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GETTING ACTIVE

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On Aug. 25, the Securities and Exchange Commission voted 3-2 along party lines to adopt a controversial proxy access regime. Together with initiatives in the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring "say on pay" and "say on golden parachute" shareholder votes, institutional shareholders and special interests will be newly empowered to directly influence issuers at annual meetings of shareholders without incurring the high costs historically associated with shareholder activism.

Issuers, incumbent directors and management will likely be forced to redirect significant time and resources to the annual meeting process. Absent a successful legal challenge, the proxy access rules will be effective for the 2011 proxy season. Companies will not be able to opt-out of the rules. However, smaller reporting companies will benefit from a three-year reprieve before effectiveness, and foreign private issuers will be exempt.

New Rule 14a-11 requires a company to include in its proxy materials director candidates nominated by a shareholder or a group of shareholders holding in the aggregate at least 3% of a company's outstanding shares entitled to vote on the election of directors, and who have held at least that number of shares continuously for at least three years.

The maximum number of candidates a company must include is 25% of the total number of directors (and always at least one director). Traditional activist hedge funds that accumulate shares for the purpose of seeking a change in governance or leadership will often not satisfy the three-year ownership requirement. Of course, these hedge funds may still seek to elect their own director candidates through filing their own proxy statement.

A nominating shareholder or member of a group may not use Rule 14a-11 if it holds any of the company's securities (1) with the purpose or the effect of changing control of the company, or (2) to gain a number of seats on the board that exceeds the maximum number of nominees permitted under Rule 14a-11. Many hedge funds and activist shareholders will likely be unwilling or unable to certify these conditions and hence will not use Rule 14a-11.

Companies whose securities trade on a national securities exchange need only include a shareholder nominee in the company's proxy materials if the nominee meets the exchange's objective criteria for independence. Nominees do not need to meet an exchange's subjective independence requirements or the stricter requirements for audit committee membership.

A company may also exclude a nominee if it believes the nominee's inclusion on the board of directors would violate federal, state or foreign law, or the rules of the applicable national securities exchange, other than rules related to independence. Companies may not exclude nominees that do not meet director qualification requirements set forth in the company's organizational documents. If a nominee does not meet such requirements, the company can include that fact or belief in the proxy statement, which presumably would influence the vote on that nominee. If a nominee who does not meet qualification requirements is nonetheless elected, then under state law, the nominee would not in fact take a board seat, and applicable state law would govern what happens with respect to that seat.

Although qualifications in governing documents cannot disqualify a nominee from being named in the company's proxy statement, such qualifications may still be a powerful tool for companies to ensure that directors meet minimum standards important to the company.

The SEC will have an optional procedure for companies to use when they believe a purported Rule 14a-11 nominee may be excluded. The company or the nominating shareholder may also litigate the eligibility of a nominee under Rule 14a-11.

Nominating shareholders and groups will be required to provide a notice on Schedule 14N to the company of an intent to include a nominee in the company's proxy materials. Schedule 14N may also include a supporting statement, not longer than 500 words per nominee, which the company must include in its proxy statement.

Schedule 14N 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 that the company mailed its proxy materials for the prior year's annual meeting. If the company did not hold an annual meeting during the prior year, or if the date of the meeting has changed by more than 30 calendar days from the prior year, the company will be required to disclose the filing date within four business days after the company determines the anticipated meeting date. The date must be reasonable, and if required to be disclosed, must be reported in a Form 8-K filed with the SEC pursuant to new Item 5.08.

It is unclear whether institutional investors that have not previously pursued proxy contests will avail themselves of Rule 14a-11. It is also unclear whether individual investors will be able to organize groups large enough to meet the 3% ownership threshold, and if they do, whether larger investors will step in and propose nominees that "trump" the nominees of smaller investors for the limited Rule 14a-11 space on the proxy statement.

Most majority voting provisions provide that they do not apply in contested elections for directors. Accordingly, one effect of Rule 14a-11 will be to restore plurality voting for directors in most elections where shareholders avail themselves of Rule 14a-11.

It is clear that proxy access presents a significant change to the prevailing order of the board nomination process. Where a Rule 14a-11 candidate is elected, board communications will likely be affected, at least at the outset. The traditional board nomination process affords management and the continuing directors significant opportunity to get to know a new board member. That process usually involves the existing directors and the new director reaching a level of comfort that assures they will operate harmoniously together. Rule 14a-11 directors that were opposed by the current board will lack the trust built through the traditional nomination process and, depending on the nature of the campaign, may be affirmatively distrusted or even disliked by the other directors.

Of course, this sort of disruption is not new -- boards that have seen successful activist shareholder campaigns have been through it. Rule 14a-11 has the potential to increase the number of boards that experience such a shift, particularly at companies that were not at a significant risk of activist shareholder attack.

The risk of shareholder nominees could affect future management decisions. That is, management at some companies might find incentive to make decisions to satisfy the concerns of small constituencies of shareholders who might otherwise disrupt the proxy process by nominating dissident directors. It remains to be seen whether directors hostile to management or otherwise unwelcome by other board members will improve corporate governance, accountability and performance, as the SEC hopes. In any case, incumbent boards and company management will likely be required to spend significant additional time and resources on the director nomination and election process. Some, including dissenting Commissioner Kathleen L. Casey, argue that this new proxy access regime may reduce the competitiveness of U.S. corporations.

In the meantime, affected companies should: (1) examine their shareholder base, constructively interact with shareholders to gain a better understanding of their views and concerns now, and closely and continuously monitor their shareholder base going forward; (2) review their existing bylaws and consider revisions to the advance notice and director qualification provisions in light of the new proxy access rules; (3) review majority voting procedures in light of Rule 14a-11 to ensure that majority voting will not apply in contested elections; (4) review corporate governance policies and committee charters to determine if changes are required to operate harmoniously with Rule 14a-11 procedures; (5) review risk factors for shareholder dissatisfaction, such as performance issues, close CEO relationships, overboarding, related party transactions, unpopular governance, and executive compensation policies and directors who received negative voting recommendations in past years from proxy advisory firms such as Institutional Shareholder Services or Glass, Lewis & Co. LLC; (6) consider whether the current size of the board and each committee continues to be appropriate; and (7) develop a game plan to address shareholder nominees if the shareholder composition suggests a reasonable chance of one or more shareholders using the new proxy access rules.

The game plan should address all aspects of the new process, including determining whether nominating shareholders and nominees are eligible, a communications strategy, a negotiation strategy and, where appropriate, a litigation strategy.

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