Proxy Access Year One: What to Expect and What to Do Now

Proxy access will be a reality beginning in the 2011 proxy season. The SEC's new Rule 14a-11 will enable long-term substantial shareholders, acting alone or in concert, to nominate candidates for up to a quarter of a company's board, and to include those nominees in the company's own proxy statement in competition with the incumbent board's nominees. The SEC also amended Rule 14a-8 to allow for shareholder proposals that would broaden proxy access. Our summary of the new rules is here.

How will shareholders use their new-found powers, and how should companies be preparing for this new world? These questions, once hypothetical, are now imminent: calendar year companies could begin receiving these notices as early as this fall, so now is the time to anticipate, prepare and, potentially, to act.

We have been discussing these matters with companies, institutional shareholders, regulators and other market participants over the past year. Here are our initial thoughts as to what to expect for 2011, together with our recommended action plan.

Who will use proxy access?

To begin with, we do not expect a stampede of proxy access campaigns in the 2011 season. There are no useful precedents, there are a host of practical unknowns as to how proxy access will play out, and there is a natural disinclination on the part of large shareholders to associate themselves with risky ventures. Instead of a frontal assault on corporate America, we anticipate a series of exploratory skirmishes, in which activists select targets thought to be vulnerable, put forward plausible candidates, and seek to mobilize shareholders and their advisors. The 2011 season, in another words, will likely be a modestly scaled clinical trial.

Who will be conducting the trial?

- Probably not your largest shareholders. The major mutual fund companies and similar institutional investors, who collectively are the single largest category of U.S. public company stockholders, have typically not been inclined to lead the charge, although they may support other shareholders' nominees. We don't think that the new rules are likely to change this mindset.
- Some hedge funds have historically used proxy contests as a means of promoting their agendas. We don't expect these firms to be big users of proxy access. They have shown themselves more than willing to wage their own contests, and we think many will be unwilling to limit their flexibility by certifying a lack of intent to change control. And while Rule 14a-11 may provide cheap access to the proxy statement and the management proxy card, it comes with a variety of limitations that these firms are likely to find unattractive. In a traditional proxy contest the insurgent has its own proxy statement and proxy card, giving it control over messaging and, importantly, real-time information as to the success of its solicitation efforts. Under Rule 14a-11, by contrast, management is the party collecting the proxy cards, giving it first crack not only at counting the votes but at assessing the validity of proxies. We think that Rule 14a-11 will thus not usurp the place of proxy contests.
- So who has the means, the motive and the opportunity? Pension funds and their allies in the activist community (*e.g.* unions) are a likely place to look. These organizations have been the leading proponents of governance proposals and withhold campaigns, and so putting forward their own candidates is a logical next step. We know that some of these organizations have been

identifying targets and assembling lists of possible candidates for use in the event that proxy access came to pass. And pension funds are just the kind of large, long-term holders that Rule 14a-11 has been designed to empower. Some are suggesting that the 3%/three year standard will make it very difficult to assemble a nominating group, especially in the case of large companies. But even if no fund individually has owned 3% of your stock for the past three years, it may be possible to assemble a group of like-minded funds for this purpose.

In any case it's useful to remember that proxy access is only one of a growing spectrum of tools at the disposal of shareholders seeking to influence companies. That spectrum starts with dialogue and persuasion, escalates to include shareholder proposals and (with Dodd-Frank) mandatory say-on-pay votes, and now includes proxy access. Because a credible ability to escalate translates to negotiating leverage, we believe that the real impact of proxy access may be as much in the threat as in deployment.

Picking Targets

Who will make the short list for proxy access campaigns in 2011? At the company level the targets are likely to have:

- a shareholder base that might be sympathetic to an insurgent (no substantial insider blocks, significant concentration of pension funds, a history of supporting shareholder proposals), and
- a performance, compensation or governance story that will provide the hook for arguing for new faces on the board.

If you've been the target of significant shareholder proposals in the past, or if your ISS GRiD ratings show significant concern in one or more areas, you should consider yourself vulnerable and, as we'll discuss further below, you should be developing an action plan designed to avoid being on the short list of activist targets and to defeat a shareholder nomination if one emerges.

But it is not just companies who are the targets here. Remember that companies will be distributing a single proxy listing all candidates, meaning that shareholders will be asked to select, say, eight out of ten names. We expect that as a tactical matter shareholders will not only advocate for their own candidates but also may focus on one or two directors for whom votes are to be withheld. Individual directors may be vulnerable because of factors like:

- poor attendance
- overboarding
- close association with the CEO
- long board tenure at companies that have had performance problems
- committee service in problematic areas (e.g. audit committee if there has been a restatement, or compensation committee if the company's pay practices are under fire).

Elements of an Action Plan

Revisit your advance notice bylaws.
Most companies have advance notice bylaws for director nominations, which typically require a minimum notice period (often in the range of 90-120 days prior to the meeting) and information about the nominee and the nominating shareholders. At a minimum you should ensure that your bylaw is consistent with Rule 14a-11, perhaps with a saving clause that provides that a notice that is valid under the rule will be valid under the bylaw. A sample bylaw that does this is here.

Aligning your bylaw notice period with that in Rule 14a-11 would be desirable, but may be aggressive as a matter of Delaware law. A notice period that is deemed unreasonably long may not be enforceable, and the conventional wisdom in Delaware has been that periods of more than 120 days from the meeting date may be too long. The 14a-11 notice period, which is measured from the prior year's mailing date, could translate into 150 days or more prior to the meeting date.

Your bylaw may require information that goes beyond the information demanded by Rule 14a-11. Many bylaws, for example, require disclosure of derivative holdings not covered by new Schedule 14N. We think that additional requirements of this sort continue to be permissible with respect to non-14a-11 nominations.

If you have a majority voting policy, confirm that it will be disabled in a proxy access situation.
Majority voting policies generally do not apply in contested elections. A "contest" for this purpose should include any situation where there are more candidates than slots.

Assess your vulnerability and brief management and the board.
We've reviewed above some of the factors that could cause your company or one or more of your directors to be especially susceptible to a Rule 14a-11 challenge. This is the time for an in-depth vulnerability analysis. If you conclude that you are at risk the time to begin the dialogue with the board is now, not after a nomination turns up. It may be that the prospect of a challenge will prompt a discussion as to potential changes in governance or other practices that would begin to address shareholder concerns. In any case an active discussion now will facilitate action later if required.

Consider enhancing your shareholder communications.
Most companies, and especially the larger companies, have in recent years increasingly been reaching out to large shareholders, including in some cases dialogue at the board level. These programs may not, however, have included those shareholders who are most likely to initiate or to be asked to support a proxy access nomination. This is thus a good time to assess how comprehensive your program has been. Affirmative outreach to key shareholders, particularly in the period prior to the deadline for proxy access nominations, could be the difference between being on or off the short list of targets.

This is also an opportunity to review the quality of your communications with respect to issues that could emerge in a campaign. For example, we think many companies could benefit from enhanced public discussion of how the board has been assembled. S-K 401(e) was amended this past year to require discussion of the "specific experience, qualifications, attributes or skills" that the company thinks each director or nominee brings to the board. And an increasing number of companies have adopted formal director qualification standards which, although not effective as a basis for excluding proxy access nominees, nonetheless furnish a record of board deliberation on the subject. A thoughtful discussion of the design principles that lie behind the overall composition of the board can be particularly helpful for advocacy purposes if the removal of a targeted director would leave the board lacking a valuable skill set.

Develop a calendar and identify a response team.
Starting from the mailing date for your most recent annual proxy statement, build a calendar that reflects the 30 days during which valid notices may be received, the two 14-day periods for dispute resolution, and the other milestones reflected in the rule. A sample is here. The schedule should include a very prompt review and conclusion as to the validity of the notice. (Note, though, that the bases for excluding nominations are extremely narrow, and that nominating shareholders will often have an opportunity to cure.) If you do not have a basis to challenge the nomination (and perhaps even if you do) you will want to allow time to consider whether there can be a negotiated alternative to the nomination. These decisions may require multiple meetings on short notice.

Because the notice of nomination will be publicly available on Schedule 14N, and because the rule gives priority in the case of competing nominations to the largest shareholder or group, we think there will be some incentive for nominating shareholders to file late in the 30-day window to reduce the risk of competing nominations. This factor will only enhance the time pressure.

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Depending on your vulnerability assessment, you may wish to begin to assemble a response team, which would include professionals in the proxy solicitation and investor communications fields as well as your legal team. In any case it makes sense to identify the short list of firms you would consider for those roles.

If you would like to discuss these matters, please contact any of us or your regular Davis Polk lawyer.

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