

MORROW & CO., LLC

Proxy Update

September, 2010

[UPDATE – October 4: SEC stays the effectiveness of Proxy Access](#)

Proxy Access - Beware the Ides of March

Proxy Access (Rule 14a-11) will be effective on November 15, 2010, having been published in the Federal Register on September 16. This means that companies that mailed on or after March 15, 2010 are subject to the rule in 2011¹, while those that mailed prior to March 15, 2010 will be spared from Proxy Access for the 2011 proxy season. This newsletter explores some of the practical considerations regarding Proxy Access.

- Which companies are at risk?
- Who will use Proxy Access?
- Limitations of Proxy Access
- What companies should do now
- What to do if you are facing a Proxy Access fight
- Proxy Access is not proxy fight ‘lite’
- Shareholder proposals on Proxy Access – Access to greater access

Which Companies are at Risk?

With the exception of smaller reporting companies with a public float of \$75million or less, who are exempt from Proxy Access for three years, *all* companies are at risk. However, we do not believe that Proxy Access will result in a significant spike in proxy fights, at least in its first year or two of implementation. We expect it will be a handful of **outliers** that are most likely to be targeted for Proxy Access nominations, for example:

- **Underperforming companies** vs. peers or index, that also have corporate governance and compensation vulnerabilities, such as:
 - Excessive compensation
 - Poor compensation practices

¹ Rule 14a-11 contains a window period for submission of shareholder nominees for inclusion in company proxy materials of 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. With an effective date of November 15, the end of the advance notice period would be March 15, 2010.

- Problematic change-in-control provisions
 - Tax gross-ups
 - Excessive executive perks
 - Shareholder votes where the company is deemed to be unresponsive to shareholder concerns:
 - Say on Pay proposals that failed or received a high Against vote
 - High Withhold votes on directors, or a failed election
 - Majority support on shareholder proposals
 - Adopted or renewed a Poison Pill without shareholder approval
- Even well-performing companies with egregious corporate governance/compensation vulnerabilities could be potential targets under Proxy Access.
- **Sympathetic Profile.** Companies with large institutional bases (70% or more) are more vulnerable since it may be easier for a dissident to be able to reach out directly to a significant percentage of shares; initially to form a group, and then during the solicitation. In addition, by targeting an institutionally held issuer, a proxy access sponsor will be taking advantage of the inherent bias of ISS to recommend support for shareholder nominated director candidates, particularly at underperforming companies.
- **Small- and mid-cap companies are more vulnerable** since the size of the monetary investment required to reach the 3% threshold, either alone or as a group, is more easily attainable. Plus there is a general perception that governance and compensation practices are less evolved as one moves down the capitalization spectrum. This is one of the reasons why the vast majority of regular proxy fights are conducted in the small and mid-cap space.
- **Large cap companies may face threats of “Agenda Fights”** where winning a seat may not be the ultimate goal. The company may be threatened by public sector, labor, or ESG activists that may have a different agenda, and are using Proxy Access as leverage; seeking to get companies to de-stagger the board, adopt majority voting, or make concessions on social or environmental issues.
- Companies that in the past have been targets of aggressive shareholder proposal campaigns or **Vote-No campaigns**. Will the proponents try to ratchet up the pressure by going from a 14a-8 or Vote-No campaign to 14a-11?

Concurrent proxy fights. Another risk is that a Proxy Access fight in 2011 prompts an opportunist to run a concurrent fight for a minority position, which in combination with the Proxy Access nominees could replace a majority of the Board. For many companies, the uniform advanced notice deadline for nominations under 14a-11 will occur prior to the advanced notice deadline in the company’s bylaws for a traditional proxy fight (often 90 to 60 days before the prior year’s meeting). This time gap provides an opportunist with time to organize a campaign.

Who May Use Proxy Access?

Certainly those that have championed Proxy Access will be on the list, including **public sector funds, pension funds, and labor activists**. We also suspect that “**Serial**” **activists/gadflies** may seek to use Proxy Access as an inexpensive way to wage a fight. **Money mangers that have a history of activism** (either leading or willing to support activist campaigns for directors or on governance issues) may be in the mix as well. **Disgruntled individual shareholders** will also use Proxy Access, but realistically, that would only likely be at small and mid-cap companies.

While mainstream institutions may not use Proxy Access often, they may at least be willing to lend their shares to a credible group (such as CalPERS) offering credible candidates. That is not to say that there won't be one-off situations where traditional institutions resort to Proxy Access.

Limitations of Proxy Access

The pool of shareholders that could use Proxy Access may appear to be deep at first blush, but we suspect the limitations imposed by the rules will result in a relatively shallow pool.

3% for 3 Years

We believe the main hurdle will be the requirement that the shareholder or group must hold at least 3% of the investment *and* voting power continuously for at least 3 years (the “3-and-3” requirement).

In many cases, the nominating shareholder may be a group, especially at large cap companies. In these occurrences, every member of the group would have to satisfy the 3-year ownership requirement, and the combined ownership of the group would have to be at least 3%. **This should preclude most hedge funds and many activists from using Proxy Access** because they, in large part, tend to be shorter term investors.

Forming a Proxy Access Group Could Be Difficult

One of the main concerns in the corporate community about Proxy Access is that **public sector funds and labor groups** will mass together and conduct a large number of Proxy Access fights. In most cases, the individual company stock holdings of labor groups tend to be much smaller than those of the public funds, making public/labor fund group formation potentially challenging from a share count perspective. The formation of these groups may require two to three dozen or more funds to participate. This difficulty will be compounded by the likelihood that many funds will probably want to withhold a portion of their shares from the eligibility threshold for liquidity purposes (see Share Blocking below).

Most of the companies we have looked at have less than 2% of their outstanding shares held by state and municipal pension funds (but obviously each company's shareholder profile is unique). Many state and municipal pension funds are indexed and thus likely to meet the 3-year continuous holding test for group formation. Private labor funds are also heavy users of indexing and will generally be qualified to participate in groups as well.

In many situations, in order to attain the 3% threshold, the public sector funds and labor groups will likely need additional shares. A natural group to approach to seek additional shares for a group would be **index funds**, since they are likely to be 3-year holders. However, traditional indexers who have a history of being supportive of management may be less willing to be part of a Proxy Access group.

Share Blocking and Section 16

Shareholders who are willing to add their shares to a Proxy Access group may reconsider when they realize they will need to tie up all of the shares they contribute for a long time, upwards of five to six months. This is because the rules require that a shareholder hold the shares that are part of the group through the date of the election of directors. With an advance notice date of 120 days (or as much as 150 days) from mail date of last year's proxy material, plus another 30 to 60 days from mail date to meeting, a shareholder is looking at blocking their shares for a considerable amount of time.

In addition, the rules require that any shares on loan would need to be called back. Even an index fund would be leery of tying up all of their shares and limiting their ability to profitably lend their shares. Indeed, we have spoken with some major index funds that expressed reservations on this very point.

Also, there is no exclusion from Section 16 under the rules. We believe that institutions that currently claim an investment purposes only exemption from Section 16 would be loath to join a Proxy Access group when they realize they would lose the exemption and be subject to things like short swing profits disgorgement and Form 3, 4 and 5 reporting.

Lack of Control

The other limitations of the rules would come under the heading of Lack of Control. First, dissidents can only nominate a maximum of 25% of the entire board, and are **precluded under the rules from seeking control of the board**.

More importantly, **dissidents don't control much of the process** because they can't send out their own proxy card or a copy of management's proxy to registered shareholders. Therefore, they don't control the timing or frequency of mailings with proxy cards; and since they can't mail a proxy card, they will have little visibility into the actual voting by registered holders.

Also, since dissidents will be unable to send out their own voting instruction form (VIF) to "street name" holders, they are not likely to have access to regular and detailed voting information from Broadridge regarding voting by banks and brokers, as they would in a traditional fight. We suspect that, at best, they may be able to get periodic, informal updates on the *total* vote. This will limit the dissident's ability to gauge the support of the retail and institutional holders behind the banks and brokers.

In order to overcome the lack of control, dissidents will have to **spend some money** if they want to get their message directly to shareholders. Dissidents may wish to demand shareholder records from the company, do mailings to shareholders, and possibly engage in telephone call campaign to shareholders. At some point, the cost of running a 14a-11 fight converges with running a regular proxy fight, and could get to a point where running a traditional, targeted proxy fight would be as cost effective.

What Companies Should Do Now

Despite the limitations imposed by the rules however, any company is potentially vulnerable, so it would be wise to do some homework now, understand your potential vulnerabilities, and take action if warranted.

Know Your Shareholders

The first step is to know the list of potential candidates for the 3-and-3 pool. Certainly, review your registered holders and institutional holders to determine if you have any holders that appear to have held 3% for 3 years. You should also look at how many holders (holding how many shares) appear to have held for 3 years, and how many it would take to aggregate to 3%.

Also review your institutional holders to ascertain if any have a history of activism, and cross reference those with the 3-year holders.

Determine how much is held by public sector activists and labor groups, and whether they can get to 3% on an aggregate basis. This often requires a more detailed examination of your shareholder base from a voting perspective since many of these shares are held by outside managers and not easily gleaned from public 13f filings.

Finally, determine the influence the proxy advisory groups like ISS, Glass Lewis & Proxy Governance, have on your institutional shareholders.

Know Your Vulnerabilities

At a minimum, you should be aware of whether your company is considered to have any significant corporate governance or compensation weaknesses, such as those outlined above. To the extent that you can correct those weaknesses or begin the process of taking action on them, you may become less vulnerable to a negative recommendation on a Director nominee and become less vulnerable to a Proxy Access campaign. However, we continue to caution companies about giving up key anti-takeover provisions just to improve their governance profile if it leaves the company more vulnerable to a takeover.

Update Your Annual Meeting Timetable

As part of your standard timetable for your annual meeting, you should add the dates for the Proxy Access nomination window (150 to 120 days before the mailing of last year's proxy).

Dialogue with Your Institutional Shareholders

We firmly believe that it is not enough to just know who your shareholders are, you need to dialogue with your institutional shareholders on a regular basis (whether you have Proxy Access concerns or not); especially the Gatekeepers (holders between 1% and 3% of shares outstanding that would make or break a proxy access group formation effort). It is also important to develop and maintain contacts on the voting side (as appropriate) as well as the investment side, and where possible to integrate discussions with both sides.

This can be an opportunity to let the institution know what makes your company unique and to engage with the individuals at the institutions that are responsible for proxy voting. We think that putting policies in place is not enough; companies need to take thoughtful action and dialogue with their institutional holders in advance of there being a real issue.

Not Proxy Fight “Lite”

Should you face the prospect of a Proxy Access fight, we would advise you not to view it as proxy fight “lite”. Despite the limitations outlined above, this is a fight very much like any other. As a result, you will still need to:

- Craft your argument: Why your board nominees are better qualified.
- Develop letters and communications to shareholders that spell out your position clearly.
- Prepare to take your message directly to each segment of the shareholder profile, including the proxy advisory services like ISS.
- Lobby your institutions.
- Deal with media, potential employee and customer disruption, and management time/distraction.

As noted above, where a Proxy Access fight differs from a conventional fight is with control, since the company **controls the mailing** of proxies: both the timing and number (for example, maybe you only do one mailing, and shorten the mailing period). The company also controls the **design of the proxy card and what goes in the proxy statement package**. The proxy card should provide clear instructions on the number of candidates a holder can vote on; box-off the Board’s nominees, and provide clear instructions on the Board’s recommendation.

But, you don’t control the dissident, and that’s why it is still a fight. While the Proxy Access dissident can’t mail a proxy, they can mail letters to shareholders. They can also be effective by posting communications on a website, filing on Edgar, using the press, social media, or other methods at their disposal. And with the 150 to 120 day advance notice period, it could make for a long campaign. We can see a dissident starting their campaign well before the mailing in an effort to influence shareholders and put the company on the defensive. So you may need to be prepared for a long fight

Private ordering: Access to Greater Access

We believe some activists will view the 3-and-3 requirement as too restrictive and may submit shareholder proposals seeking what some have called “Access to Greater Access”, i.e., relaxing the limitations of 14a-11 by seeking lower thresholds and holding periods such as 1%-and-1 year or increasing the percentage of nominees available under the access regime, such as 33% instead of 25%. Once proxy access has evolved for a year or two, we expect these types of proposals to become popular.

Morrow & Co. is available at any point during this process to assist you as you move toward the 2011 proxy season. Please feel free to contact your Morrow representative with any questions you may have. You may also contact Tom Ball, Fred Marquardt or John Ferguson at 203-658-9400.

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