ISSUE ALERT

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The Proxy Access Debate

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Pursuant to U.S. Securities and Exchange Commission (SEC) rules, a public company must include shareholder nominees in its proxy along with the nominees of the Nominating Committee of the board. In addition, a public company is required to ask for a shareholder vote on shareholder-initiated proposals to change the company's nomination and election process. These are significant and controversial changes.

Rule 14a-11 (Direct Access): A company must include in its proxy names and information about a qualifying shareholder's (or group of shareholders) nominees for director along with any candidates proposed by the Nominating Committee of the board.

Directors proposed under Rule 14a-11 cannot represent more than 25% of the board. If the number of directors proposed exceeds 25% of the board, the largest shareholders' nominees take precedence.

Proxy access will be available to a shareholder, or group of shareholders, who own and have owned continually for at least the prior 3 years, at least 3 percent of the company's voting stock.

This has been a highly controversial proposal, with over 600 comment letters sent to the SEC, prior to their issuing rules on August 25, 2010.

Rule 14a-8 (Private Ordering): A company must include in its proxy and ask for a vote on shareholder proposals aimed at changing the corporation's nomination and election process. Currently, these proposals may be excluded from the proxy.

Steps to Take Now

1. Track the status of the lawsuits and probable implementation of the SEC proxy access regulations.
2. Make preparations to enable proxy access in the likely event that proxy access is implemented, and shareholders nominate potential directors for your board.
3. Take another look at your large shareholders, especially those with holdings over 3%, and evaluate your current shareholder relations' effectiveness, capabilities, and resources.
4. Evaluate your existing board, committees, and directors and consider ways of improving accountability, transparency, and value.
5. Consider the impact any changes in process and board make-up will have on the future of the board of directors and the company.

Background

Corporate directors are elected by shareholders in an annual process that is governed by a combination of state and federal law. State law (the law of the state in which the corporation is incorporated) controls the director nomination process and the vote required for election. In a publicly held corporation, most shareholders do not attend the annual shareholders meeting in person. Rather, the corporation solicits proxies so that shareholders may indicate their choice with regard to the election of directors by returning a proxy card or by using electronic voting. The proxy voting process is regulated by federal law pursuant to the Securities Exchange Act of 1934, as amended, and regulations adopted by the Securities and Exchange Commission ("SEC").

On more than one occasion in the last decade, the SEC has indicated that the proxy solicitation process should be enhanced in order to facilitate shareholder nominations for directors, and several proposals have been advanced in order to accomplish this goal. These proposals are generally known as proxy access proposals. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section14(a) of the Securities Exchange Act of 1934 to authorize, but not require, the SEC to issue rules regarding the inclusion of shareholder nominees in a company's proxy materials. The SEC's most recent proxy access regulations were issued on August 25, 2010.
http://www.sec.gov/rules/final/2010/33-9136.pdf

The vote on the SEC regulations was 3-2, with Commissioners Casey and Paredes dissenting due to numerous concerns, including that the proxy access rules encroach on state corporate law and interfere with private ordering by companies and their shareholders.

The final rules take effect sixty days after publication in the Federal Register, except for smaller reporting companies (as defined in Rule 12b-2, generally companies with a public float of less than $75 million). Thus, except for the lawsuit that has delayed implementation, proxy access would have taken effect in time for the 2011 proxy season of most calendar year issuers.

The SEC changes to the federal proxy rules do two things. First, under certain circumstances, a company is required to include in its proxy material information about a shareholder's (or group of shareholders) nominees for director and include the names of those nominees on the company's proxy voting card along with any candidates proposed by the Nominating Committee of the board. This aspect of the SEC's proposals is known as "**direct access**," pursuant to a brand new SEC rule designated Rule 14a-11.

Second, the SEC rules (known as the "14a-8" rules) require a company to include in its proxy material certain shareholder proposals aimed at changing the corporation's nomination and election process. Currently, proposals to change this process may be excluded by the company from its proxy material on the basis of Rule 14a-8(i)(8), which allows a company to exclude shareholders proposals that relate to a nomination or an election of a director or a procedure for such nomination or election. The SEC reverses the existing rule and specifically requires such proposals to be submitted to shareholders for a vote, thus allowing shareholders to vote on and "customize" a corporation's director election process. For example, a shareholder could propose that a corporation adopt diversity requirements for board membership. The proposal would be presented to shareholders for

adoption or rejection under the new SEC rule. This concept is sometimes referred to as "**private ordering**" of proxy access.

Direct Access

The SEC's rules for direct access to the proxy process include several requirements. New Rule 14a-11 applies to all public companies, except those that are subject to the proxy rules solely because they have a class of publicly held debt. Companies with revenues under $75 million are exempt for three years. The final rule requires that investor groups hold a minimum of a 3 percent stake for at least three years to be eligible to nominate board candidates to appear on management proxy statements. Only shares over which the shareholder has investment and voting control will be counted toward the three percent threshold. It is estimated that more than 30% of publicly traded companies have one or more shareholders with 3% stock holdings.

All shares must be held through the date of the meeting at which directors are elected. Borrowed shares will be excluded.

There are *disclosure requirements* with respect to proposed nominees. The shareholder or shareholder group (shareholders may align to propose nominees) proposing to make a direct access nomination must state that it is not holding its securities for the purpose of, or with the effect of, changing control of the company or to gain more than a limited number of seats on the Board of Directors. In other words, Rule 14a-11 is not intended to function as a substitute for an election contest. Shareholder nominees must be in compliance with applicable law and regulations requiring that directors and director nominees be independent. Companies may not impose additional independence standards.

Thus, any proposing shareholder must represent that the nominee satisfies any applicable national securities exchange requirements regarding director independence and that there are no relationships or agreements between the nominee and the company or its management. However, there is no requirement that the shareholder nominee be independent of the nominating shareholder. In its proxy access proposals in 2003, the SEC proposed a limitation on relationships between the nominating shareholder or shareholder group and its director nominee. However, those limitations were eliminated in the SEC's new rules.

The maximum number of shareholder nominees that a company is required to include in its proxy materials as a result of direct access is limited to no more than one shareholder nominee or the number that represents 25% of the company's board of directors, whichever is greater. If there are multiple nominating groups, nominees proposed by the largest shareholders are prioritized.

Shareholders must formally propose their nominees through a new Schedule 14N filing with the SEC and must provide a copy to the company.

The California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), two very large pension funds, working with other investors, are currently developing a database of potential director nominee candidates.

Companies cannot "opt out" of being subject to Rule 14a-11.

To exclude Schedule 14N nominees, a company must file with the SEC to exclude nominees and notify the nominating shareholder within 30 days of such filing.

Private Ordering

The SEC's proposed revisions to Rule 14a-8(i)(8) enable shareholders, under certain circumstances, to require a company to include in the company's proxy material proposals that would amend the company's director nomination and election process. Thus, company A might have a shareholder nomination process different from company B. Each company's shareholders may determine its own process, as opposed to the "one size fits all" concept of Rule 14a-11 (direct access). But shareholder proposals would not be allowed to conflict with Rule 14a-11. The SEC considers this to mean that shareholders could require ownership thresholds, holding periods, or other qualifications different than those in Rule 14a-11, but could not "opt out" of Rule 14a-11 or prevent the operation of Rule 14a-11 allowing shareholders to directly nominate directors. The relationship between these two rules will require additional guidance.

Legal Issues and Delays

The SEC's proxy access proposals have been controversial, particularly the provisions for direct access. After the most recent proposals were published in June 2009, the SEC received over 600 letters of comment (an unusually high number). A group of seven of the largest law firms on Wall Street submitted a joint letter urging that direct access not be adopted, while a group of 80 law, business, economics, and finance professors submitted a joint letter urging that all of the proxy access proposals be adopted quickly.

After President Obama signed the "Dodd-Frank Wall Street Reform and Consumer Protection Act." (http://www.docs.house.gov/rules/finserv/111_hr4173_finsrvcr629.pdf) in July 2010, the SEC moved quickly to adopt final proxy access rules.

This legislation authorizes (but does not require) the SEC to adopt proxy access (without mandating the detail of what shall be included) and also authorizes the SEC to exempt smaller companies from such requirements.

However, on September 29, 2010, the U.S. Chamber of Commerce and the Business Roundtable filed a suit challenging Rule 14a-11, The SEC joined the suit in seeking an expedited review of the new rule by the U.S. Court of Appeals for the D.C. Circuit. The SEC also agreed to a stay of the effective date of the new rules, so that, even if the appeals court acts quickly and upholds the controversial rule, it's not likely that proxy access would take effect until at least the 2012 proxy season.

The rule had been slated to take effect in November 2010 and would have impacted companies holding meetings during the second half of the spring 2011 proxy season.

The SEC also said it would delay an amendment to Rule 14a-8, which would have allowed investors to file bylaw proposals that seek more permissive access procedures.

Pros and Cons

Proxy access proposals were made by the SEC in 2003, 2007, and in 2009. Each time, there have been sharply divided opinions. Currently, there seems to be a grudging recognition that private ordering is an acceptable idea, but there is still strong dispute about direct access.

Pros

Proxy access advocates say the following:

- Shareholders should have a greater voice in corporate governance, and proxy access will enable this.
- Corporate boards have not functioned well, and proxy access will result in greater accountability to shareholders by making directors more responsive to shareholders' opinions and input.
- The ability to nominate director candidates is a fundamental shareholder "right."
- The incumbent board should not have sole control of the proxy card and the election process.
- Proxy access creates greater alignment between the board and the interests of shareholders, thus improving corporate governance.
- Prior efforts to reform boards have had little effect, so proxy access is needed now.

Cons

- Proxy access, as it is now prescribed, is not the best way to upgrade shareholders' rights, because the new rules allow shareholders to bypass an objective recruiting process. Board members with the right mix of background, expertise, experience, and perspective are the fundamental prerequisite for a good board. Random nominations will not achieve the necessary balance.
- The process of filling Board seats may become politicized and subject to campaigning, special interest pressures, sizable expenditures to lobby other shareholders, horse trading for seats, and other disruptions that will divert the resources of the company and the rightful focus of the board on the business of the business.
- Shareholders frequently represent short term financial interests, special interests, or narrow agendas and constituencies that may be in direct conflict with the long term interests of the corporation. Shareholder blocks of 3% are frequently held by hedge funds whose viewpoint is narrow and opportunistic, as opposed to long-term and strategic. Allegiances may sharply diverge and discourage deliberative, thoughtful, and strategic corporate governance. Management tenure could be subject to blocks of shareholders jockeying for control.
- Many (if not most) corporate boards function very well, and it is not wise to blame all of corporate America for the faults of the well-publicized failures.
- There are too many inconsistencies and incongruities in the new rules. Private ordering by which each company can adapt the rules to suit its needs seems preferable to a one size fits all approach, especially when traditional state law principles are tossed aside.
- Under proxy access, there would be no way to ensure or enhance board diversity. Direct access might result in a divisive and less diversified and functional board rather than one that is more accountable, representative, and forward looking.
- The ability of activist shareholders to bypass a thoughtful, proactive process of recruitment may encourage a professional director class – closing the door to diversity in age, experience, gender, ethnicity, geography, global representation, functional expertise, industry knowledge, vision, and culture. Further, this approach

would create a barrier to those who currently do not hold board seats and thus could perpetuate the failed practice of recycling directors. This seems in direct conflict with the intent of the recent SEC directive that boards must disclose how they have addressed diversity in the composition of their board.

- Directors should be recruited proactively, objectively, and independently. In order to avoid conflicted allegiances on the board, the New York Stock Exchange now requires issuers to disclose the method of recruiting. Last year, 51% of companies disclosed the source of their new directors.

What's Next

At this point, we await the rulings on the legality of the SEC's proxy access rules and the possibility that the rules will be revised.

The authors believe that imposing direct access is not a good approach and that many alternatives exist that can result in an objective board recruitment process and enhanced shareholder engagement. SEC Chairman Schapiro said, in June 2010, that "the Commission's approach to corporate governance is not to mandate outcomes. We don't believe that there is a single structure that ensures accountability in all circumstances." Yet, the SEC has imposed a single, mandatory structure.

In a related development, the SEC has issued a request for comment on a broad range of proxy voting topics, including the ability of companies to directly contact investors, accuracy in vote tabulation, the role of proxy advisory firms, and other matters.
http://www.sec.gov/rules/concept/2010/34-62495.pdf

The untold stories are the thousands of companies, public and private, that have avoided crises; that have succeeded, because of the advice and counsel of diligent, independent, strategic boards of directors.

Just as Congress is elected to protect our national interests, so boards of directors can safeguard our investments – and thus our nation's financial health. The financial team's ability to ensure transparency and accountability is key to the vibrancy of our free enterprise system.

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