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Dodd-Frank and the 2011 Proxy Season: SEC Adopts Final Proxy Access Rules

New rules offer corporate governance activists important leverage in seeking reform agenda, and an inexpensive alternative to proxy contests, writes **James D. C. Barrall** of Latham & Watkins.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. This is the second in a series of columns that will provide public companies, general counsel and their legal advisors with a succinct and plain English description of important Dodd-Frank and related proxy season development as they occur, commentaries on 2011 proxy season trends and issues and practical guidance as to their likely impacts on public companies.

By James D. C. Barrall

As I wrote in my Aug. 12, Daily Journal overview of Dodd-Frank, the most important provisions of the act for U.S. public companies in general (those not just in the financial services sector) are on proxy access, say on pay, broker non-voting, clawbacks, independence requirements for Board Compensation Committees and their advisors, and enhanced proxy disclosure requirements—these are expected to be in full effect for the 2011 proxy season. Most of these provisions will need SEC rulemaking, even if not expressly required, and companies and their advisors should expect

the SEC to propose implementing rules throughout the next few months and to move expeditiously to finalize them by late this year or very early next.

Year-end 2010 portends to be very busy for U.S. public companies.

For many years, corporate governance activists, lead by labor unions, government pension plans and the Council of Institutional Investors, have been pushing to give shareholders access to public company proxies to nominate their own slates of directors to challenge a company's slate, without having to resort to expensive proxy contests. Other groups, including the U.S. Chamber of Commerce and the Business Roundtable have pushed back. During this increasingly contentious environment, the SEC issued a series of proposed proxy access rules in 2003, 2007 and 2009, which would have allowed shareholders to nominate slates of directors under various circumstances. The meltdown of the financial sector in late 2007 gave proxy access new impetus. Members of Congress introduced their own legislative proxy access proposals and in May 2009, the SEC proposed new rules that were

expected to be in effect for the 2010 proxy season. However, the proposed rules generated more than 500 comments and much opposition and controversy, which included whether the SEC had authority to adopt proxy access rules. This led the SEC to announce in October 2009 that the rules would be studied further and not be in effect for 2010.

Dodd-Frank does not mandate proxy access or establish conditions for shareholder access. Instead in Section 971, Dodd-Frank amends Section 14(a) of the Securities Exchange of 1934 to expressly authorize the SEC to adopt proxy access rules and to set the terms and conditions of shareholder access. Having



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adopted its last set of proposed proxy rules in May of 2009 and seeing no need to expose them to further comment, on Aug. 25 the SEC quickly accepted Dodd-Frank's invitation to regulate and adopted 452 pages of final rules on proxy access. The final rules are substantially different than the proposed rules, and even recent popular expectations. The key features of the rules are as follows:

Effective Date. In general, the new rules will apply to the 2011 proxy season. The cut-off date for proxy access nominations (on a new Schedule 14N) will be the 120th day preceding the anniversary of the mailing of a company's 2010 proxy statement (e.g., Nov. 1, 2010, for a company that mailed its proxy statement on March 1, 2010). However, smaller reporting companies (i.e., generally those with a public float of less than \$75 million) are exempt from the rule for three years while the SEC determines whether to make changes to the rules for them (such as a higher share ownership threshold). But in the meantime, shareholders are allowed to propose their own proxy access resolutions.

Ownership Requirement. 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. Shares that are sold short or borrowed are not includable as shares owned.

Holding Period Requirement. The nominating shareholder or group must have held the minimum three percent of voting securities continuously for at least three years as of the filing date, and must continue to hold the

minimum required amount through the date of the shareholder meeting.

Limited Exposure. 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). If the company receives more shareholder-nominated nominees than it is required to include in its proxy materials, 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.

Mandatory Access. Proxy access is mandatory and companies may not opt out unless governing law or their charters completely prohibit shareholders from nominating directors (which would be rare). But shareholders are allowed to propose amendments to a company's charter to allow proxy access procedures that are less restrictive (but not more restrictive) than the new rules.

It is not clear to what extent shareholder activists will use the new proxy access rules, especially in 2011, or whether they will lead to proxy excesses. But it is clear that the new rules will give corporate governance activists important new leverage in seeking their governance reforms agenda, as well as an inexpensive and efficient alternative to proxy contests. Proxy access will be particularly potent when used in combination with or as a follow-on to a "no" vote on say on pay. Companies that have experienced recent friction with shareholders over poor financial performance, problematic executive

compensation or corporate governance practices will be at risk of having a truly "outside" director forced onto their Boards, with mandates to be change agents. In 2011, it's expected that shareholder activists will target proxy access campaigns against targets that have already been in their sights, and likely to be too busy to go on new hunting expeditions.

However, all companies need to factor the specter of proxy access challenges into their governance calculus and pay practices, and to deal with shareholder concerns before they manifest themselves as contests. This generally will require reviews of existing pay and governance practices, and proactive and constructive engagement, with key shareholders. In addition, all public companies (other than smaller reporting companies, which have three years to learn) need to now start reviewing and revising their advance notice bylaws to deal with the proxy access requirements, and should consider adopting clear director qualification requirements that would apply to all director nominees and provide companies with some minimum qualification protections in the event of a proxy access contest.

For more information and to view the author's previous articles, "A Practical Look at the Impact of the Dodd-Frank Act on Public Company Executive Pay and Corporate Governance" and "2011 Proxy Season: The First 100 Days — How to Get Ready for the Brave New World of Say on Pay and Proxy Access," visit www.lw.com.