

Wednesday, July 29
9:00 a.m. Pacific
11:00 a.m. Central
12:00 p.m. Eastern

Webcams

Corporate Governance Forum

Proxy Access: What Boards, Senior Management and Their Corporate Governance Advisors Need to Know and Do Now

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What is Proxy Access?

- Now – Only candidates for election to the board *nominated by the company* are included in the company's proxy materials
 - If a shareholder wants to nominate opposition candidates, it must prepare, pay for and distribute separate proxy materials
- Proxy Access – Shareholders would be allowed to include in the company's proxy materials candidates *nominated by the shareholder(s)* in opposition to the board's candidates for election to the board

What is Happening Now?

- Proxy access is a critical (if not *the* critical) corporate governance issue for every public company in 2009
- On May 20, 2009, the SEC (by a 3-2 vote) proposed new rules to create a “prescriptive” federal proxy access regime
- Delaware has amended its corporation law to permit Delaware corporations to adopt proxy access bylaws
 - ABA has similarly amended the Model Act
 - Proposed SEC proxy access rules would eliminate most of the flexibility permitted under state law
- Legislation has been proposed in both Houses of Congress:
 - Confirming the SEC’s statutory authority to issue proxy access rules
 - Mandating the SEC to adopt rules governing proxy access

Proposed Rule 14a-11

- Companies subject to proxy access
 - All Exchange Act reporting companies, regardless of size, that are subject to the proxy rules
 - Also all publicly held investment companies
- Tiered minimum-ownership requirement
 - 1% of the shares of a large accelerated filer (\$700MM +)
 - 3% of the shares of an accelerated filer (\$75 - \$700MM)
 - 5% of the shares of a non-accelerated filer (<\$75MM)
- Minimum holding period
 - At least one year prior to date shareholder notifies company of intent to nominate a director

Proposed Rule 14a-11

- Timing of nomination
 - Same as for Rule 14a-8 proposals: no later than 120 days prior to the date of publication of prior year's proxy material, *unless different period in company's advance notice bylaws*
- Number of access directors
 - Shareholders could nominate the greater of one director (for a board of seven or less) or up to 25% of the board
 - Additional shareholder-nominated directors could be elected through a concurrent conventional proxy contest
- More nominees than slots
 - Priority determined by the date of submission, not the amount of shares held by the nominating shareholders

Proposed Rule 14a-11

- Independence
 - Nominee must meet “objective” independence standards if company is listed, but not the “subjective” standards
 - Leaves board composition at risk if elected and “fails” subjective standards
 - No mandated independence standard for non-listed companies
 - Independence from the nominating shareholder not required
- Aggregation permitted
 - No limit on the size of a nominating group
 - Communications exempt from the proxy rules
- Dispute resolution analogous to Rule 14a-8

Proposed Revisions to Rule 14a-8(i)(8)

- SEC also proposes to amend Rule 14a-8 to permit shareholder proposals relating to proxy access
- Would reverse SEC's 2007 codification of its interpretation of the "election exclusion"
- The thresholds for proxy access proposals under amended Rule 14a-8 would be the same as for other Rule 14a-8 proposals

Some Key Issues

- The proposed access rules do not allow “opt-out” by companies, even by shareholder vote
 - Create “one way street” where shareholders can make access easier but not harder, principally by using revised Rule 14a-8
- Although probably not intended, proposed rules have serious implications for changes in control
- Proposed rules are very cursory in terms of operation and mechanics—many “workability” issues
- Dispute resolution likely to be skewed to nominating shareholders and will be difficult to challenge in court for timing reasons, among others

Comment Process

- Comment period expires on August 17, 2009
- There are 171 specific requests for comments (approx. 500 separate questions)
- Under the APA, the SEC must consider the comments that it will receive
- There will be a vibrant comment process
- As a result, many observers predict that only Rule 14a-8 will be amended for the 2010 proxy season, while the SEC continues to work on its substantive access proposals

What Should Private Sector Do?

- Senior managements and boards need to be educated
- Companies should consider submitting comment letters to SEC
- Premature to embark on bylaw amendments

Our Recommendations: Educate

- Schedule Sessions *Now* to Educate Management, Board, Governance Committee
 - General counsel, corporate secretaries and outside advisers should ensure that management, board, and relevant committees understand the proposed SEC rules and the new Delaware statutory authorizations for proxy access bylaws
 - Education should also cover practical implications in terms of potential proxy contests resulting from proxy access nominations and internal board governance issues that would be raised by a successful proxy access candidacy
 - Boards should also understand the range of choices they will face if proxy access becomes reality in fall of 2009, either as prescriptive rule or as a result of shareholder proposals under an amended Rule 14a-8

Our Recommendations: Comment

- Consider Submitting Comment Letter to, or Requesting Meeting with, SEC
 - SEC Commissioners and staff appear sincere in desire to hear from all parties affected by the proposed rules
 - Activist shareholders and long-term supporters of proxy access will mount major campaigns for proposed rules
 - No form letters – Comment letters should be as specific as possible, and provide reasons, supporting facts and figures
 - Comment letters will be posted on SEC's website
 - For meeting, only a memorandum summarizing topics discussed at meeting and persons involved will become public
 - A large number of companies will probably comment, even if important time and resources are necessary for thoughtful letter

Our Recommendations: Do Not Amend Bylaws Now

- Several commentators suggested public companies consider revising bylaws in anticipation of SEC's adoption of proxy access regime
 - Preemptive proxy access bylaws to demonstrate voluntary governance changes and private-ordering are better solutions
 - Amend bylaws to deal with proposed access rule provision that advance notice bylaws will supersede 120 day notice period as latest date for access nominations
- We recommend against adoption of either bylaw revision during pendency of SEC rule-making process
 - Companies may waste time and expense on bylaw revisions that may prove unnecessary or require revision in few months

Possible Topics for Company Comment Letters

- Fundamental policy issues, including:
 - Whether SEC has authority to adopt prescriptive rules
 - Whether SEC has articulated rational basis for rule-making
 - Whether principles of federalism are inappropriately ignored by proposed rules (particularly in light of Delaware and ABA efforts)
 - Whether necessary or appropriate to impose “one size fits all” proxy access for all public companies,
 - Whether shareholder democracy is appropriately served by prescriptive rule that is not subject to modification or elimination by shareholder vote
 - Appropriateness of informal no-action letter process to resolve disputes about proxy access eligibility and rule interpretation

Possible Topics for Company Comment Letters

- Change in control issues, including
 - Possibility of nominating shareholder(s) changing control intent after notice of nomination, even before annual meeting
 - Ability of one shareholder or shareholder group to nominate 25% of board
 - “Exemption” of nominating shareholders from Schedule 13D reporting requirements (only subject to Schedule 13G even if have an intent to “influence” control)
 - Ability to solicit any number of shareholders to form a nominating group and no cap on number of shares held by group—all exempt from existing proxy rules if done in writing
 - Possibility of simultaneous proxy access and traditional proxy contest, with or without cooperation

Possible Topics for Company Comment Letter—Workability Issues

- The SEC proposals create a host of “workability” issues, including:
 - Definition of beneficial ownership
 - Timing conflicts
 - Changes in circumstances between nomination notice and meeting
 - Simultaneous proxy access and traditional proxy contests
 - Variations in capital and board structures

Beneficial Ownership

- No general definition under 1934 Act and no definition in proposed rule
- Section 13(d) definition of “beneficial ownership” not appropriate for determining a “significant” shareholder for whom proxy access intended
 - Voting power, standing alone, not appropriate because includes “empty voting”
 - Investment power, standing alone, may also include derivative-based strategies that reduce or eliminate economic risk
 - Even with conventional “physical” ownership, hedging allows reduction or elimination of economic risk
- To accomplish purpose of rule—provide proxy access only to long-term investors—we believe ownership concept in the proxy access rule should be limited to continuous net long conventional ownership of “physical” securities

Timing Conflicts—Advance Notice Bylaws

- Proposed rule establishes a minimum notice period of 120 days before the date of the mailing of last year's proxy materials (i.e. 150-160 days prior to the annual meeting), unless another deadline is established in company's advance notice bylaw
- Most advance notice bylaws require a minimum notice of only 60-90 days prior to the annual meeting
 - Too short to accommodate proposed no-action dispute resolution system, but providing longer timeframe in advance notice bylaws would be questionable under state law

Timing Conflicts—Proxy Access Nominations and Board Nominations

- Proxy access nomination notice is late fall event
- Board nomination process usually a mid-winter event
- If company has a proxy access director sitting on board
 - Will shareholders assume renomination?
 - If don't and renominate or nominate another, will board be likely to renominate?
 - Potential for creating or exacerbating “adversarial” situation
 - Board cannot reasonably be asked to accelerate nomination process
 - Shareholder access nominations cannot be moved closer to meeting to accommodate board nomination process

Timing Conflicts—Possible Solutions

- Decouple proxy access minimum notice and advance notice bylaws because timing cannot be reconciled
- Encourage integration of proxy access director and board functioning by providing either:
 - Proxy access director retains status for a period of time (2-3 years) or
 - Limit proxy access elections to every second or third year

Changes in Circumstances Between Nomination and Meeting

- SEC proposed rules do not deal with a variety of possible changes in circumstances after proxy access notice period expires, including
 - Withdrawal of proxy access nominee's candidacy because of death, disability, other inability to serve as director, change of mind by either nominating shareholder or nominee, an agreement is reached to include nominee on board slate, etc.
 - Determination that nomination did not meet, or did not continue to meet, requirements for proxy access
- Suggested solution—no substitute proxy access nominee
 - Alternative of reverting to other qualifying nomination not practical because of time constraints

Simultaneous Proxy Access and Traditional Proxy Contests

- If this were to occur:
 - Would any form of cooperation between nominating shareholders for proxy access and traditional insurgent group be permitted?
 - Could insurgents include proxy access candidates on their proxy card?
 - Could either solicit for other?
 - Risk of confusion for shareholders confronted with simultaneous contests and at least two different proxy cards
 - Could Broadridge and proxy dissemination and vote collection system cope with two simultaneous proxy contests?

Simultaneous Proxy Access and Traditional Proxy Contests

- We recommend that the proxy access rules not permit simultaneous proxy access and traditional proxy contests by allowing company to drop the proxy access nominees from its proxy materials
- If shareholders are willing to accept the economic burden of a traditional proxy contest, the policy need for proxy access is dispelled
- Simultaneous proxy access and traditional proxy contests raise significant control issues
 - Proxy access and traditional insurgents may cooperate in their respective proxy contests, even if don't share proxy card
 - Following election, proxy access directors and dissident directors may become board room allies

Variations in Capital and Board Structures

- Proposed rule apparently premised on simple capital structure of single class of common stock and simple board structure without class voting for different classes of directors
- Many public companies have more complex structures that raise complicated issues not addressed by rule proposal, for example:
 - Two classes of common stock with different voting rights
 - Different classes of directors, elected by different classes of stock
 - Specified shareholders may have contractual rights to designate directors

Variations in Capital and Board Structures

- We are skeptical that a prescriptive rule can be drafted that deals with all of the factual variations that arise in practice
- Nor does proposed rule seem to provide ability of company to use private ordering to address these variations
- Consequence of variety of capital and board structures and prescriptive rule is that application of rule in many situations will not be clear
- Reliance on no-action letter process for interpretation not satisfactory from a timing or process point of view

Conclusion

- The proxy access debate is far from over and will continue to play out throughout the fall (and possibly beyond)
- There is opportunity for the private sector to influence the outcome
- Latham & Watkins and Georgeson will continue to publish and distribute updates and analyses
- Be prepared, be up-to-date, and stay tuned ...