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Proxy Access: What Comes Next?

Introduction

- Mandatory – no “opt out” permitted; no “opt in” required
 - Does not preclude shareholder proposals advancing additional mechanisms
- In place for much of 2011 proxy season; rules become effective 60 days after publication in Federal Register
 - Notice of nomination must be sent 120-150 days before anniversary of prior year’s annual meeting proxy statement mailing
 - Example – if publication on September 16, company may receive a nomination if it mailed this year’s proxy statement on or after March 15, 2010
- Applies to companies subject to SEC’s proxy rules, except debt-only registrants and “smaller reporting companies” (generally, those having a public float of less than \$75 million, which are exempted for three years), including:
 - Controlled companies
 - Investment companies
 - Non-U.S. companies other than “foreign private issuers”

Overview of Rule 14a-11

- Aggregate 3% ownership
 - Requires investment and voting power
 - Prescribed calculation that reduces ownership for short sales and borrowed shares but permits inclusion of shares loaned to others under certain conditions
- Three-year continuous holding period, and must continue to hold through vote date (i.e., an additional period of approximately 5 months)
- Maximum of 25% of the board, with a minimum of one
- Cannot hold company shares with purpose or effect of changing control of company or to gain board seats exceeding maximum permissible under Rule 14a-11
- Rule facilitates solicitations to form nominating shareholder groups, but a shareholder may not participate in more than one group
- No exception or other accommodation if company faces concurrent traditional proxy contest

Are Proxy Access Nominations Likely?

- At least for larger companies, ownership, holding and non-control requirements present significant barrier to use of Rule 14a-11
 - Need to retain minimum ownership through vote date creates liquidity risk that likely will deter active managers and may also raise concerns for passive institutional investors (e.g., index funds) and investors outsourcing management (e.g., pension funds)
 - Hedge funds may also be deterred by need to certify absence of “changing control” purpose or effect and reluctant to sacrifice control of proxy card
 - Some large institutional investors have ongoing relationships with many companies
- Nonetheless, provides shareholders with additional leverage, particularly given new shareholder votes on executive compensation arrangements
- Likely to further empower proxy advisory firms

Ownership Threshold

- Shareholder or group must own, as of nomination notice date, an aggregate of at least 3% of total voting power of company's shares entitled to vote on relevant director election
- For shares to "count" toward the 3% threshold, shareholder(s) must hold (directly or through those acting on its behalf) both voting and investment power
 - Include loaned shares if owner has recall right and will recall if notified that its nominee(s) will be included in company's proxy materials
 - Reduce ownership by shares subject to a short sale that has not been closed out
 - Reduce ownership by shares borrowed for purposes other than a short sale
 - Exclude shares that holder has right to acquire, such as shares underlying options that are exercisable but have not been exercised
- Securities intermediary does not have voting power or investment power solely by holding shares on behalf of another person, even if it may vote shares without instructions
- Although shares sold short reduce qualifying ownership, true "net long" economic interest not required (e.g., calculation does not take into account total return swaps or comparable contractual arrangements)

Holding Period and Demonstrating Ownership

- Nominating shareholder (or each group member) must:
 - Have owned requisite amount of shares continuously for at least three years as of nomination notice date; and
 - Continue to hold requisite amount of shares through vote date
- Ownership calculated in same way across these periods as at the time of nomination notice
- Nominating shareholder must provide (or cause registered holder to provide) proof of ownership, over the three-year period, of the amount of securities used to satisfy requirements
 - Not required to provide proof with respect to related calculations (e.g., amount of shares sold short)

Nominee Eligibility

- Nominee must meet generally applicable objective stock exchange independence criteria
 - No requirement to meet criteria requiring subjective board determination of independence
 - No requirement to meet any company-adopted additional independence standards
 - No requirement to be independent of nominating shareholder
- Nominee and company must not have agreement about nomination
- Nominee's candidacy and board membership must not violate applicable law (e.g., antitrust or banking restrictions on interlocking directorates)
- No requirement that candidacy or board membership otherwise be consistent with internal corporate requirements, such as director qualifications or nominating procedures

Director Qualifications

- While eligibility not conditioned on nominee's meeting director qualifications specified in governing documents, Schedule 14N must disclose whether nominee does so
- Consider whether to include qualifications in bylaws
 - For example, Delaware law permits director qualifications in bylaws but may impose constraints under some circumstances
 - Some obvious qualifications (e.g., no bar to service) likely to be surfaced in Schedule 14N or by nominating shareholder; others may be undesirable if applied generally to directors
- Must (or may) an elected, but non-qualifying, nominee be seated?
 - SEC proxy access rule would appear not to address; would appear to be state law issue
 - Board may be pressured to waive or amend qualifications and seat new director, unless qualification readily satisfied (e.g., completing D&O questionnaire, or compliance with limitations on board service at other companies)

Number of Nominees; Allocation Among Shareholders

- Maximum number is 25% of the total board seats, with a minimum of one
- Classified boards
 - Percentage calculated based on total board size, not class up for election
 - Proxy access nominee whose term continues past meeting date counts against maximum
- Incumbent director originally nominated under proxy access but who is re-elected by company does not count toward maximum
- Priority based on voting power percentage
 - If eligible nominations exceed maximum, priority goes to nominees of shareholder or group owning largest percentage of qualifying voting power as of date of nominating notice
 - Remaining nominations go to shareholder or group with next highest voting power, etc.

Timing of Nominations

- Notice of nomination and related disclosures required on Schedule 14N, which must be filed with SEC and sent to company on same day
- Uniform window for notice – no earlier than 150 days, and no later than 120 days, before anniversary of prior year’s annual meeting proxy statement mailing
 - If no annual meeting in prior year, or if annual meeting date is changed by more than 30 days from prior year, notice must be given “a reasonable time” before proxy materials are mailed – company must specify this deadline
- Interplay with timing under advance notice bylaws
 - Window not affected by any time period contained in company’s advance notice bylaw
 - For many companies, proxy access deadline will be significantly earlier than deadline under advance notice bylaw
 - As a result, when responding to a proxy access nomination, board may not have visibility into whether other shareholders may make nominations and pursue a traditional contest

Negotiations with Nominating Shareholder

- Nominating shareholder and company must have no agreement or understanding about nomination
 - Anti-collusion rule
 - Unsuccessful negotiations do not constitute agreement
- If nominating shareholder makes an eligible proxy access nomination “before beginning communications with the registrant about the nomination,” and then company agrees to slate nominee, that nominee counts against maximum
- But if nominating shareholder and company reach agreement on a nominee to be slated by company before nominating shareholder files Schedule 14N, nominee does not count against maximum

Negotiations with Nominating Shareholder (cont.)

- Implications for discussions with shareholders
 - Diminishes incentive for company to seek agreement with potential nominating shareholder before a nomination is made
 - But company should not conclude that all pre-nomination discussions ought to be avoided or limited
 - Interplay with decision on whether to nominate for re-election an incumbent originally nominated through proxy access
- If company and nominating shareholder discuss Candidate A and shareholder nominates Candidate B, whom the company subsequently slates, does Candidate B count against maximum?
- If nominating shareholder discusses with company desire for a nominee with certain skills or characteristics, then shareholder nominates a candidate with those skills or characteristics, whom the company subsequently slates, does that nominee count against the maximum?

Optimal Board Size and Composition

- Increased focus on overall board composition, requisite financial and other expertise, and succession planning
- Ability to add company-slated nominees depends on “headroom” below maximum board size, or board authority to increase maximum
- Considerations impacting board size in light of proxy access

Replacement Nominees

- If nominating shareholder or group withdraws or becomes ineligible, company must include nominees of nominating shareholder or group with next highest voting power
- If nominee withdraws or becomes ineligible, company must include any other nominee of the same shareholder or group, and allocate remaining slots to shareholder or group with next highest voting power
- Company not required to replace nominees if it has begun printing proxy materials
- Timeline for board slating action and proxy statement preparation must be flexible to accommodate developments

Timing Provisions for Excluding a Nominee

- No later than 14 days after nomination window ends, company must notify nominating shareholder of determination to exclude nominee or supporting statement
 - No right to exclude because supporting statement is false or misleading
- Nominating shareholder has 14 days after receipt of deficiency notice to respond and correct deficiencies
 - Composition of nominating group and nominee may not be changed to cure deficiency
- Thereafter, if company intends to exclude nominee, it must notify SEC (copying the nominating shareholder) no later than 80 days before it files definitive proxy materials, subject to SEC discretion to permit later notice on showing of good cause.
 - Company may seek no-action letter to exclude one or more nominees
- Within 14 days after receipt of company's notice to SEC, nominating shareholder may submit response to SEC

Timing Provisions for Excluding a Nominee (cont.)

- How will SEC administer?
- Practical implications
 - If first-priority shareholder or its nominee(s) withdraws or is disqualified after company's first submission to the SEC, insufficient time to address other nominees
 - Initial request for no-action relief should address all nominees (including those of any lower-priority shareholder or group) which the company believes it may exclude

Limited Exemptions for Nominating Shareholder Solicitations

- Exemption from disclosure and other generally applicable requirements of SEC's proxy rules for communications by shareholders in forming a nominating shareholder group
 - Applies to written communications, subject to limitations on content; must be filed on Schedule 14N on the date first used
 - Oral communications also exempt, and unlimited as to content; Schedule 14N must be filed on the date communications commence
 - May initially rely on existing exemption to solicit 10 or fewer shareholders
- Exemption for solicitations by nominating shareholder or group, subject to conditions, that begins to apply after company notifies nominating shareholder or group that its nominees will be included in company's proxy materials pursuant to Rule 14a-11
- Neither exemption is available if shareholder subsequently engages in a non-Rule 14a-11 nomination or solicitation in connection with the relevant election or becomes a member of a group with persons engaged in soliciting or other nominating activities in connection with the election

Effect of Concurrent Proxy Contest

- No exception or other accommodation from proxy access rules where company is engaged in concurrent traditional proxy contest
- Shareholders relying on proxy access are restricted from soliciting with respect to nominees advanced by another shareholder or group through a traditional proxy contest and from acting as a “participant” in the proxy contest
- However, shareholder pursuing a traditional proxy contest can “round out” short slate with proxy access nominees
 - Could result in turnover of a majority of the board, but proxy access nominee may not solicit against the short slate nominees

Implications for Change in Control Provisions

- Change in control provisions in debt instruments and other contracts may include trigger if majority of the board turns over within certain period without approval of incumbent directors
- Consider whether actions such as approving the nomination or election of a proxy access nominee for this purpose may be appropriate

Rule 14a-8 Proposals

- Rule 14a-8 amended to enable shareholders to require company to include in annual proxy statement shareholder proposals advocating alternative proxy access mechanisms. Examples might include:
 - Access bylaws with lower ownership thresholds and holding periods
 - Access bylaws permitting more nominees
 - Access bylaws loosening control-related provisions – but cannot of course change 13(d) requirements
- Proposals may also include reimbursement bylaws (while solicitation expenses for a Rule 14a-11 election will typically be minimal, that may not always be the case)
- New mechanisms cannot restrict availability of Rule 14a-11, but would function in parallel
- Shareholder eligibility requirements under Rule 14a-8 remain unchanged
- Use of competing management proposals under Rule 14a-8(i)(9)

Preparing for Proxy Access: Assessing the Likelihood of a Nomination

- Risk factors – poor financial performance; regulatory enforcement actions; vulnerability on “hot button” governance issues such as executive compensation
- Well-functioning, accountable board should reduce likelihood that an access nomination will emerge
 - Board alignment around strategy, and alignment of director skills and experience with strategic objectives and needs
 - Consider whether self-evaluation processes, director nominations policy and director succession practices could be improved
- Proactive posture towards shareholders, especially large institutions key to group formation
 - Knowing shareholders and how to engage – shareholders are not a monolithic population
 - Ongoing regular engagement without regard to dissatisfaction
 - Even where strong differences exist, constructive relationships matter
 - Monitor changes in share ownership

Preparing for Proxy Access: Responding to a Nomination

- If proxy access candidate may be nominated, plan for next steps
 - Ability to react quickly to Schedule 14N filings indicating solicitation to form group
 - Board review of nominee and determination about slating or opposing candidate
 - Negotiation and external communications strategy

Preparing for Proxy Access: Integrating a Shareholder-Nominated Director

- As with any new director, if proxy access nominee elected, board integration should be prompt and effective
- Appropriate policies and practices to support effective board operation
 - Orientation and completion of D&O questionnaire, including, at least if new director is re-slated by the company, irrevocable resignation consistent with company's majority voting standard in uncontested director elections
 - Application of conflict of interest policies
 - Policies and practices to protect confidential information and ensure company "speaks with one voice," without creating atmosphere of distrust among directors
 - Training to inform and educate directors, including detailed orientation for new directors
- Attempts to isolate new director likely to be disruptive and counter-productive

Preparing for Proxy Access: Documentation and Related Activities

- Review external communications to ensure clarity in communication of strategy and other key “hot button” matters, such as pay versus performance
- Review board calendar for director succession, including recruitment and re-slating decisions
- Review proxy calendar to understand how proxy access timetable would be accommodated
- Review bylaws and governance documents to identify needed changes
 - Clarify that advance notice bylaw and Rule 14a-11 operate in parallel
 - Majority voting policies or provisions should define “contested election” in a way that covers elections involving proxy access nominees
 - Consider amending the nominating committee’s charter to give it authority to evaluate and respond to proxy access nominations and related matters, or recommend responses to board
- Compliance with SEC filing requirements, if company solicits in opposition

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