

September 1, 2010

## SEC Adopts New Rules to Facilitate Rights of Shareholders to Nominate Directors

After receiving approximately 600 comments letters to its June 2009 proposed amendments to the federal proxy access rules, on August 25, 2010 the SEC voted 3-2 to approve a series of amendments to the federal proxy rules promulgated under the Securities Exchange Act of 1934 (the "Exchange Act") to facilitate shareholders' rights to nominate directors. See [Release Nos. 33-9136, 34-62764, and IC-29384](#).

### Summary of Key Changes

#### Rule 14a-11

- In their proxy materials, companies must include the director nominees of certain shareholders or groups of shareholders who have held an investment of at least 3% of the voting power of the company continuously for the previous three years.
- Shareholders must submit their nominations to the company on new Schedule 14N no earlier than 150 days and no later than 120 days before the anniversary of the date the company mailed the prior year's proxy statement.
- Shareholders may not have their nominees included in the company's proxy materials if they are holding securities for the purpose of affecting a change of control of the company.
- Shareholders are limited to nominating the greater of one director or the number of directors equal to no more than 25 percent of the board's total membership.
- If the company determines that a shareholder and its nominee meet the requirements for inclusion in its proxy materials, the company must notify the shareholder at least 30 days before filing its proxy materials and the company's proxy materials must include information about the director nominee, which will be provided by the shareholder on Schedule 14N.
- If the company determines that a shareholder or its nominee does not meet the requirements for inclusion in its proxy materials, the company must notify the shareholder no later than 14 days after the period for submission of nominations closes. Notification triggers the following timeline of events:
  - The shareholder has 14 days to cure any eligibility or other defects, but may not nominate a substitute director;
  - If the company determines that the shareholder failed to remedy all defects and still does not meet the requirements for inclusion in its proxy materials, the company must notify the shareholder and the SEC at least 80 days prior to filing its definitive proxy materials (and request whether it wants a "no-action" letter from the SEC);
  - The shareholder then has 14 days to respond to the company and the SEC; and
  - If the company and the shareholder cannot reach an agreement, the company can request the SEC to express its views.

#### Rule 14a-2

- The new rules exempt certain communications by the shareholder or group of shareholders relating to nominees to be included in a company's proxy materials from certain traditional disclosure requirements:
  - Written and oral solicitations seeking to form a group of shareholders for the purposes of nominating directors only need to be filed with the cover page of Schedule 14N; and
  - Written solicitations sent in support of a shareholder nominee only need to be filed with a cover page on Schedule 14N.

### Rule 14a-9

- The SEC amended this rule to prohibit false or misleading statements or omissions by nominating shareholders with the liability for any such statements or omissions being on the shareholder.
- Information relating to shareholder nominees provided by shareholders will not be incorporated by reference into company filings unless the company specifically elects to do so.

### Rule 14a-8

- Shareholders may amend the provisions of a company's governing documents relating to director nominations to adopt more permissive access standards.
- Companies may seek investor approval of more permissive rules, but are not able to opt out of the federal access standards.
- Shareholders must submit their requested amendments to a company's governing documents relating to director nominations no later than 120 days before the anniversary of the date on which the company mailed the prior year's proxy statement.

### **Background**

The purpose of the federal proxy process is to replicate the conditions of a shareholder meeting as closely as is practical without requiring attendance of a large and widely dispersed group of shareholders. Before the issuance of these new rules, a company's proxy materials only needed to provide for the election of those directors nominated by the incumbent board. Shareholders were permitted to submit their own slate of nominees to be voted upon by the shareholders, but to do so required a very costly process of the shareholders' preparing and distributing separate proxy materials. It is also possible to attend an annual meeting and present an opposing slate of nominees to be voted upon; however, at that point many votes have already been cast by proxy.

The goal of the amendments is to provide more viable means for shareholders to exercise their rights under state law to nominate directors.<sup>1</sup> The amendments do not empower shareholders seeking to change the control of the company. Rather, they are to allow shareholders limited access to the company's proxy statement by submitting a short slate of director nominees to be nominated at the expense of the company.

The SEC's approval of the new measures follows enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provided the SEC with explicit authority to make rules addressing access to company proxy materials.

### **Rule 14a-11**

The new rule applies to all companies subject to the Exchange Act proxy rules other than those companies that are subject to the proxy rules solely because they have registered debt<sup>2</sup> and will allow certain shareholders to include their nominees for director in the proxy materials prepared by the company, subject to the following conditions:

#### Stock Ownership

---

<sup>1</sup> The new rule defers entirely to state law as to whether shareholders have the right to nominate directors and what voting rights shareholders have in the election of directors.

<sup>2</sup> The reach of the new rules includes investment companies, controlled companies, smaller reporting companies and companies that voluntarily register a class of securities under Exchange Act Section 12(g). The new rules contain several provisions related specifically to investment companies to address regulations unique to such companies; however, the treatment of investment companies under the new rules is largely similar to that of non-investment companies.

Nominating shareholders must own a minimum of three percent of the voting power<sup>3</sup> of the company's securities<sup>4</sup> entitled to vote for directors, and must have held this position for at least three years before submitting a nomination (shareholders may aggregate holdings to meet the appropriate threshold). Ownership is considered holding both investment and voting power and does not include securities exercisable or convertible into voting securities such as options, warrants and convertible securities. Shareholders cannot count shares for which there are still open short sales or shares borrowed other than for short sales. However, shareholders can count shares that they have loaned so long as they have the right to recall the shares and will recall them if any of their nominees are included in the proxy materials.

Nominating shareholders must continue to own the required amount of securities through the date of the shareholder meeting and must express whether they intend to continue to hold the securities after the shareholder meeting. In addition, the nominating shareholders must certify that they do not have a change of control intent or intent to gain more than the maximum number of board seats permitted under Rule 14a-11.

### Nominee Requirements

Nominees for election as director must be eligible for election to the board consistent with applicable laws and regulations. Additionally, nominees must meet the objective independence standards of the national securities exchange or association rules that are applicable to the company. If the registrant is an investment company, the nominee must not be an interested person of the registrant. Consistent with the requirement that the nominating shareholders not act through an agreement with the company, the nominee also must avoid agreements with the company. The new rules do not impose restrictions on the relationship between the nominating shareholders and the nominees.

### Number and Priority of Nominees

The nomination of directors under Rule 14a-11 is limited to the greater of one director or the number of directors that represent up to 25 percent of the board. If the board consists of seven or fewer members, shareholders could nominate one director in the company's proxy materials. If the board consists of eight members, shareholders could nominate two directors. Directors who have been elected pursuant to Rule 14a-11 and whose term extends past the date of the election (i.e., if the company has a staggered board) count towards the maximum and accordingly decrease the number of nominees shareholders may make under Rule 14a-11 for an election. If a shareholder nominee is elected and then is renominated by the board of directors for an additional term, that nominee will no longer be considered a shareholder nominee and will not affect the permitted number of shareholder nominees.

Priority is given to Rule 14a-11 nominations by shareholders with the largest voting stake in the company. To the extent that the largest nominating shareholder or group of nominating shareholders does not nominate the maximum number of shareholder nominees permitted to be included in the company's proxy statement, the nominees of the next largest nominating shareholder or group who provided timely notice on a Schedule 14N shall be included in the proxy materials, up to the total number of shareholder nominees permitted to be included.

---

<sup>3</sup> The new rules adopt a threshold for voting power to accommodate different classes of shares with disparate voting rights. The three percent threshold is thus based upon the calculated voting power, rather than the number of shares held.

<sup>4</sup> Only securities subject to proxy solicitation rules are considered under Rule 14a-11, both for the purposes of determining the total outstanding voting power, and for determining whether a shareholder meets the 3% ownership threshold for voting power.

### Timing of Nomination

A shareholder must submit the Schedule 14N proposing the nomination of a director no more than 150 days and no less than 120 days before the anniversary of the mailing date of the prior year's proxy statement.

### Inclusion of a Nominee

If the nominating shareholders and the nominee meet all the requirements in the rule, the company is required to include the nominee in its proxy statement and must so notify the shareholder at least 30 days before filing the definitive proxy statement. The company is also required to include various disclosures in the proxy statement related to information provided by the nominating shareholders. To the extent this information is included in the proxy statement, nominating shareholders will be liable for any false or misleading statements. This information will not be incorporated by reference into filings except where the company specifically chooses to do so.

### Process for Exclusion of a Nominee

If the company determines that it may exclude a shareholder nominee from the proxy materials, it must notify the nominating shareholders in writing no later than 14 days after the window for nomination submissions closes. A company, however, may not exclude a proposal because the company believes it contains materially misleading information. The nominating shareholders then have 14 days from receipt of such notice to respond to and correct any eligibility requirements.

If, after the above notice and response, the company determines that it still may exclude a shareholder nominee, the company must provide notice of the basis for such determination to the SEC and the nominating shareholders no later than 80 days before it files its definitive proxy statement. The nominating shareholders may submit a response to the SEC no later than 14 days after receipt of such notice from the company. If requested by the company, the SEC may provide an informal statement of its views to the company and the nominating shareholders. In any event, the company must provide the nominating shareholders with notice of whether it will include or exclude the nominating shareholders' nominee no later than 30 days before it files its definitive proxy statement.

### Relationship to State Law and a Company's Governance Documents

Except to the extent that applicable state law or the company's governing documents prohibit shareholders from nominating in any form a candidate for election as a director, Rule 14a-11 applies. Additionally, and contrary to the 2009 proposed rule, the adopted rule overrides any provision in the company's governing documents that limits or prohibits inclusion of a shareholder nominee in the company's proxy statement, even if such provision is in direct opposition to Rule 14a-11.

### **Rule 14a-18/Schedule 14N**

Rule 14a-18 sets forth the disclosure requirements of Schedule 14N. Notice on Schedule 14N is to be sent to the company and filed with the SEC between 120 days and 150 days before the anniversary of the date the company mailed the prior year's proxy materials (unless otherwise noted on Form 8-K, as discussed below).

A Schedule 14N notice must include the following:

- Representations that
  - To the knowledge of the nominating shareholders, the nominee's candidacy or board membership would not violate applicable laws or rule, including the objective rules of applicable securities exchanges or associations (the subjective rules of applicable securities exchanges or associations regarding director independence are not covered by this representation);
  - The nominating shareholders satisfy the conditions of Rule 14a-11 regarding shares owned; and
  - Neither the nominee nor any of the nominating shareholders has any direct or indirect agreement with the company regarding the nomination;
- A statement from the nominee that the nominee consents to being named in the proxy statement and to serve on the board if elected;
- A statement that the nominating shareholders intend to continue to own the requisite shares through the date of the meeting at which the nominee will be nominated as well as a statement regarding the nominating shareholders' intent with respect to continued ownership after the election; and
- Various other disclosures similar to those currently required in a contested election, including information about the amount and percentage of securities beneficially owned and information regarding the nominee similar to that provided for company nominees in the proxy statement.

A statement in support of the nominee not to exceed 500 words may be included in the Schedule 14N if the nominating shareholder desires to make such a statement.

The actual text of Schedule 14N includes a certification by the nominating shareholder that the securities described are not held for the purpose or for the effect of changing control of the company or to gain more than the permitted number of seats on the board.

### **Rule 14a-2**

The new rules also allow shareholders to communicate among themselves more freely for the limited purposes of forming a shareholder nominating group or soliciting support for a nominee under Rule 14a-11. Rule 14a-2 allows such solicitations without as much of the disclosure and limitations typically associated with such solicitations, subject to the following conditions:

- For solicitations to form a nominating group, each written communication shall include no more than the following:
  - A statement of each soliciting shareholder's intent to form a nominating group;
  - Identification of, and a brief statement regarding, the potential nominees (or characteristics of potential nominees if no such individual has yet been identified);
  - The percentage of voting power owned by each soliciting shareholder or by the group; and
  - The means by which shareholders may contact the soliciting party.

The written communications must be filed with the SEC with a cover page on Schedule 14N. For any oral communications, the shareholder must file a cover page on Schedule 14N announcing the commencement of the oral solicitation.

- For written solicitations by or on behalf of a nominating shareholder in support of its nominee who is or will be included in the company's proxy materials, each written communication shall include the following:
  - The identity of the nominating shareholder;
  - A description of the nominating shareholder's security ownership; and
  - A legend advising that the shareholder nominee is or will be included in the company's proxy materials and that the recipient should read the proxy materials.

The written solicitation material must be filed with the SEC with a cover page on Schedule 14N. This limitation on required disclosure only applies if the solicitor does not seek to act as a proxy for a shareholder and does not request a form of revocation, abstention, consent or authorization from a shareholder.

### **Rule 14a-8(i)(8)**

Prior to the amendments, Rule 14a-8(i)(8) allowed a company to exclude proposals from the company's proxy materials if they related to the election of the board of directors. As amended, the Rule 14a-8(i)(8) narrows the scope of this exclusion. Notably, proposals that request an amendment to the company's governing documents regarding the director nomination process or nomination disclosure will not be excludable, provided such an amendment does not conflict with Rule 14a-11 or applicable state law.

Rule 14a-8(i)(8) will continue to allow the board to exclude proposals which would do one or more of the following:

- Remove a director before his or her term expired;
- Question the competence, business judgment, or character of one or more director nominees;
- Nominate an individual for election to the board of directors other than pursuant to Rule 14a-11 (or similar provisions in state law or the company's governing documents); or
- Otherwise affect the outcome of the upcoming election of directors.

### **Other Rule Changes**

In connection with the changes described above, the SEC made the following amendments:

#### Rule 13d-1

Any group of shareholders formed solely for activities in connection with a nomination under Rule 14a-11 whose aggregate beneficial ownership exceeds five percent of the company's securities shall be permitted to file on Schedule 13G as opposed to on Schedule 13D, provided the group otherwise meets the requirements to file on Schedule 13G. This exception is not available after the election of a director so nominated such that the shareholder group should evaluate after the election whether it is still appropriate for it to file on Schedule 13G.

### Rule 14a-4

Consistent with the goal of the new rules, the changes also provide that proxy cards including at least one shareholder nominee in accordance with Rule 14a-11 may not contain the option to vote for, or withhold authority as to, any group of nominees. Each nominee must be voted on individually, thus making it easier to vote for a combination of nominees recommended by the company and nominees recommended by shareholders.

### Form 8-K

The new rules amend Form 8-K for a company that did not hold an annual meeting the previous year or has changed the date of the annual meeting by more than 30 days from the anniversary of the previous year's meeting date. Such a company is required to disclose the date by which a nominating shareholder must submit a Schedule 14N. The date must be a reasonable time before the company mails its proxy materials.

### Rule 14a-19

In connection with including a nominee in the company's proxy materials pursuant to a procedure set forth under applicable state law or the company's governing documents rather than Rule 14a-11, the SEC mandates a number of disclosure requirements. These requirements are largely the same as those required for a nomination under Rule 14a-11.

### Schedule 14A

The new rules include a requirement that if a shareholder nominee is included in the company's proxy materials, the materials must include certain information disclosed by the nominating shareholders with regard to the nominee and the nominating shareholders.

### **Effective Date**

The new rules will be effective 60 days after they are published in the Federal Register. However, if a company has an annual meeting that will occur after the effective date of the new rules and the effective date of the new rules is less than 120 days before the anniversary of the mailing date of the prior year's proxy materials, the Rule 14a-11 nomination process will not apply to the upcoming annual meeting. In addition, the rules are not effective for smaller reporting companies until three years after the effective date.

### **Outstanding Issues**

The new rules present several issues.

First, corporate governance is an issue of state law. Under the internal affairs doctrine, matters such as the election of directors are left to states and not decided under federal law (i.e., the Exchange Act). Delaware has recently passed amendments allowing companies to provide in their bylaws for shareholder proxy access or for reimbursement of shareholder proxy expenses.

Secondly, in regulating issues of corporate governance, states have often taken an enabling approach, rather than a mandatory approach. For instance, the Delaware amendments regarding proxy access allow each company to

choose the extent of access provided for in the company's bylaws, if any. In contrast, the SEC rules now require that each company allow proxy access to the same extent.

In light of these first two issues, a number of commentators, and even SEC Commissioner Kathleen Casey, have indicated that litigation challenging the amendments is likely. Commissioner Casey opposed the rule, stating "I believe the rule is so fundamentally and fatally flawed that it will have great difficulty surviving judicial scrutiny."<sup>5</sup>

The U.S. Chamber of Commerce, which has successfully challenged other SEC rules, has retained counsel to review whether to file suit to block access.<sup>6</sup> The principal arguments would likely be that the new rules create a substantive right and that they conflict with corporate rights under state law.<sup>7</sup> Both the character of the actions taken by the SEC and its authority to take such actions appear to be unsettled questions. In addition, there could be issues regarding the interpretation of the phrase "prohibit shareholders from nominating candidates for the board of directors" in relation to whether state law or a company's governing documents prohibit the nomination of directors by shareholders. This prohibition may mean that no shareholder nominations are permitted or it may mean that a prohibition on certain types of directors, such as those who are not approved by the nominating committee, is adequate to prevent proxy access for that type of nominee. Given the strong polarization between those supporting and those opposing the new rules, it is likely that litigation will result challenging the authority of the SEC and the new rules as adopted.

Finally, the new rules raise a number of practical concerns. While the changes seem to speak of shareholders as one unanimous whole, shareholders are not in fact uniform. As a result, these amendments may pave the way for "special interest" directors – those who cater only to a small minority of shareholders, albeit, shareholders with significant enough holdings to meet the three percent threshold. Further, while some shareholders may welcome increased proxy access, for others the amendments may, at best, only change one unsympathetic board member for another and, at worst, replace desirable directors with self-interested directors. Some shareholders may benefit at the expense of others.

As Professor Stephen Bainbridge has observed, experience with the effects of cumulative voting has shown that once these "outside" directors are elected to the board pursuant to the new rules, the result may be a rift in the board leading to "pre-meeting caucuses" by the majority, adversarial relations between board members, and decreased flow of information between directors.<sup>8</sup> While increased oversight and accountability may be a desirable goal, any benefit of these new rules may come at the cost of a non-unified board.

Taken one step further, if a director elected pursuant to the new rules is going to be effectively shut-out of the board, why would anyone want to serve in such a position? At the same time, in addition to the increased duties and potential for liability as a director under Sarbanes-Oxley, the risk of being singled-out and replaced by a

<sup>5</sup> Kathleen L. Casey, Commissioner, SEC, Statement at Open Meeting to Adopt Amendments Regarding Facilitating Shareholder Director Nominations (Aug. 25, 2010).

<sup>6</sup> "This special interest-driven rule is a giant step backwards for average investors," David Hirschmann, president and CEO of the U.S. Chamber of Commerce's Center for Capital Markets Competitiveness, said in a press release dated August 25, 2010. "Using the proxy process to give labor union pension funds and others greater leverage to try to ram through their agenda makes no sense. Instead of giving some investors front-of-the-line passes, the SEC should be focused on advancing the interests of all investors, including retail investors. The Chamber will carefully review the rule that was approved today and will continue to fight this flawed approach using every method available."

<sup>7</sup> The new rules defer to state law and governing documents as to whether shareholders have the right to nominate directors at all, but if the state law or governing documents permit shareholder nominations, the new rules provide the substantive right of proxy access for shareholder nominations that did not previously exist.

<sup>8</sup> For a more detailed analysis of this issue, please see *A Comment on the SEC Shareholder Access Proposal*, by Stephen M. Bainbridge, available [here](#).

shareholder nominee may make it difficult to find people willing to serve as directors. The result may be having to fill directorships with less qualified individuals – harming rather than benefiting shareholders.

### **Actions to Consider**

#### Identify Shareholders in a Position to Nominate Directors

Companies should identify their shareholders that have at least three percent of its voting power and consider which of those shareholders may want to make a director nomination. It is important for a company to understand the reasoning behind why a shareholder would want to make a nomination in order for the company to consider taking proactive steps to alleviate the shareholder's concerns and avoid the shareholder nominating its own director using the company's proxy materials. It may be far better for a company to agree in advance with a shareholder on a candidate than to have the shareholder nominate its own candidate. Therefore, with the new proxy access rules and the say-on-pay rules, the investor relations function has never been more important.

#### Consideration of Shareholder Nominees

Companies should determine their process for examining whether a shareholder and its nominee meet the requirements to be included in the proxy materials. Since a company only has 14 days after the end of the nomination period to determine whether a shareholder and its nominee meet the requirements for inclusion in the proxy materials, it may be more efficient for a board committee such as the nominating committee or corporate governance committee to examine each nominating shareholder and its nominee rather than the entire board of directors.

#### Consider Actions of Other Companies

Some companies may challenge the SEC regarding these rules. Other companies may want to follow these challenges as they proceed through the legal process to determine if they should consider making amendments to their bylaws or formation documents regarding director nominations by shareholders and shareholder proxy access.

If you have any questions about this topic, please contact a [member](#) of our [Securities/Capital Markets](#) practice group.