxy statements on or after March 15, 2010. Accordingly, most public companies need to prepare for the 2011 proxy season with proxy access in mind. As companies review the impact of the new proxy access rules, there are a number of important issues to consider.

Shareholder Dynamics

The SEC's new proxy access rule—Rule 14a-11—gives proxy access to shareholders and shareholder groups who have collectively held at least three percent of the voting power of a company's securities continuously for at least three years.[3] Therefore, it is essential that companies actively monitor their shareholder base, and track changes in that shareholder base, in order to know who their major shareholders are and which, if any, shareholders may have similar interests that could lead them to aggregate their holdings to meet the three percent threshold. Companies should consider engaging outside assistance to help them identify holders who may be eligible to initiate, or may be inclined to participate in, the formation of nominating groups, as well as to gain additional transparency into the trading of their shares.

In recent years, it has become increasingly important for companies to communicate effectively and engage actively with their major shareholders. Proxy access heightens the stakes in this relationship. Companies may wish to expand the group of

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[1] SEC Release Nos. 33-9136; 34-62764; IC-29384, available at www.sec.gov/rules/final/2010/33-9136.pdf.

[2] The final rule was published in the Federal Register on September 16, 2010, available at www.sec.gov/rules/final/2010/33-9136fr.pdf.

[3] The nominating shareholder(s) must have held both investment and voting power equal to at least three percent of the voting power of the company's securities.

shareholders with whom they regularly engage, using the information gained from careful monitoring of the company's shareholder base. While even the best shareholder outreach efforts cannot forestall all nominations—particularly from union funds, pension funds and other activist organizations—good communication with the right shareholder groups can be invaluable as companies anticipate the concerns that might lead to nominations, resist the formation of nominating groups, and, if it comes to a proxy contest, combat special interest access slates. The time to engage with significant shareholders is before a problem arises. Once an activist appears on the scene, the company will be in a defensive posture, and it becomes much more difficult to successfully engage with shareholders and promote the company's agenda if relationships with major shareholders have not already been formed.

The new Schedule 14N likely will prove to be a valuable early warning sign for companies as they navigate proxy access. Unless a shareholder can meet the three-year, three-percent threshold on its own, a shareholder who wishes to participate in proxy access will attempt to form a group with other shareholders to meet the threshold. In order to engage in a solicitation to form such a group, the shareholder may use a new exemption from the proxy rules, which requires the shareholder to file a notice on Schedule 14N. These filings disclose the number of shares held by the soliciting shareholder and may disclose the identity of potential nominees or the characteristics of potential nominees that the shareholder intends to propose. Companies should pay close attention to Schedule 14N filings and consider engaging with the soliciting shareholder or those being solicited in order to understand and, if possible, address the shareholders' concerns outside the nominating process. Companies should also actively monitor Schedule 14N filings by their own significant shareholders in other public companies so they can be prepared to proactively engage with those shareholders and attempt to forestall problems at a later time.

Once a nomination is submitted, the danger is that companies may find themselves forced into a reactive (and thus defensive) posture with less ability to control the momentum of the situation and its eventual outcome. Thus, it is very important for companies to know their shareholders, understand the dynamics of their shareholder bases, maintain effective and targeted communication with key shareholders, and avoid being caught off guard by a nomination under the new proxy access rules.

The recent changes limiting discretionary voting by brokers[4] will continue to put pressure on quorums and obtaining support for management initiatives, including equity

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[4] On July 1, 2009, the SEC approved an amendment to NYSE Rule 452 and § 402.08 of the NYSE Listed Issuer Manual that eliminated discretionary voting by brokers in uncontested elections. *See* SEC Release No. 34-60215 (July 1, 2009) available at www.sec.gov/rules/sro/nyse/2009/34-60215.pdf. The Dodd-Frank Wall Street Reform and Consumer Protection Act also would require the stock exchanges to prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter, as determined by the SEC, which could lead to the elimination of broker discretionary voting in its entirety. The elimination of the broker discretionary vote in director elections coupled with the widespread adoption of a majority voting standard in the election of directors, have increased the ability of shareholder activist organizations and proxy advisory firms to affect vote outcomes.

compensation plans. In addition to increasing shareholder outreach, companies should also consider the need for more aggressive proxy solicitation and carefully weigh the benefits of lower cost from the electronic delivery of proxy materials against the downside of a lower percentage of retail votes when no paper proxy materials are sent. Companies also should monitor and consider commenting on the SEC's recent proxy plumbing concept release, which could have a significant impact on how shares are voted in corporate elections.[5]

Governing Documents

Another important facet of preparation for the new proxy access regime centers around reviewing the company's governing documents, including advance notice bylaws and director qualification bylaws, although any amendments must be consistent with the company's certificate of incorporation. Companies should review and consider updating advance notice and director qualification bylaws in light of the new proxy access regime to make sure that they operate as intended. Advance notice bylaws set the requirements for notice of shareholder proposals of business or for director nominations made outside of the federal rules 14a-8 and 14a-11, consistent with established practice and case law. They can be crucially important in certain situations, and we strongly recommend that companies ensure that their advance notice bylaws are state-of-the-art. One item to consider is the appropriate length of time for advance notice. Under Rule 14a-11, the deadline to nominate directors with access to the company's proxy statement is no earlier than 150 days and no later than 120 days before the one year anniversary of the mailing of the previous year's annual meeting proxy statement. Most public companies with advance notice provisions generally have shorter time frames (often 90 to 120 days prior the anniversary of the previous year's annual meeting), but we do not recommend changing the company's advance notice provisions to match the access notice timing requirements.[6]

Director qualification bylaws also operate alongside the new proxy access rules. While failure to satisfy the company's director qualification requirements—which are governed by state law—will not preclude a properly nominated access nominee from being included in the proxy statement under Rule 14a-11, or from being voted upon, the company may (subject to state law) preclude nominees from serving as directors for failure to satisfy reasonable qualification requirements. Furthermore, shareholders using Rule 14a-11 must disclose whether, to their knowledge, their nominees meet the director qualification requirements of the company. It is therefore very important that the company establish clear requirements and review the company's bylaws to ensure that they are up-to-date. We recommend that companies include disclosure requirements in their advance notice bylaw provisions regarding the proponent's

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[5] Concept Release on the U.S. Proxy System, 17 CFR Parts 240, 270, 274 & 275; Release Nos. 34-62495; IA-3052; IC-29340; File No. S7-14-10 available at www.sec.gov/rules/concept/2010/34-62495.pdf; s*ee also* David A. Katz & Laura A. McIntosh, "Proxy Plumbing Fixes Are Desperately Needed," NYLJ, July. 22, 2010, at 5.

[6] For Delaware corporations, in formulating advance notice requirements and director qualifications in bylaws, they must function in a manner that is reasonable and equitable. These requirements and limitations must serve a proper corporate purpose without unduly limiting stockholders in nominating and electing directors.

holdings in the company's securities and derivatives of the company's securities as well as the proponent's relationship with any director nominee or interest in any business proposed to be brought before the annual meeting.

Corporate Governance

Similarly, companies should take this opportunity to review their corporate governance policies and guidelines, their business ethics and business conduct policies and board committee charters. The proxy access rules may result in the nomination and election of directors who are unknown to the board or have never served on a board before. Companies may wish to address these and other possibilities by giving the nominating committee responsibility for reviewing nominees proposed by shareholders, by reviewing director education programs, and by implementing or strengthening director policies regarding confidentiality and public statements on company matters. The last item could be particularly important if a nominee with close ties to a major shareholder is elected to the board. While nominating shareholders must disclose any such ties (as well as any ties between themselves or their nominees and the company), there is no requirement that the nominees be independent from the nominating shareholders.[7] One possible approach is to publicly disclose confidentiality requirements applicable to directors on the company's Web site and to consider including these provisions in the company's ethics or business conduct policies. In addition, it might be useful to have the company insider trading policy as it applies to all directors publicly disclosed on the company's Web site so there can be no question as to the requirements applicable to all directors.

Under the new proxy access rules, shareholders may nominate the number of candidates that represents up to 25 percent of the board (or the greatest whole number below 25 percent, with a minimum of one). Boards should be aware of this number and keep it in mind when reviewing any proposed changes in board size. Companies should be careful, however, to separate the consideration of any changes in board size from any potential election contest.

Another element of corporate governance that is potentially implicated by the new proxy access rules is the director qualification disclosure required in the proxy statement. The SEC adopted amendments to the proxy rules in December 2009 requiring companies to disclose the qualifications, skills and experiences the board considered in determining that each particular director was qualified to serve on the board.[8] Proxy access makes it all the more important that boards thoroughly and candidly evaluate their members, both in order to ensure that board composition remains appropriate in the changing business climate as well as to identify any potential vulnerabilities that may be exploited by antagonists in a proxy access or short-slate contest. Companies should stay up-to-date on the policies of proxy advisory services such as Institutional Shareholder Services in order to be aware of any issues with respect to which the

[7] In addition, shareholder nominees must meet the objective criteria for independence of the stock exchange on which the company is listed, but not its subjective criteria.

[8] SEC Release Nos. 33-9089; 34-61175; IC-29092, available at www.sec.gov/rules/final/2009/33-9089.pdf.

company may face a withhold recommendation against one or more board nominees. This possibility becomes increasingly fraught with danger in a world of majority voting and proxy access. The company's nominating committee should consider regularly, and at least on an annual basis, the criteria that the proxy advisory services use for a withhold authority recommendation.

Some commentators have suggested "hardball tactics" for circumventing the intended effect of the rules, such as screening out challenge candidates through director qualification bylaws, preventing shareholder eligibility with poison pill thresholds below three percent, or delegating decision-making to board committees from which access nominees are excluded;[9] in our view, such actions could in many cases be significantly more disruptive than accepting access nominees who are elected as full members of the board and forging a constructive working relationship with the new director or directors and their nominating shareholders. If they are to be used at all, the use of hardball tactics should be reserved for extreme cases in which an elected proxy access nominee becomes disruptive or threatens the effective operation of the board, which we believe will be the exception rather than the rule.

Conclusion

We view the new proxy access regime as an unfortunate development and one that may empower activist shareholders (especially unions and special interest groups) to the detriment of companies' ability to focus on creating long-term value. We have argued that the potential disruption caused by proxy access threatens board stability and effectiveness.[10] Nevertheless, the time for debate is over, and proxy access now represents a major change in the landscape of corporate law and governance. It will take some time for the ramifications of the new rules to become clear. It is possible that there will be a higher incidence of proxy contests, or that shareholder antagonists will use the possibility of shareholder nominations as a tool to threaten or bargain with companies. It is likely that activists will continue to press for easier requirements for proxy access (such as a lower threshold of share ownership).[11]

In the meantime, companies need to prepare for these and other possibilities by maintaining accurate information regarding their shareholder base, by establishing good

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[9] *See, e.g.*, J.W. Verret, "Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank," George Mason Law & Economics Research Paper No. 10-37 (Aug. 8, 2010), available at www.ssrn.com/abstract=1655482.

[10] *See, e.g.*, David A. Katz & Laura A. McIntosh, "SEC Revisits Shareholder Access to Director Nominations," NYLJ., Aug. 30, 2007, at 5; David A. Katz & Laura A. McIntosh, "Proxy Access—Not Then, Not Now," NYLJ., Sept. 28, 2006, at 5.

[11] In connection with Rule 14a-11, the SEC amended Rule 14a-8(i)(8) to facilitate shareholder proposals requiring companies to provide for proxy access in the company's governing documents. SEC Release Nos. 33-9136; 34-62764; IC-29384, available at www.sec.gov/rules/final/2010/33-9136.pdf. Such proposals likely would be aimed at expanding the proxy access procedures and lowering the proxy access thresholds beyond what is set forth in Rule 14a-11.

communication with shareholders and groups, by ensuring that their governing documents and board policies are up-to-date, and by generally monitoring developments in this area. Companies need to keep their directors apprised of significant developments, especially with respect to the application of the new proxy access rules. In this way, companies will have a fighting chance of staying a step ahead of any access nominations and minimizing disruption from them.