Director Notes

Governance in the Dodd-Frank Act

Private Ordering and Proxy Access Rules: The Case for Prompt Attention

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The delay in implementation of the proxy access rules offers a grace period for companies to consider amendments to their governing documents in response to future changes to the director nomination regime. Regardless of the timing of the effectiveness of the proxy access rules, extrinsic forces such as corporate governance activist pressure will increasingly affect the nomination process for many companies. In light of these factors, companies should review and consider the private ordering initiatives discussed in this report with an eye toward amending their bylaws and corporate governance policies no later than summer 2011. Areas of focus should include advance-notice bylaws, director qualification bylaws (such as those setting age standards, term limits, or stock ownership requirements), conduct-of-meeting bylaws, and nominating committee charters.

Proxy access will not be operative during the 2011 annual meeting season after the decision by the U.S. Securities and Exchange Commission (SEC) to stay the new rules pending litigation challenging their validity on administrative law procedural grounds (see "The SEC Proxy Access Rules," p. 3). However, this report recommends that public companies promptly begin discussing the need for possible changes in their governing documents to take into account the almost-certain advent of this new shareholder right, in one form or another, in the near future.

There are three main reasons why board members should not delay assessing the implications of the introduction of proxy access to their company's shareholder voting system:

1. **Adjusting takes time** When the SEC adopted its proxy access rules in mid August 2010, anticipating their effectiveness in November 2010, companies immediately realized the challenges of implementing important organizational changes within such a short time frame. The desirability of bylaw and other governance policy revisions needed to be investigated thoroughly. Senior

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management needed to be educated with respect to proposed private ordering initiatives. Boards had to be brought into the process and given time to understand the issues and consider appropriate company responses.

2 **Perception matters, especially in Delaware courts** Postponing this issue until a tangible proxy access threat emerges after the effectiveness of the rules could prove disastrous for the company. History of election contests–and a proxy access nomination invariably creates an election contest–teaches that bylaw or other governance policy changes during a proxy battle present significant issues under Delaware law and the Chancery Court's avowed protection of the shareholder franchise.[1] Moreover, changes to governing documents once a proxy contest is in sight will be perceived by many institutional shareholders as defensive and unfair. This reaction might favor the proponents of the proxy access nomination and cause many in the corporate governance community to vote for the access nominee as a means of disciplining the company for its departure from best governance practices.

3 **Rules or not, pressure from activists continues** It is important to realize that the historical regime of board hegemony over selection and election of directors has been under attack by corporate governance activists for many years and will continue to erode. Conventional proxy contests may not worry most companies, and the same may be true of proxy access nominations. However, the threat of proxy access nominations, "say-no-on-pay" campaigns, and withhold vote campaigns by corporate governance activists is an increasing reality for public companies. Corporate governance activists are expected to continue their unrelenting pressure for corporate change, and the most recent regulatory developments will give activists far greater sway over director nominations. There will be an increasing number of newcomers in the boardroom, products not of the traditional board-driven search process for new directors but of shareholder initiatives. Companies need to be prepared for the advent of a new regime for director selection and ensure that it does not threaten traditional board cohesion and collegial values.

In light of these considerations, it is not too soon to begin evaluating bylaw and other governance revisions. In particular, companies should consider adopting appropriate private ordering initiatives by summer 2011, well before the likely 120- to 150-day window for the 2012 proxy access nominations that would open in late fall 2011 for year-end reporting companies.

The Scope of Private Ordering

The new SEC rules contemplate the private ordering of the proxy access process under state corporation laws, allowing shareholders to propose amendments to a company's governing documents to provide for proxy access. However, since such bylaws cannot override the SEC proxy access regime, as a practical matter, creation of an alternative proxy access regime by private ordering will be effective only if it sets less restrictive eligibility and procedural requirements than those under the federal regime. It is safe to assume that few companies will opt for alternative proxy access systems of this sort.

However, there are other private ordering initiatives a company should consider in light of the possible future effectiveness of the new SEC rules[2]—namely:

1 Revising advance-notice bylaws to accommodate the proxy access regime, including adding new conditions to the right to nominate candidates at a shareholder meeting (p. 4)

2 Revising bylaws establishing qualifications for the seating of directors and rules for the conduct of shareholder meetings (p. 4)

3 Adopting or revising board informational and governance policies (p. 8)

4 Revising nominating committee charters and processes (p. 9)

5 Reconsidering the size of the board, as well as board quorum and voting standards (p. 10)

1 See, e.g., *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906 (Del. Chan. 1980), at 914, holding a bylaw amendment proposed by management in the face of a proxy contest was "inequitable (in the sense of being unnecessary under the circumstances) and had the accompanying dual effect of thwarting shareholder opposition and perpetuating management in office." Also see *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A. 2d 1118, 2003 Del. LEXIS 5.

2 The SEC adopting release contemplates that the new rules operate solely in the realm of disclosure included in proxy materials. If the requirements under the rules are met, the candidate's name must be included in the proxy statement and on the company's proxy card, accompanied by a supporting statement of up to 500 words. On the other hand, the proxy access rules do not purport to operate in the traditional state-law regulated area of director nominations and qualifications or conduct of shareholder meetings.

The SEC Proxy Access Rules

Eligibility New Rule 14a-11[a] allows a shareholder or group of shareholders to nominate directors using a company's proxy materials if the shareholder or group:

- holds at least 3 percent of the total voting power of the company's securities that are entitled to vote on the election of directors at the annual meeting; and
- has held such securities continuously for a period of three years prior to the date a notice of nomination on new Schedule14N is filed with the SEC and transmitted to the company (and continues to hold at least that amount of securities through the date of the relevant annual meeting).

Exclusions The rule does not apply to a company if applicable state law, foreign law (in the case of foreign companies that do not qualify as foreign private issuers) or the company's governing documents prohibit shareholders from nominating candidates for election as a director.

Shareholders using Rule 14a-11 must not hold any of the company's securities with the purpose or effect of changing control of the company or to gain a number of board seats that exceeds the maximum number allowable under Rule 14a-11. If any nominating shareholder is, or becomes, a member of a Section 13(d) "group" with persons engaged in soliciting or other nominating activities in connection with the subject election of directors, conducts a separate solicitation with respect to the shareholders' nominees or participates in another person's election of directors outside of the SEC's proxy access procedures, then such nominating shareholder would be ineligible to use new Rule 14a-11. Shareholders seeking a change-in-control or a majority of board seats or greater may continue to use existing SEC procedures for such election contests.

Nominating shareholders may not participate in more than one Rule 14a-11 nomination process or group at a time.

Advance-notice requirements for proxy access Advance notice of nomination on a new Schedule 14N must be filed with the SEC and provided to the company by the nominating shareholder during a window period of 120 to 150 calendar days before the anniversary of the date that the company mailed its proxy materials for the prior year's annual meeting.

Alleged violation of Administrative Procedure Act On September 29, 2010, the U.S. Chamber of Commerce and the Business Roundtable petitioned the U.S. Court of Appeals for the District of Columbia Circuit for a review of the proxy access rules, alleging, among other things, that the rules are arbitrary and capricious and violate the Administrative Procedure Act and that the SEC failed to properly assess the rules' effects on "efficiency, competition and capital formation" as required by law. Pending resolution of that petition, the SEC stayed the operation of Rule 14a-11 and related amendments.[b]

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a See SEC Release 33-9136 ("Facilitating Shareholder Director Nominations"), August 25, 2010, available at http://sec.gov/rules/final/2010/33-9136.pdf.

b For the SEC order granting the stay, see http://sec.gov/rules/other/2010/33-9149.pdf.

Right to nominate and right to be seated It is important to distinguish between two types of bylaws affecting the election and seating of directors:

1. Qualifications on the right to nominate candidates for director.
2. 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:

- A valid bylaw establishing conditions or qualifications on the right to nominate candidates for director would ordinarily operate at the time nominations are actually made at a shareholder meeting and, if not satisfied, would justify declaring the nomination out of order and excluding the nominee from the election ballot.[3] Qualifications for valid nominations appear to be recognized under state law and should be upheld if reasonable and equitable in their operation and reasonably related to a proper corporate purpose.[4] The result of invoking a nomination qualification is that the candidate would not be voted upon by shareholders and would not be elected as a director. Proxies to vote for the proposed nominee would be ineffective.
- A qualification for seating an elected nominee on the board does not operate until the candidate is elected. While its legality would likely be subject to the same tests as a nomination qualification—that it be reasonable and equitable in its operation and reasonably related to a proper corporate purpose—its operation raises more challenging public relations and legal issues than a qualification for nomination. While in the case of disqualification of a nomination there has been no vote, in the case of a disqualification from seating, the nominee has already been elected. Moreover, if found wrongful, a failure to seat an elected director may have implications regarding the validity of board actions taken during the time the director was improperly denied a seat on the board and excluded from board information flows and meetings. These issues presumably would not arise if it were subsequently determined that a candidate had been wrongfully excluded from the voting, because votes would not have been cast.

Based on the potential issues and lack of clarity in state law regarding a seating condition, the safer position would be to frame the standard as a condition on the right of nominations and then further provide in the bylaw that a candidate not meeting the stated standard is also not qualified to be seated as a director. Many advance-notice bylaws employ this drafting expedient.

Conventional Advance-Notice Bylaws

Conventional advance-notice bylaws set a time window of either 60 to 90 or 90 to 120 days preceding the prior year's annual meeting date for valid notice of a shareholder nomination of a director candidate (as well as for any other motions a shareholder might want to make) at the coming year's annual meeting.[5] This window occurs later in the proxy season cycle than the 120–150–day anniversary of the mailing of the prior year's proxy statement for a proxy access nomination (see "The SEC Proxy Access Rules," p. 3). In light of the permissibility under proxy access for bylaws relaxing the qualifications for a proxy access nomination, it is not hard to envision a court holding that a later advance-notice bylaw nomination window supersedes the proxy access window period. This would drastically curtail notice to a company of a proxy access nomination.

Many advance-notice bylaws also contain minimum informational requirements for a valid director nomination. In some cases, the informational requirements will be less extensive than the proxy access rules, with the result that the bylaw could be interpreted as superseding the more stringent proxy access rule informational requirements.

Avoidance of these and other possible interpretative issues requires careful review and appropriate revision of all advance-notice bylaws. Therefore, the question is how to revise the advance-notice bylaw, whether by:

- making it explicit that the advance-notice bylaw is not intended to apply to proxy access nominations; or
- revising the company's existing advance-notice bylaws to integrate all shareholder nominations, including proxy access nominations (see "Drafting Options," p. 5).

3 The ballot is separate from the proxy. The proxy conveys authority to cast a ballot, as agent for the record holder; it is not the vehicle for the actual vote. The actual vote is conducted through submission of ballots completed by eligible voters—i.e., record holders and proxy holders present in person at the meeting.

4 *Stroud vs. Miliken Enters, Inc.*, 585 A. 2d 1306, 1308 (Del Ch. 1989), appeal dismissed, 552 A. 2d 476 (Del. 1989), ruling that the Delaware General Corporation Law expressly authorizes qualifications for directors if such qualifications are reasonable.

5 On advance-notice bylaws, see Frederick H. Alexander, "Responding to Unsolicited Takeover Offers," in Matteo Tonello, *The Role of the Board in Turbulent Times: Leading the Public Company to Full Recovery*, The Conference Board, Research Report 1452, 2009, p. 66.

This section of the report examines the two primary drafting choices companies will be facing should they choose the integration option.

Creating a unified informational standard The first key decision pertains to creating a unified informational standard for all shareholder nominated candidates. With respect to this point, the drafting choices to be discussed are limiting the informational requirements to those required under the proxy access rules or imposing greater informational requirements as a qualification for valid shareholder nominations.

The proxy access rules require 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, as well as limited additional information. While not as extensive as the information called for in some advance-notice bylaws, the disclosure requirements for proxy access implicitly represent the SEC's judgment as to what information is material to shareholders in the context of all election contests.

There are, however, good reasons for going beyond disclosures mandated by the SEC in an integrated advance-notice bylaw. For example, the company and its board will need to evaluate the independence of a proxy access candidate under the subjective rules of the relevant stock exchange, as well as under more stringent standards of independence imposed by the Sarbanes Oxley Act of 2002 for audit committee membership or voluntarily adopted by the company for other committees or the board as a whole.

Drafting Options

The explicit differentiation option An obvious and simple option is to make explicit that the advance-notice bylaw is not intended to apply to proxy access nominations. This approach would establish two entirely separate regimes for advance notice, one for proxy access nominations and the other for conventional proxy contests when the insurgents issue their own proxy card. Administering the two advance-notice regimes could be challenging, particularly if the company is facing simultaneous election contests, one under proxy access and the other of the conventional, old-fashioned variety. More important, carving proxy access wholly out of advance-notice bylaws would preclude using the advance-notice bylaws as a vehicle for provision of information appropriately sought by the company from every candidate for director.

In light of explicit staff comments that the proxy access rules would not preempt otherwise valid advance-notice bylaws, carving proxy access out of the advance-notice bylaw cedes what might be very important informational and other provisions that would otherwise be properly applicable to a proxy access nomination. Moreover, addressing advance-notice bylaws sooner rather than later should make it harder for a would-be proxy access nominating shareholder to argue that the amendments to a company's advance-notice bylaw are not general but rather targeted solely against proxy access candidacies and, thus, not reasonable or equitable as a matter of state law. For these reasons, as stated above, companies should not procrastinate in their consideration of amendments in light of proxy access until the validity of rules has been fully established.

The integration option The other drafting choice, which would be more advantageous to most companies, would be to revise the company's existing advance-notice bylaws to include all shareholder nominations, including proxy access nominations. While the challenge of integration will vary depending on the details of the company's existing advance-notice bylaw, there are two key decisions that will influence much of the drafting:

1. creating a unified informational standard for all shareholder-nominated candidates; and
2. deciding whether to leave intact the totally separate advance-notice calendars for conventional election contests and for proxy access contests.

A company that opts for going beyond the informational requirements for proxy access faces two critical legal issues.

1. The legality of the informational standards under state law: Are the increased informational requirements reasonable and equitable in content and reasonably related to a proper corporate purpose?
2. The permissibility of the informational standard as a matter of federal law: Do the additional informational requirements differ sufficiently from the proxy access standards to be preempted on the basis of "conflict" with the SEC rule?

With respect to the first issue, an informational qualification standard requiring all candidates to provide information sufficient to permit determination of the candidate's independence under all standards applicable to the company's directors should easily pass muster as a matter of state law, so long as the timing of adoption of the qualification is not inequitable (for example, by being adopted only when a proxy access nomination seemed imminent). The same should be true of other information going, for example, to the substantive qualifications and history of the proposed candidate, the proposed candidate's relationships with the nominating shareholder, and the proposed candidate's and nominating shareholder's involvement with the company or with other insurgents. Certainly, many companies have long had advance-notice bylaws that call for information beyond the scope of that required by the proxy rules and beyond the subject of a candidate's independence from the company. Explicitly or implicitly, these companies and their counsel have concluded that the informational requirements are acceptable as a matter of state law. Proxy access should have no effect on these conclusions.

With respect to the second issue, providing additional informational requirements as a condition for nomination should not be preempted by the SEC proxy rules. This conclusion is based on a number of considerations:

- The SEC in its adopting release clearly contemplates a director qualification standard imposing more stringent independence standards than the objective standards of the relevant stock exchange. If such a qualification standard is not preempted by the proxy access rules, it is hard to see how a condition-to-nomination standard that only requires provision of information to make the determination could be successfully challenged.
- Moreover, the proxy access rules and adopting release also contemplate disclosure by the company concerning the candidate's inability to meet more stringent independence standards. An advance-notice bylaw seeking the information necessary to make such a disclosure is obviously in furtherance of the SEC's contemplated disclosure-based solution to the issue of independence of proxy access candidates and, for this reason, is also unobjectionable.
- Finally, as noted above, SEC staff has indicated that it does not believe an advance-notice bylaw that is valid under state law would be preempted by the proxy access rules, even if it requires information (including information beyond that relating to independence) in addition to that called for by the proxy access rules. The SEC staff's position, with which we agree, apparently is that the proxy access rules do not preempt or purport to preempt otherwise valid state-law-based conditions for nominations and director qualifications.

Of course, these considerations should not lead to the conclusion that a company has a free hand in drafting advance-notice bylaws. As a matter of state law, it obviously does not. For example, if the information required in the bylaw is already in possession of the company, a requirement of disclosure might not be reasonable and equitable as a matter of state law. After all, what point would be served by the required disclosure, except to provide a basis for the company to assert the disclosure was incomplete or misleading?

Another potentially contentious nomination requirement under state law would be a bylaw provision requiring a nominating shareholder under the proxy access regime to demonstrate at the time of the annual meeting continuous compliance with the qualifications for proxy access from the date of its original notice of intention to make a nomination some five or six months earlier. What state law purpose, it might be asked, would be served by a company bylaw intended to vindicate a federal rule for proxy access, particularly when the SEC didn't see fit to require such evidence as of the meeting time?

The point is that drafting an integrated advance-notice bylaw that imposes informational requirements in addition to those contained in the proxy access rules will require fine judgments of reasonability and equitability as a matter of state law. Not everything will pass this test. In the absence of meaningful precedent under state law, the boundaries are difficult to map out with total confidence.

Advance-notice calendars for proxy access The second principal drafting decision for successful integration of advance-notice bylaws with proxy access is whether to leave intact the totally separate advance-notice calendars for conventional election contests and for proxy access contests.

The former does not pose any difficult legal judgments, but does expose the company and its board to a double-jeopardy type of process. The company may have to cope with a decision (typically following a negotiation) to accept a proxy access nominee as a member of the board's slate to avoid an election contest, only to have to confront the same need for negotiation and decision several months later in the context of a threatened conventional election contest.

This double-jeopardy-like situation could be avoided by:

- postponing any decisions regarding the proxy access nominee until after the separate advance-notice deadline has passed for conventional election contest nominations. However, doing so could adversely affect the negotiation and decisional process to the detriment of the company and/or the shareholders nominating the proxy access candidate;
- requiring conventional election contest nominees to comply with the advance-notice requirements of the proxy access rule. Under this approach, all shareholder notices of nominations for director, proxy access or otherwise, would be confined to the 120- to 150-day window specified in the proxy access rules. But would this be viewed as reasonable under state law? It certainly could be argued to have a "chilling" effect on conventional election contest nominations, one that would allegedly be unreasonable because it would require potential insurgents to decide on their strategy some five or six months prior to a shareholders' meeting. Nor could the company justify the truly advanced notice by citing the SEC's elaborate calendar for dispute resolution under proxy access, which would not be relevant to conventional election contest nominations.

The balance of considerations in deciding between one uniform or two different notice windows may be too close to predict with any certainty. However, on a more practical note, what would be the downside to providing a single window period for all nominations based on the proxy access calendar?

If the proxy access window was not challenged, the company would have the benefit of the additional advance notice. However, if the single shareholder notice window based on the proxy access calendar was successfully challenged by a conventional insurgent, would the company be appreciably worse off than if it had been more conservative and provided two separate windows?

The litigation over the validity of the one-window bylaw would effectively provide the company with sufficient advance notice to accomplish the basic purpose of the conventional advance-notice window period. So long as the advance-notice bylaw contained an effective savings provision to protect the validity of all of its other requirements, would the company be truly disadvantaged if the aggressive window period were ultimately struck down?

Other Qualification Bylaws

Advance-notice bylaws do not exhaust the potential field of qualifications for directors. Some companies have bylaw provisions dealing with the qualification of directors, but many do not. Even those that do probably have not thought hard about them, particularly in the context of the shift of power toward corporate governance activists. To date, as a practical matter, most boards have relied on their control over the recruiting of board candidates to deal with all but the most obvious qualification issues. Doing so may no longer be prudent in light of the expanding role corporate governance activists are seeking in director nominations and board composition.

Traditional director qualification standards There are a number of traditional director qualification standards that companies have been using,[6] including:

- Age standards
- Term limits
- Limits to service on multiple boards
- Citizenship, for certain regulated entities
- Minimum company stock ownership requirements
- Independence qualification under appropriate stock exchange and, where applicable, additional company specific standards

6 For best practices and other benchmarking information on board composition, see Matteo Tonello and Judit Torok, *The 2010 U.S. Directors' Compensation and Board Practices Report*, The Conference Board, Research Report 1467, 2010.

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. Presumably, they also are valid in the context of their application to a proxy access candidate. The only one that might give pause in terms of preemption would be the imposition of more stringent independence standards on all candidates, including proxy access candidates. However, as discussed above, while the SEC specifically declined to make all independence requirements applicable for purposes of the rule's requirements, the adopting release and the rule itself clearly contemplate that a company may have a valid director qualification imposing more stringent independence standards.

Written agreement to comply with board governance and informational policies as condition to nomination

Typically, companies assume that each board member will comply with board governance and informational policies. In many cases, those policies may not be spelled out in their entirety but are assumed to be known and understood. A classic example of such an assumed policy is maintenance of confidentiality of board discussions in and out of the boardroom. It is highly desirable that a board adopts an explicit policy requiring total confidentiality of boardroom and other director communications.[7] This view is reinforced by the growing recognition that board composition is ceasing to be the exclusive purview of the board and that shareholder nominees are going to become more frequent.

A nominating committee can introduce a board confidentiality policy to committee-selected candidates that have not previously served on the board and rely on an implicit agreement to adhere to the confidentiality policy. However, the committee should not conclude that a proxy access nominee or conventional proxy contest nominee will share the other directors' assumptions about the need for confidentiality or necessarily feel bound to observe the policy, especially if the nominee considers himself or herself to be a "representative" of a particular interest group (be it a hedge fund or an activist corporate governance proponent). Accordingly, it is recommended that boards consider adoption of a bylaw requiring every candidate, whether a board or shareholder nominee, to agree in writing to be bound by all governance and informational policies applicable to directors as a condition to the right of nomination.

7 See Latham & Watkin's Corporate Governance Commentary "*Board Confidentiality,*" which can be found at http://www.lw.com/upload/pubContent/_pdf/pub2916_1.pdf.

In this regard, it is also recommended that all boards review their other governance and informational policies to make sure they are complete and explicit. This would include (among others):

- codes of conduct;
- compliance with insider trading rules and regulations;
- adherence to company policies restricting trading in company securities;
- adherence to company policies regarding reporting under Section 16 of the 1934 Act; and
- prompt completion of director questionnaires.

Companies in regulated industries should consider also codifying director responsibility with regard to regulatory compliance issues.

Conduct-of-Meeting Bylaws

The advent of proxy access also serves as a good reminder to companies to review and, if appropriate, revise their conduct-of-meeting bylaw. This is an area in which many companies have outmoded or incomplete bylaws, particularly with respect to proxy contests. It is important to recognize that proxy contests in today's world are not limited to election contests, but may also include the now mandatory "say-on-pay" vote (if there is any form of a "say-no-on-pay" campaign, overt or otherwise) as well as shareholder proposals under Rule 14a-8 that are contested by the company.

Conduct-of-meeting bylaws should cover such matters as:

- Qualifications required to make a valid motion (e.g., proof that the moving party is a shareholder of record or holds a valid proxy from a shareholder of record).[8]
- Authority of the chair of the meeting to rule shareholder motions, including nominations, out of order for failure to meet advance-notice or other nomination qualification bylaw provisions.
- Authority of chair to open and close the polls.

8 Rule 14a-8 is of particular concern in this regard because of the SEC staff view that an authorized representative of the shareholder who submitted the proposal may act at the meeting in place of the shareholder. Query if that position would override a bylaw requiring that the moving party actually have legal authority to vote at the meeting in the form of a valid proxy from a record holder.

- Process for postponement and adjournment of meetings, including—if permissible under state law—to vest authority solely in the chair of the meeting.
- Process for selecting meeting chair, election inspectors, and other meeting officials.
- Identification of other applicable rules of order for the meeting (e.g., Roberts Rules of Order or similar recognized source).
- Authority of chair to make definitive rulings on all points of order.
- Limitations on right of speech at meeting.

Nominating Committee Charter

Companies should review their nominating committee charter in at least two respects.

Delegation to review credentials and qualifications It would be desirable to include in the nominating committee charter an explicit delegation to the committee to review the credentials and qualifications of all shareholder-proposed candidates for the board, whether as a result of proxy access or of a conventional election contest process. It is important that the board pursue a formal process of investigation and consideration before it decides to recommend that shareholders vote against shareholder nominees. Formalizing the committee's responsibilities will also serve the board if it engages in settlement discussions with the nominating shareholder or shareholder group, which almost invariably will raise the issue of putting the shareholder nominee or a replacement nominee on the board slate.

Nominating committee schedule It is also recommended that companies consider formalizing a nominating committee schedule that would contemplate the committee evaluating the performance of sitting directors and the credentials of potential nominees (including any proxy access nominees)[9] in the late fall or early winter, followed by its decision regarding the composition of the board slate of nominees during the winter months, and culminating in a presentation of that slate to the full board for approval at a meeting preceding finalization of the proxy materials for the forthcoming shareholder meeting.

Among the reasons for such a time table is a provision in the proxy access rules that, if a company engages in a discussion with a nominating shareholder or group before it files its Schedule 14N and subsequently the company puts the proxy access candidate on the board slate, the candidate is not considered a proxy access director for purposes of the 25 percent cap on access nominees. If there is no prior discussion and the candidate is put on the board slate after the Schedule 14N is filed, that candidate retains his or her status as a proxy access candidate for purposes of the 25 percent cap.

One way a company can preserve its flexibility to add a proxy access nominee to the board slate while retaining that nominee's proxy access status would be to refuse to discuss the candidacy before the Schedule 14N deadline. Simply refusing to do so may be awkward and counterproductive and would, at least, tip the board's hand in terms of application of the 25 percent cap on access nominees. However, the company may be spared negotiating embarrassment if it can credibly point to the nominating committee's responsibility under its charter and an established nominating committee process that makes it inappropriate to consider composition of the board's slate so early in the nominating committee process.

The suggested timeline for the nominating committee process would also preserve flexibility for the company in the circumstance when a proxy access nominee has been elected to the board and the board will have to decide whether to re-nominate that director as part of the board's slate for the forthcoming year.

The proxy access director and the shareholder(s) who nominated the director usually will want to know if the board will re-nominate the director well before the deadline for notice of proxy access nominations for the next year. However, at that point in time, the proxy access director will have served for only six months or so, a very short period for a meaningful evaluation, particularly for boards that only meet quarterly. Requiring a nominating committee and board to act on such a limited basis is hardly a model of good corporate governance and would undermine the credibility of the nominating committee's review process.

9 If a company amends its advance-notice bylaws to provide a single window period for all shareholder nominees, proxy access and conventional, including conventional election contest nominees in the nominating committee's articulated review process would not only be appropriate, but should also reinforce the corporate purpose and reasonableness arguments in favor of the single window period.

Moreover, any discussion between the company and the access nominee or his or her supporters before the Schedule 14N filing deadline could well have the result of ensuring that the director would not count as a proxy access nominee for the forthcoming year. This could lead to what a number of commentators have called "proxy access creep," in which consistent successful annual proxy access nominations could lead to a major shift in the composition of the board and make the 25 percent cap illusory in practice.

Having in place an established schedule for the nominating committee could fairly justify a refusal to engage in discussions about re-nomination prior to the Schedule 14N deadline. Postponing any consideration of re-nomination until after the Schedule 14N deadline would put the nominees' supporters to the test of having to file a Schedule 14N for that nominee, in which case the access director, if subsequently re-nominated by the nominating committee, would be included as an access candidate for purposes of the 25 percent cap.

It should be emphasized that the recommendation of the suggested timeline for the nominating committee process is not a recommendation that companies not engage in discussions about a proposed proxy access nominee or re-nomination of a proxy access director prior to the Schedule 14N filing deadline. Rather, the recommendation is appropriate as a matter of good corporate governance and would be helpful in giving a board and nominating committee a reasonable basis for declining engagement on proxy access nominations prior to 14N the filing deadline. It does not bar prior negotiations, but it does help give a company a choice in its tactics for dealing with the potential for proxy access nominations.

Other Bylaw Issues

Bylaws setting board size or quorum or voting percentages, when in place, should be reviewed in light of the new proxy access regime.

Size of board Most companies have the ability through bylaw amendment or director action to vary the size of their boards. In light of the operation of the 25 percent cap on proxy access nominees (rounded down to the next whole number), board size can have an impact on the percentage of proxy access nominee seats. For example, a four-person board would have one proxy access seat. A seven-person board would likewise have one proxy access seat by reason of the rounding down principle. Similarly, an eight-person board and an 11-person board would have a cap of two proxy access nominees. Accordingly, companies may wish to consider adjusting the size of their board to take into account the operation of the proxy access cap. While proxy access should not be the only consideration in determining board size, it could be a relevant one.

Another size-of-board issue is making sure that there are no unfilled vacancies on the board that could be filled by a proxy access (or other shareholder) nomination. Too many companies do not bother to adjust board size to fit the actual number of board nominees. If there are no other nominations, no harm and no foul. However, if there is a vacancy of this type, a shareholder- nominated candidate would automatically go on the ballot to fill the vacancy. This would be tantamount to election because the shareholder nominee would be unopposed.

Quorum and voting percentages Companies should review their board quorum and voting structures to take into account the higher possibility of having one or several shareholder nominated directors who may act as dissidents. Higher percentages for quorums and votes than required by statute and the charter could be disadvantageous in these circumstances.

Conclusion

The delay in implementation of the proxy access rules offers a grace period for companies to consider changes to their bylaws and be prepared for the possible future changes to the director nomination regime. Regardless of the timing of implementation of the proxy access rules, extrinsic forces, such as corporate governance activist pressure, will increasingly affect the nomination process for many companies. In light of these factors, companies should be reviewing and considering the private ordering initiatives discussed in this report with a view toward amending their bylaws and corporate governance policies no later than summer 2011.

Areas of focus should include:

- Advance-notice bylaws, particularly the windows for notice of nominations for proxy access and for conventional election contests and the informational requirements for both types of nominees
- Traditional director qualifications, such as age, term limits, citizenship, and ownership of minimum amount of stock
- Additional director qualifications, such as written adherence to board governance and informational policies
- Conduct of shareholder meetings
- Board size
- Nominating committee processes and procedures

Postponing review and action beyond summer 2012 could be imprudent. Acting now in an orderly and thoughtful fashion is far better than waiting for a court or subsequent SEC decision establishing proxy access for the 2012 annual meeting season and risking a hasty process or, worse, a lack of time for effective board action.

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