

The Impact of the SEC's New Proxy Rules

BY DAVID RAUFMAN

In late August, the SEC adopted sweeping access amendments to the proxy rules. Voting along party lines, the SEC will now require shareholder nominees to be included in public company proxy statements for the upcoming 2011 proxy season. The newly adopted rules will cause more companies to go private, providing private equity firms and other market participants with the know-how and guts to make lots of money.

Shareholders and groups who collectively have held both investment and voting power of at least three percent of the voting power of a company's securities for at least three years will be able to have their nominees for director and a brief description included on a company's proxy materials. Shareholders will also be able to nominate up to a maximum of 25 percent of the entire board, with a minimum of at least one director, even if the company has a classified board. If shareholders propose more candidates than must be included in the proxy statement, priority shall be given to the candidates nominated by the largest shareholders or shareholder groups. Shareholders desiring to place nominees in a company's proxy statement must communicate their intent by filing a form with the SEC well in advance of a meeting.

Nominating shareholders must make specified disclosures, including as to their intent to hold their securities and that they do not intend to change control of the company or nominate greater than a quarter of the board. They must also note whether the nominees meet the company's director qualifications as set forth in the company's governing documents. Any nominee would be required to satisfy any federal or state law eligibility requirements as well as any objective, but not subjective, independence standards of applicable exchange rules to be considered as a direc-

tor. Companies may exclude these nominees under limited circumstances.

This new regime will allow creative shareholders enhanced ability to pressure management teams. For example, a private equity investor could acquire a 3 percent stake now and get the clock running towards nominations. Currently no rule even requires public disclosure of that level of ownership. Now the shareholder could begin a dialogue for change with management in private with the treat looming. Management would have only limited ability to stall such a shareholder, but eventually that shareholder could get a nominee on the board, particular with a company whose financial performance has suffered. That election would basically be a referendum on management.

The SEC has now imposed a three-year time clock on many smaller, poorly performing public companies. Many of these companies are owned by a small group of shareholders, with a large concentration with the directors and officers, usually for many years. Often there is no, or limited, analyst coverage and minimal stock float. As a result, if even a small position could be acquired, the new shareholders could force a review of strategic alternatives once they join the board, through this new process or by request. (It will be harder now for companies to reject such reasonable requests now with these new rules.) Such a process could likely lead to a going private transaction sanctioned by the board. At these smaller public companies, many management teams may now consider it an even better time to go private to avoid having to deal with this morass next year during the proxy season.



Smaller public companies also may not have sophisticated counsel with the resources and strategic thinking necessary to thwart these kinds of thoughtful, well-financed attacks.

These new rules also create complexity, requiring careful lawyering and good knowledge of the shareholder back-office “plumbing system” of holdings, both long and short, borrowing stock and actual ownership. Much additional attention should be paid to investor relations and keeping happy those shareholders above that 3-percent threshold, those who could go over that threshold or who could join with others to do so. Further, it may cause some decreases in stock price among some companies. As portfolio managers recognize this an important threshold, for its smaller holdings it may no longer be profitable to hold less than this 3-percent level because below that number, maybe management will not take their concerns as seriously. Small investment may pay outsized returns.

Union pension funds and other institutional “passive” investors will benefit from these new rules with access to the ballot boxes. But these kinds of shareholders rarely cause the kind of change necessary or appropriate to improve corporate performance. Hedge funds and activist investors, carefully counseled, could take advantage of these rules to wedge themselves onto a board. Timid firms will view these rules as simply

political payback from the Democrats to union investors. Savvy investors will instead find new mechanisms to use these rules to pressure management teams by acquiring small stakes and forcing their ways onto a board. Smaller public companies are at even greater risk because it will cost these aggressive investors small amounts to force change. For example a 3-percent stake in an \$100 million public company may only cost \$1.5 million, with leverage of 50 percent.

Barring last-minute threatened legal challenges from some industry participants, public company management teams and their boards should begin planning for a possible eventful season this fall. Management teams should research their holdings to try to ascertain who holds above this threshold and for three years, and gauge their interest in a constructive dialogue on potential changes that holder or group of holders would propose. Some formerly passive holders may be emboldened by these new rules so past history may not guide future behavior. Interestingly, there is no easy way to even figure out who these holders are – let alone track down specific contact information.

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