LATHAM & WATKINS LLP

Corporate Governance Commentary

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Proxy Access and Advance Notice Bylaws in the Wake of Invalidation of the SEC's Proxy Access Rule: An Approach to Private Ordering

Introduction

Rule 14a-11, the US Securities & Exchange Commission's (SEC) Proxy Access Rule, originally intended to take effect in November 2010, was stayed and ultimately vacated by the US Court of Appeals for the District of Columbia Circuit (DC Circuit) in July 2011. Importantly, however, the companion amendment to Rule 14a-8, permitting shareholder proposals regarding proxy access, was not affected by the DC Circuit decision, and the SEC stay on effectiveness of the amendment has expired. As a result, shareholder proposals for adoption of some sort of proxy access regime can be expected for the 2012 proxy season and ultimately may become as ubiquitous as majority voting, anti-poison pill and board declassification proposals.

Companies will adopt a variety of approaches to the new era of proxy access through private ordering under the stimulus of Rule 14a-8 proposals. Some may decide proactively to adopt proxy access bylaws shaped to the company's particular circumstances, whether as an expression of their views of good corporate governance or in expectation of pre-empting less company friendly shareholder proposals. Most companies, we believe, initially will adopt a "wait and see" approach. If and when a company receives a shareholder proposal recommending board adoption of a proxy access bylaw,[1] the board may respond (and seek to exclude the proposal from the ballot) by (i) adopting a proxy access bylaw (and claiming the Rule 14a-8 exclusion for substantial implementation) or (ii) proposing a proxy access bylaw for approval by shareholders at the annual meeting (and claiming the Rule 14a-8 exclusion for conflicting proposals). Other companies will let the shareholder proposal go to a vote and try to beat it at the polls. If shareholders approve the proposal, the company may then consider adoption of a proxy access bylaw, either to head off a withhold vote recommendation for directors by Institutional Shareholder Services (ISS) at a subsequent annual meeting based on the board's failure to implement a proxy access regime or merely to resolve the matter.[2]

Whatever approach is taken, we believe that over the next several years proxy access bylaws will be adopted at a large number of companies as a result of shareholder pressure under Rule 14a-8. Accordingly, we have prepared a form of proxy access bylaw for such circumstances. Click here to view the form.

In addition, prior to the DC Circuit decision vacating the SEC's Proxy Access Rule, and as part of the preparation for the then-likely advent of SEC mandated proxy access, a number of public companies had begun to consider amendments to their advance notice bylaws to deal with the adoption of the SEC's Proxy Access Rule.[3] These efforts were typically suspended when the SEC stayed its mandatory proxy access regime pending the DC Circuit decision. Given that some number of proxy access bylaws via private ordering is a virtual certainty as a result of the now effective Rule 14a-8 amendments, public companies should resume or begin reviewing their advance notice bylaws to be sure they appropriately address proxy access nominations for director. Moreover, periodic review and revision of advance notice bylaws are

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generally desirable to reflect newer concepts and refinements, particularly since there is no reason to think that traditional proxy contests will become less frequent.

We therefore recommend that, whether or not companies consider or adopt a proxy access bylaw, they review and update their advance notice bylaw provisions. Accordingly, we have revised our form of advance notice bylaw to coordinate with our form of proxy access bylaw, as well as to clarify and, in some cases impose, other "rules of the road" for all shareholder nominations and nominees–whether through proxy access or a traditional proxy contest. Click here to view the form.

Proxy Access Bylaw

Because the SEC's Proxy Access Rule presumptively reflected a fair and balanced approach, we have drafted our form of proxy access bylaw to mirror many of the substantive provisions of the SEC's Proxy Access Rule, including:

- Adopting the 3 percent and three year continuous net long beneficial ownership requirements
- Permitting any number of shareholders to combine to meet the 3 percent and three year continuous net long beneficial ownership test
- Limiting the number of proxy access directors on the board at any one time to 25 percent of the full board
- Precluding proxy access for shareholders that have a control intent and precluding proxy access sponsors from participating in a simultaneous proxy contest or circulating a different proxy card

We do not believe any of these provisions in our form of proxy access bylaw will prove particularly controversial, with the exception of the 3 percent/three year holding period tests. We think it is likely, if not certain, that many corporate governance proponents of proxy access will take issue with the 3 percent/three year threshold as being too onerous and effectively eviscerating the practical utility of proxy access, particularly at large cap companies. Most likely this group will advocate a 1 percent/one year standard and vote against higher thresholds.[4] What is less certain is whether the bulk of institutional investors will agree, and also vote against board adopted or recommended proxy access bylaws using the higher 3 percent/three year standard. Nor is it clear what position ISS and Glass Lewis will adopt for their recommendations—whether the minimum ownership threshold will be the sole or principal lynch pin of their voting policies or whether they will adopt a more holistic approach and also consider the other "bells & whistles" under a vaguer standard of being against management proposed proxy access bylaws that are on the whole too "restrictive."

We also adjusted certain other provisions of the SEC's Proxy Access Rule. For instance:

- We have provided that a proxy access director does not lose that status until having sat as a director for three years without regard to whether the directors' terms are one year or three years in a classified board regime. We believe that this provision will give an annually elected access director enough time to integrate with the board and will encourage a board to re-nominate an otherwise effective proxy access director without fear of opening its door to "proxy access creep," whereby new access candidates could be put up for election each year even if previous access candidates were re-nominated by the board.
- We have added provisions intended to avoid repeated proxy access nominations by parties whose previous proxy access candidate did not receive a meaningful favorable vote, as well as repeated nominations of a candidate who did not receive a meaningful favorable vote.
- We have provided that proxy access will not be available at any meeting at which there is a traditional proxy contest. We believe that having two simultaneous proxy contests, utilizing two entirely separate proxy cards, would be very confusing for stockholders and raise significant informational issues for all parties. Moreover, the right of stockholders to nominate and elect a candidate not of the board's choosing will, by hypothesis, be vindicated through the traditional proxy contest, thereby obviating much of the rationale for a simultaneous proxy access nominee.

- We have refined the SEC concept of net long beneficial ownership by making clear that all hedging of the benefits and risks of full economic ownership, through options, puts, calls, forward contracts and other derivatives, whether settled in shares or cash, are also deducted in arriving at a party's net long beneficial ownership.

Advance Notice Bylaws

Informational Requirements. The advance notice bylaws for many public companies set forth minimum informational requirements for a valid director nomination by a shareholder, whether through proxy access or in a conventional proxy contest. The SEC's Proxy Access Rule would have required the nominating shareholder or shareholder group to provide all of the information about itself and the nominee that would be required in a conventional proxy contest. Accordingly, as we discussed in an earlier *Corporate Governance Commentary*,[5] the drafting choice prior to the invalidation of the SEC's Proxy Access Rule would have been whether to limit informational requirements in advance notice bylaws to those set forth in the SEC's Proxy Access Rule or to impose greater informational requirements as a qualification for any valid shareholder nomination, proxy access or conventional.

The invalidation of the SEC's Proxy Access Rule has simplified the issue to some extent. Moreover, as the SEC implicitly acknowledged in its adopting release for its Proxy Access Rule, state law and private ordering under state law can lawfully require information in addition to that required under the proxy rules. We believe that, at least under Delaware law, the test of the legality of informational requirements in this context is whether the requirements are reasonable and equitable in content and reasonably related to a proper corporate purpose, without regard to whether they expand on the disclosures mandated by the proxy rules.

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The drafting choice we have made in our revised form of advance notice bylaw is to provide public companies the option to impose greater informational requirements as a qualification for valid shareholder nominations than would have been required under the SEC's Proxy Access Rule, but in a limited and targeted manner that we believe meets the reasonable and equitable test. To be clear, drafting an integrated advance notice bylaw that imposes informational requirements beyond those under the proxy rules requires fine judgments of reasonability and equitability as a matter of state law. Not everything will pass this test.

One area that bears particular mention is the disclosure of a nominating group's and nominee's stock ownership. With the explosive use of derivative ownership and hedging techniques, we think it is vital that public companies require full disclosure, not just of ownership of stock in the conventional sense, but also of all related derivative and hedging positions, in order to ascertain the true ownership position of an insurgent in advance of a potential proxy contest. We have revised the language relating to ownership in our form advance notice bylaws such that it reflects the most current thinking of industry experts on these matters.[6]

Qualification Requirements. In addition to informational requirements, some companies have bylaw provisions dealing with qualification of directors, but many do not. Even companies that have some qualification requirements may wish to review them, particularly in the context of the shift of power toward corporate activists. As a practical matter, most boards have relied on their control over the recruiting of candidates for the board to deal with all but the most obvious qualification issues. Doing so may no longer be prudent in light of the expanding role of proxy access and the continued pressure being put on public companies by activist investors seeking board representation through traditional proxy contests.

An important caveat in this regard is that many advance bylaw provisions operate only with respect to candidates nominated by shareholders, not those nominated by the board. We think such differentiation may raise issues about the reasonability and fairness of qualification standards. Accordingly, the qualification provisions of our form of advance notice bylaw apply to all candidates for election, no matter how nominated.

There are a number of traditional director qualification standards that companies have used and which are suggested for consideration in our revised form of advance notice bylaws, including:

- Age
- Term limits
- Not serving on more than a specified number of company boards
- Regulatory requirements concerning the background or status of a director
- Criminal history and integrity
- Compliance with SEC and stock exchange rules
- Business understanding and achievement
- Citizenship (for regulated entities)

All of these qualifications are presumptively valid under state law, unless of course they establish unreasonable conditions or are not reasonably related to a valid corporate purpose or are applied in a discriminatory manner.

Conditions on Right To Nominate Candidates vs. Qualification for Seating Directors. There is an interesting and potentially important distinction between two types of bylaws affecting the election and seating of directors — qualifications on the right to nominate candidates for director and qualifications on entitlement of elected nominees to be seated as directors. While the end result of these two types of bylaws may be similar, their implications are not the same.

Because of the potential issues and lack of clarity or precedent in state law regarding a seating condition,[7] the position we take in our revised form of advance notice bylaw is to frame the qualification standards (as well as compliance with all other provisions of the advance notice bylaw) as a condition on the right of nomination, and then to further provide that a candidate not meeting the stated standard is also not qualified to be seated as a director.

Written Agreement to Comply with Board Governance and Informational Policies as Condition of Nomination. As we have explained in greater detail elsewhere,[8] we believe it is highly desirable that a board adopt an explicit policy requiring total confidentiality of board room and other director communications. Accordingly, we recommend in our revised form of advance notice bylaws that boards consider adoption of a bylaw requiring, as a condition to the right of nomination, that every candidate for election, whether nominated by the board or by a shareholder and whether a traditional insurgent candidate or a proxy access candidate, agree in writing to be bound by all governance and informational policies applicable to directors.

In this regard, we also recommend that all companies review their board governance and informational policies to make sure they are complete and explicit. This would include, in addition to explicit director confidentiality policies, codes of conduct, compliance with insider trading rules and regulations, adherence to company policies restricting trading in company securities and conflicts of interest, adherence to company policies regarding reporting under Section 16 of the 1934 Act, prompt completion of director questionnaires and the like. Our form of advance notice bylaws contains provisions which would require all candidates for election, no matter how nominated, to agree to comply with all such company policies and guidelines as an explicit condition to their right to be nominated.

Conclusion

The invalidation of the SEC's Proxy Access Rule has left the future of a mandatory proxy access regime uncertain. However, considering that the companion amendment to Rule 14a-8 is now in effect, public companies can expect shareholder proposals for proxy access beginning in the 2012 proxy season and likely gathering steam in subsequent years. Many public companies, rather than accepting proxy access initiatives contained in shareholder proposals, will proactively adopt a company drafted proxy access bylaw or propose that its shareholders do so in response to or in anticipation of a shareholder proposal. We believe our form of proxy access bylaw sets forth a reasoned approach for private ordering that takes into account, and in some important respects improves upon, the SEC's thinking on proxy access, as embodied in the invalidated SEC's Proxy Access Rule and its related adopting release.

We also strongly recommend that companies revisit their advance notice bylaws whether or not they are thinking of implementing proxy access. It is important for companies undertaking a review of their advance notice bylaws to be sure that they do or will integrate appropriately with proxy access. More importantly, the revised advance notice bylaws should contain appropriately protective provisions that have been developed since adoption of the company's current advance notice bylaws.

Endnotes

1. A shareholder proposal may take two distinct forms: first, a recommendation that the board take certain action (a so-called "precatory" proposal) and, second, a proposal that shareholders act directly, for example by adopting a bylaw (which in most cases is permissible under state law and the certificate of incorporation). The vast majority of shareholder proposals are of the first "precatory" type because of the dual challenges of drafting an actual by-law and fitting it into the 500 hundred word limit Rule 14a-8. The text assumes that most shareholder proposals on proxy access will be "precatory." If the proposal is for direct shareholder adoption of a proxy access bylaw, the tactics available to a board which opposes the bylaw will necessarily differ in some respects.
2. ISS policy is to recommend withhold votes for members of the board if the board does not implement a shareholder proposal that receives a "yes" vote from a majority of outstanding shares prior to the next annual meeting. ISS policy is also to recommend a withhold vote if the shareholder proposal has received a "yes" vote from a majority of shares voted in the most recent, and one of the two preceding annual meetings.
3. See Latham & Watkins' Corporate Governance Commentary "*Private Ordering in the Brave New World of Proxy Access,*" which can be found at http://www.lw.com/upload/pubContent/_pdf/pub3801_1.pdf.
4. Indeed the US Proxy Exchange, an advocacy group for retail shareholder activists, has suggested a standard as low as 100 shareholders who have all held $2,000 of stock for one year.
5. See Latham & Watkins' Corporate Governance Commentary "*Private Ordering in the Brave New World of Proxy Access,*" which can be found at http://www.lw.com/upload/pubContent/_pdf/pub3801_1.pdf.
6. It is important to note that, in contrast to the net long beneficial ownership concept for testing eligibility to make a proxy access nomination (where the goal is to test for the underlying un-hedged full economic and voting ownership so as to limit access to true long term holders of all incidents of stock ownership), the policy goal in advance notice bylaws is to identify all aspects of a party's interest in the company's stock, hedged and un-hedged. As a result, the definition of beneficial ownership in the revised form of advance notice bylaws is intentionally broad and inclusive.
7. See Latham & Watkins' Corporate Governance Commentary "*Private Ordering in the Brave New World of Proxy Access,*" which can be found at http://www.lw.com/upload/pubContent/_pdf/pub3801_1.pdf.
8. See Latham & Watkins' Corporate Governance Commentary "*Board Confidentiality,*" which can be found at http://www.lw.com/upload/pubContent/_pdf/pub2916_1.pdf.

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