New Proxy Rules Signal Shift in Balance of Power

On August 25, 2010, the Securities and Exchange Commission ("SEC") voted to approve a rule that provides shareholders with the ability to nominate candidates on the corporate ballot for boards of directors.

This follows on to proxy access rules published by the SEC in June 2009. It represents another step in the shifting balance of power away from management and boards toward shareholders. In our view, it portends a potential movement in the critical mass of shareholder activism away from the standard hedge fund financial engineering to activists with more of a focus on social issues such as corporate governance, labor and the environment. As such, companies must, if they have not already, take notice.

This heightens the importance of management assessing its company's corporate governance weaknesses and divergence from best practices, understanding the sentiment of its shareholder base and knowing who is likely to be critical, and proactively engaging its investors so that issues can be put on the table and resolved privately rather than in the public spotlight of the proxy process.

Relevant Provisions of the Rule

Numerous other experts will have analyzed the provisions of the new rules, but our purpose here, as communications consultants, is to provide a framework for companies to assess their vulnerabilities and engage their investors in order to mitigate the impact of the new proxy rule.

Key elements of the rule for the purpose of this discussion are as follows:

- Eligibility is limited to a shareholder or group of shareholders who have owned 3% of the voting securities continuously for a three-year period. Shares that are borrowed or sold short do not count toward the 3% threshold, but shares that are lent may be included if they can and will be recalled if the nominee is included in the proxy.
- <u>However</u>, shareholders who satisfy the three-year holding period but who own less than 3% of the voting shares may form a nominating group to aggregate their shares in order to meet the 3% requirement.
- Shareholders or groups may nominate from one director to 25% of the board size, whichever is greater.
- A company will only be required to include director nominations from one shareholder or group. In the case of multiple proposals, priority will be given to the shareholder or group with the most voting shares. This differs from the proposal, which awarded priority to the first party to nominate a slate of directors.
- Shareholders or groups must not use this process with the intent (or the effect) of taking control of the company or the board.

- Shareholders cannot submit proposals that serve to opt out of the rule or increase the restrictions, <u>but</u> they can submit proposals that relax the restrictions.
- This rule will be effective for the 2011 proxy season.

Without debating the merits of proxy access, at face value the rule as passed could have been a lot worse for corporations. There are some provisions in the rule that are significant improvements on the provisions in the proposal. In particular, the 3% ownership requirement, compared to the tiered 1% to 5% requirement in the proposal, benefits large companies, which were to have a 1% threshold. In addition, the three-year holding period was increased from two years in the proposal and acts as a deterrent to activist investors who might use the new rule to exploit the proxy process for short-term gains.

Recommendations

There has been public resistance to the new rules, notably from SEC commissioner Kathleen Casey, who has laid the groundwork for a legal challenge, and the U.S. Chamber of Commerce, which has vowed to fight the rule and has said that it might consider litigation.

The outcome of these efforts is uncertain, so we believe the prudent thing is for companies to begin planning for the 2011 proxy season now and not wait until the spring. The actions we propose here are the right things to do irrespective of what happens, and companies will benefit even if the rule is overturned.

1. **Review corporate by-laws and director qualifications**
   The first thing is to consult with the company's securities counsel to determine whether there are options available to revise corporate by-laws, governance, director qualifications, etc. to strengthen its ability to fend off unfriendly overtures.

2. **Analyze the shareholder base**
   Thanks to the three-year ownership requirement, companies can anticipate from where nominations might come. An analysis of the company's shareholder base is critical to determine which institutions will have satisfied the three-year holding period by next spring and which have been associated with activism in the past.

   As noted above, we expect the recent rules to empower a broader universe of activists beyond the traditional event-driven hedge funds who lobby for financial strategies such as share repurchases, sale of the company, monetization of assets, leveraging the balance sheet and other short-term machinations. Companies need to be alert to activists who have social or political orientations and will work for changes in corporate governance, labor practices and environmental causes, among others.

   We would look for labor unions and public pension funds who routinely engage companies with shareholder proposals. Examples would be the AFL-CIO, AFSCME, Laborers' International Union, United Brotherhood of Carpenters and Joiners, and the New York City Pension Funds, all of whom sponsored between 10 and 20 corporate governance proposals in 2010.

The rule stipulates a requirement for the nominating shareholder or group to own 3% of the voting shares, but a company is vulnerable even if there are no 3% shareholders. Shareholders who own less than the required 3% of the voting shares can combine as a group and nominate a director slate, and we would be prepared for these holders to find investors with aligned interests.

3. **Benchmark corporate governance to best practices**
   Another preemptive initiative should be a comprehensive review of the company's exposure to issues that could be taken up by activists as a rallying flag to enlist support for their nominees. The pressing topics for activists in this environment are corporate governance, executive compensation, labor practices, supermajority voting, classified boards, etc., so it is important to assess the company's exposure to criticism in these areas. Particular topics to benchmark and review are compensation, compensation committees, "say on pay" and classified boards, which will likely instigate withhold votes for directors on next year's proxies.

4. **Engage the shareholder base**
   Even as the new rule allows shareholders or groups to nominate directors, they still must be elected by shareholders. As such, it has never been more important for management and the board to solidify their relationships with investors. This means using the period between now and next year's proxy season to assess the sentiment of shareholders, understand their proxy voting processes and trends, as well as to identify and shore up relationships with shareholders who might be dissatisfied. A robust perception analysis would facilitate an understanding of the attitudes of shareholders from which a strategy can be devised for remediating negative views and misunderstandings.

   Companies should engage not only the analysts and portfolio managers who are responsible for the investment positions, but also those in the compliance or governance departments at many of the institutions who are charged with actually voting of the proxies.

   This increased involvement with the shareholder base is important to enhance the dialog between the two parties and, ideally, arrive at understandings and resolutions that circumvent the public proxy process. It is far preferable to agree on compromises in private than to carry out the debate in public through SEC filings.

   Beyond avoiding director nomination, this dialog can mitigate the risk of shareholders submitting proposals to relax the requirements, which would make it easier in the future to accelerate the shift in the balance of power. Furthermore, with the risk of investors withholding approval for directors this initiative will put on the table any issues that might result in standing directors not receiving a majority of shareholder votes and being obliged to resign.

While the corporate governance community is not entirely declaring victory over the new rule, we believe it is giving consideration to how it will use these new powers. Corporate boards and managements should dedicate a comparable amount of consideration to how they will respond to the heightened activity that is likely to occur over the next nine to ten months.

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