

Corporate Governance Alert

2011 Proxy Season: The First 100 Days—How to Get Ready for the Brave New World of Say on Pay and Proxy Access

Introduction

- On August 25, by a 3-2 vote, the SEC ushered in a new era in the company-shareholder relationship when it adopted its final proxy access rules. Although legal challenges to these rules will doubtless follow, the rules are nevertheless expected to be effective in time for the 2011 proxy season for most calendar-year companies.
- Although the SEC's final proxy access rules contain higher thresholds than most expected (three percent continuous ownership for three years) and for this reason may not be used frequently in practice, the rules will nonetheless give corporate governance activists important new leverage in seeking their governance reforms agenda, including increased company engagement. It will be particularly potent when used in combination with or as a follow-on to a "no" vote on say on pay.
- We expect that corporate governance activists, energized by their seminal victories on proxy access and say on pay, will reinvigorate their shareholder proposal campaigns to further reshape the corporate governance landscape. Their agenda includes proliferation of majority voting for directors from the larger public companies to mid-size and smaller companies (which we believe will see the largest number of proposals), separation of the offices of Chairman of the Board and CEO, 10 percent or lower thresholds for shareholders to call special meetings and enabling shareholders to act by majority written consent.
- As the new rules allow "private ordering" if the alternative regime is *more* generous to stockholders, some corporate governance activists are likely to sponsor shareholder proposals to relax significantly the key three percent/three-year ownership thresholds for proxy access. If successful, those proposals would greatly increase a company's vulnerability to proxy access nominations, or at least threatened nominations.

Proxy Access Key Points

The key points of the new proxy access rules include the following:

- *Effective for the 2011 Proxy Season.* The new proxy access rules are expected to apply to the 2011 proxy season. The cut-off date for proxy access nominations (on new Schedule 14N) will be the 120th day preceding the anniversary of the mailing of a company's 2010 proxy statement (e.g., November 1, 2010, for a company that mailed its proxy statement on March 1, 2010). This is the same cut-off date as Rule 14a-8 shareholder proposals for the 2011 proxy season.
- *Proxy Access is Mandatory.* A company does not need to opt in to proxy access; Rule 14a-11 applies automatically. It also may not opt out of Rule 14a-11 unless governing law or its governing documents completely *prohibit* shareholders from nominating directors. So there is no right for private ordering, with the big exception that Rule 14a-8 allows shareholders to propose modifications to a company's governing documents to allow proxy access procedures less restrictive (but not more restrictive) than Rule 14a-11.

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- *Three Percent Ownership Threshold; Aggregation Allowed.* A shareholder, or group of shareholders acting together, must hold (either individually or in the aggregate) at least *three percent* of voting power of the company's securities as of the filing date of the newly adopted Schedule 14N.
 - *Three-Year Holding Period.* The nominating shareholder or group must have held the minimum qualifying amount of voting securities continuously for at least three years as of the Schedule 14N filing date. The nominating shareholder or group must also continue to hold the required amount of securities through the date of the shareholder meeting.
 - *No More Than 25 Percent of the Board (With a Minimum of One).* A company must include a number of shareholder-nominated director nominees that represents no more than 25 percent of the company's board of directors (rounded down), but no less than one director.
 - *Priority Goes to the Shareholders Who Hold the Most Voting Power.* In the event the company receives more shareholder-nominated director nominees than it is required to include in its proxy materials under Rule 14a-11, the company may include in its proxy materials only the nominee or nominees of the nominating shareholder or group with the highest qualifying voting power percentage.
 - *Smaller Reporting Companies Get a Three-Year Pass.* The effective date for smaller reporting companies (*i.e.*, generally those with a public float of less than \$75 million) will be three years after the effective date for all other companies, during which time the SEC may determine to make changes to the rules or accommodations for the smaller reporting companies (such as a higher share ownership threshold). However, this "pass" does not apply to proxy access shareholder proposals that will now be permitted under amended Rule 14a-8 (discussed below).
 - *No Change of Control Intent.* The nominating shareholder or group must not hold their securities with the purpose, or with the effect, of changing control of the company or to gain a number of seats on the board of directors that exceeds the 25 percent/one director maximum.
 - *Concurrent Proxy Contests Allowed.* A company must comply with Rule 14a-11 even if it is the subject of a concurrent proxy contest.
 - *Shareholder "Custom-Tailored" Proxy Access Proposals Under Rule 14a-8.* The SEC amended existing Rule 14a-8(i)(8) to allow shareholders to propose amendments to a company's governing documents to establish different criteria for proxy access nominations. This amendment will permit shareholders to propose their own, custom-tailored proxy access regime providing shareholders with a greater ability to nominate director candidates than Rule 14a-11.
 - *Not All Shares Count Toward the Three Percent.* In order to include share holdings in calculating a nominating shareholder's ownership, the shareholder must have both voting and investment power. Shares that are sold short or borrowed are not included in the share ownership calculation. Shares that are lent are included only if the shareholder has the right to call them back and will recall them upon being notified that its nominees are included in the proxy.
 - *No Agreements With the Company.* A nominating shareholder or group must not have a prior agreement with the company regarding the nomination. Unsuccessful negotiations with the company will not result in an exclusion of a nominee under this basis alone.
 - *Certain Directors Can Be Excluded.* A company can exclude director nominees who do not meet the *objective* independence standards of the relevant stock exchange (but not its *subjective* standards). A company would also be able to exclude a nominee whose candidacy would violate state or federal law or stock exchange rules (other than those related to independence) if the violation cannot be cured during the time period provided in Rule 14a-11 (*i.e.*, 14 days after being notified by the company that it intends to exclude the nominee on this basis).

- *Dispute Resolution.* The proxy access rules contain an elaborate calendar for dispute resolution through the SEC Staff “no action” process that tracks the current process under Rule 14a-8. Although the prescribed notice requirements are mandatory, companies will also be free to challenge proxy access nominations through litigation.
- *Schedule 14N Due Date; 500 Word Supporting Statement.* Notices on Schedule 14N of the shareholder’s or group’s intent to require the company to include the nominating shareholder’s or group’s nominee(s) in the proxy materials must be filed with the SEC no earlier than 150 calendar days and no later than 120 calendar days before the anniversary of the date on which the company mailed its proxy materials for the prior year’s annual meeting. Schedule 14N requires that the nominating shareholder or group must include a statement as to whether the nominee meets the company’s qualification standards in its governing documents, and provides an option for the nominating shareholder or group to include a statement in support of the nominee of no more than 500 words.

The First 100 Days of the 2011 Proxy Season Starts Now

The roughly 100 days following adoption of the final proxy access rules and ending in mid-to-late November when shareholder proposals and proxy access nominations will begin arriving are a critical period for companies and their management and directors. Management and boards will want to be educated, advised and organized for the 2011 proxy season. Moreover, we believe there are a number of pro-active steps companies should consider taking during this period that will not be feasible, or at least not as productive, if attempted later in the proxy season.

We plan to address our recommendations for advance preparation for the 2011 proxy season in detail at a Webcast we will hold on Thursday, September 23. Details about the Webcast appear at the end of this *Alert*. We will also publish *Corporate Governance Commentaries* dealing with our recommendations for advance planning during the First 100 Days in conjunction with the Webcast.

These recommendations will include:

- Consideration of the benefits of constructive engagement with key investors to exchange views not just on your company’s financial and operating performance (which has been the traditional focus of most company-shareholder dialog to date), but also on your company’s executive compensation programs and corporate governance policies. Given the rapidly changing dynamics of companies’ relationships with institutional investors, we believe that companies should welcome direct engagement with significant shareholders on the latter topics.
- Use of the First 100 Days to resolve possible governance and compensation controversies with your investors before your company receives a potentially challenging shareholder proposal or a proxy access nomination. The act of actually submitting a shareholder proposal or proxy access nomination may take on a life of its own and make consensual resolution of the issues more difficult. Early engagement in an attempt to avoid submission is desirable.
- Revision of your advance notice bylaws to deal with proxy access mandated timeframes and information requirements for proponents and shareholder nominees under the new rules.
- Consideration of implementation of a comprehensive director confidentiality policy that would cover not only traditional “inside information” issues, but also establish clear-cut rules for maintenance of the confidentiality of board room discussions.¹
- Review of director qualifications to be set forth in your bylaws and apply to all nominees who are elected, including shareholder nominees. These qualifications might include qualifications driven by company policy, such as mandatory retirement age, restrictions on “over-boarding,” and adherence to confidentiality and loyalty obligations, as well as legally required limitations, such as compliance with Clayton Act prohibitions on interlocking directorships, and citizenship or other director requirements for regulated industries, such as defense, gaming, airlines and broadcasting.

- Amendment of corporate governance and nominating committee charters and related bylaws to deal appropriately with vetting shareholder nominees.
- Advance engagement with significant investors advocating the desirability of avoiding the burdens and short-termism of annual say on pay votes and urging them to support biennial or triennial say on pay votes on the Congressionally mandated advisory vote in 2011 on the frequency of say on pay voting. Engagement of this sort will be made easier if companies are able to resolve any lingering executive compensation controversies to lay the groundwork for supporting less frequent votes.
- Consideration of available strategies for contending with directors nominated as a result of proxy access, including how to work with proxy advisory firms in such cases.
- Advance preparation for the 2011 enhanced proxy disclosure requirements.

Endnotes

- ¹ http://www.lw.com/upload/pubContent/pdf/pub2916_1.pdf

Latham & Watkins and Georgeson Guidance for the 2011 Proxy Season

Latham & Watkins and Georgeson believe that the 2011 Proxy Season will begin a new era in the ongoing relationship of companies and the investor community. For this reason, we are presenting a series of Webcasts and related *Corporate Governance Commentaries* intended to provide practical strategic and tactical guidance for the entire 2011 proxy season.

- The first phase of our guidance focuses on the First 100 Days of the 2011 proxy season and our recommendations for advance preparations during this limited time frame. It includes our September 23 Webcast on Advance Preparation for the 2011 proxy season, this *Alert* and forthcoming *Corporate Governance Commentaries* on this topic.
- As the run-up to the 2011 proxy season continues, we plan to hold a second Webcast on Tuesday, November 16, to discuss how to respond to shareholder proposals under the SEC rules, as well as how to deal with any proxy access nominations. At this Webcast, we will also continue our guidance for other aspects of the 2011 proxy season, including preparing senior executives and board members for the inevitably tough year-end compensation decisions and preparation of the related CD&A that will be the focus of the mandatory say on pay votes at 2011 annual meetings. We also will publish related *Corporate Governance Commentaries* on these topics.
- The third and last phase of our 2011 proxy season guidance will consist of another Webcast, to be held on Wednesday, January 19, 2011, and related *Corporate Governance Commentaries*, that will focus on finalization of your company's proxy materials, including new required disclosures on pay-for-performance, implementation or modification of clawback policies in light of any SEC rulemaking on the topic, deciding whether and, if so, how best and when to solicit shareholders regarding voting at your 2011 annual meeting, pros and cons of engaging with proxy advisory firms and issues relating to the conduct of your annual meeting.

2011 Proxy Season Webcast Schedule

Don't miss out on our upcoming programs:

September 23, 2010

The First 100 Days - Advance Preparation for the New World of Proxy Access and Say on Pay

November 16, 2010

Dealing With Proxy Access Nominations, Say on Pay and Shareholder Proposals

January 19, 2011

Drafting Your Proxy Statement and Preparations for a Successful Annual Meeting

Invitations to follow closer to program date. To ensure that you receive an invitation, please [click here](#).

If you have any questions regarding this *Alert*, please contact the Latham & Watkins LLP or Georgeson Inc. representatives listed below or the Latham or Georgeson representative with whom you normally consult.

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