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Explanation and Practical Tips Regarding the SEC's New Proxy Access Regime

On August 25, 2010, the United States Securities and Exchange Commission (the "SEC"), in a 3 to 2 vote along party lines, adopted fundamental changes to the federal proxy rules that will require public companies subject to the proxy rules to include director nominees by shareholders in their proxy materials.

Proxy access is the right of shareholders of a public company to use the company's proxy materials to nominate their own candidates for the board of directors, thus avoiding significant costs and procedural challenges that would otherwise be involved in proposing a director nominee. The SEC has considered proxy access on three previous occasions since 2003. The most recent impetus for proxy access was the enactment on July 21, 2010 of the Dodd-Frank Act, which granted express rulemaking authority to the SEC on proxy access, thereby significantly lowering the risk of a successful challenge to the constitutionality of the final rules and providing political catalyst for the change.

The final rules will likely disappoint companies and shareholder activists alike. Companies will be dismayed that the SEC adopted a one-size-fits-all approach rather than allowing shareholders to propose arrangements tailored to each company's needs, referred to as "private ordering." Shareholder activists will be disappointed that the 3 percent/three-year requirement facilitates shareholder nominations in only limited situations.

Effectiveness and Timing

The new rules will become effective 60 days after publication in the Federal Register, which is expected to happen in the coming days, and will impact the upcoming 2011 proxy season for many companies. Under the rules, a nominating shareholder or group will be required to provide notice to a company of its intent to use the new proxy access regime by filing a Schedule 14N during a 30-day period between 150 days and 120 days prior to the anniversary of the mailing of the prior year's proxy statement. This timing applies regardless of whether the company's governance documents provide otherwise. If, for example, the new rules become effective on November 1, 2011, shareholders would have a proxy access right if a company mailed its proxy materials on or after March 1, 2010.

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Changes to the Proxy Rules

Rule 14a-11—Proxy Access

Right to Include Shareholder Nominees

Subject to certain conditions, new Rule 14a-11 requires a company to include information about a shareholder's, or group of shareholders', director nominees in its proxy statement and the names of such nominees on its proxy card. The rule permits a company to exclude nominees from its proxy materials under certain circumstances, such as when a nominating shareholder or group fails to satisfy the eligibility requirements of the rule.

Commentary. The inclusion of even a single shareholder nominee in a company's proxy materials will result in an election becoming contested. Since majority voting policies only apply in uncontested elections, the inclusion of shareholder's director nominee pursuant to Rule 14a-11 will have the counterintuitive effect of causing the election to revert to a plurality vote.

Companies Subject to the New Rule

Rule 14a-11 applies to companies that are subject to proxy rules under the Securities Exchange Act of 1934, as amended, including investment companies and controlled companies, but excluding "debt-only" companies. The new rules do not apply to foreign private issuers, but do apply to other foreign issuers that are subject to US proxy rules unless applicable foreign law prohibits shareholders from nominating directors. The new rules provide for a three-year phase-in period with respect to smaller reporting companies.

Commentary. As a practical matter, controlled companies with a single class of stock should face no risk of a shareholder-nominated director being elected. For such companies, proxy access primarily represents a means of protest. However, controlled companies with dual class stock that allocate a fixed number of board seats to each class of voting stock face the possibility that shareholders may use proxy access to have their nominees elected as directors for that particular class.

Only One Means of Opt-Out

The new proxy access regime is mandatory and does not permit a company or its shareholders to opt out. The SEC considered and rejected provisions for "private ordering" with the exception of amended Rule 14a-8 which will permit shareholder proposals to amend a company's governing documents relating to proxy access, but only if such proposals expand on, or provide alternatives to, the new Rule 14a-11 regime. The only way provided by the SEC for a company to opt out of the new proxy access regime is for the company's governing documents to prohibit shareholders from nominating a candidate for election as a director altogether (as opposed to just prohibiting the inclusion of shareholder nominees in the company's proxy materials).

Commentary. While the right to vote shares of a Delaware company is considered a fundamental element of the shareholder franchise, the Delaware courts have recognized that the right of shareholders to vote can be conditioned on reasonable procedural rules. This principle has enabled the adoption of advance notice bylaws for shareholder proposals and nominations of directors pursuant to a company's governing documents. However, the Delaware courts have also held that "the shareholders' right to vote includes the right to nominate a contesting slate."[1] Therefore, as a matter of Delaware law, excluding shareholders' right to nominate directors is unlikely to be upheld. As a result, at least with respect to companies incorporated in Delaware, the SEC's statement that a company's governing documents could provide a basis to exclude Rule 14a-11 is not applicable.

Interaction with Advance Notice Bylaws

The new proxy access regime exists alongside any other director nomination procedure provided for in a company's bylaws and cannot be changed or limited by advance notice provisions for director nominations in those bylaws. In addition, a statement in a company's bylaws that the bylaws provide the exclusive means for nominating directors does not limit the availability of Rule 14a-11.

Commentary. Shareholders that meet the 3 percent/three-year eligibility requirement of Rule 14a-11 may still continue to use any advance notice provisions for the nomination of directors contained in a company's bylaws. However, such provisions may impose more onerous procedural and disclosure requirements for nominating shareholders and, importantly, do not generally permit the nominating shareholder to use the company's proxy materials. As a result, shareholders using advance notice provisions generally have to bear the expense of printing and distributing their own proxy materials. It should be noted that new Rule 14a-8(i)(8) and the general advance notice provisions contained in many companies' bylaws would permit shareholders to introduce a resolution to amend the company's bylaws to permit reimbursement of proxy expenses incurred by dissident shareholders in accordance with Section 113 of the Delaware General Corporation Law. Such reimbursement goes a significant way towards mitigating the inability of shareholders to include their own slate of directors in the company's proxy statement.

1 See *Hubbard v. Hollywood Park Realty Enters., Inc.*, 17 DEL. J. CORP. L. 238, 250 (1991).

Interaction with State Law and Foreign Law

Rule 14a-11 cannot be overridden or limited by state or foreign laws that seek to impose more restrictive requirements on proxy access. State and foreign laws can permit parallel methods of nominating directors in which case a shareholder may elect to use those provisions rather than Rule 14a-11. Shareholders are required to indicate clearly on new Schedule 14N (described below) whether they are using Rule 14a-11 or an alternate means of nominating directors. The only way for state or foreign laws to negate Rule 14a-11 is for such laws to prohibit shareholder nominations altogether. Currently, no state nor the District of Columbia prohibit shareholder nominations.

Commentary. The new rules undercut the threshold for proxy access mandated by the most shareholder-friendly state's corporate law, North Dakota's Publicly Traded Corporation's Act. The Act imposes a 5 percent threshold and related procedural requirements on shareholder nominations, which are arguably less burdensome than those under Rule 14a-11. It remains to be seen whether North Dakota—where currently only a small number of public companies are incorporated—amends its Publicly Traded Corporation's Act to lower its 5 percent threshold to 3 percent to mirror the new federal standard more closely.

Eligibility of Director Nominees

A company will not be required to include in its proxy materials any nominee whose candidacy or if elected, board membership, would violate controlling state, federal or foreign law, or the rules of the applicable national securities exchange or national securities association and such violation could not be cured during a prescribed time period. A company may also exclude any nominee who does not meet the objective independence standards of the relevant stock exchange. The new rules require the nominating shareholder or group to disclose whether, to the best of its knowledge, a director nominee meets the company's director qualification requirements as set forth in its governing documents. However, a company may not require the nominee to meet such standards or to complete a questionnaire addressing them. A nominee who meets the objective, but not the subjective independence requirements, (e.g., the NYSE's requirement relating to existence of a "material relationship" or Nasdaq's requirement relating to existence of a relationship that would interfere with the exercise of independent judgment) or who fails to meet company qualification standards, may not be excluded from the company's proxy materials. A company may choose to include disclosure in its proxy materials as to whether a nominee meets stock exchange subjective independence requirements or satisfies the company's director qualifications.

Commentary. Disclosure of any conflict between director qualifications established by a company's governing documents and a nominee's qualifications would be important to shareholders. Rule 14a-11 does not contain a definition of "governing documents," but footnote 67 of the adopting release states that "governing documents" generally means "a company's charter, articles of incorporation, certificate of incorporation, declaration of trust, and/or bylaws, as applicable." As a result, companies should consider moving key qualification requirements from their corporate governance guidelines or other governance documents to their bylaws in order to force nominating shareholders to disclose a failure to meet such requirements. Examples could include the number of other directorships permitted and maximum age.

Eligibility of Nominating Shareholders

To use Rule 14a-11, (i) a nominating shareholder or group must have voting and investment power over securities representing at least 3 percent of the voting power of the company's securities entitled to be voted at the meeting and (ii) such shareholder or each member of the group must have held such power for at least three years. This represents a significant change from the 1 percent, 3 percent and 5 percent thresholds and the one-year holding period contained in the June 2009 proposed rules. The SEC estimates that 33 percent of public companies have at least one shareholder that meets the 3 percent/ three-year requirement.

The following additional requirements apply:

- In determining total voting power, securities sold short and borrowed securities may not be counted towards the required ownership threshold. However, a nominating shareholder can include securities loaned to a third party if those securities can and will be recalled upon notification to the shareholder that any of its nominees are included in the proxy statement. This provision will be especially helpful to large pension funds that derive significant revenue from share lending.
- A nominating shareholder must continue to own the qualifying amount of securities through the date of the meeting and provide disclosures concerning its intent with regard to continued ownership of these securities after the election of directors at such meeting.
- A nominating shareholder must certify that it has no intent to seek a change in control of the company or to gain a number of board seats that is more than the number of nominees a company could be required to include in its proxy materials under Rule 14a-11.

Commentary. Although shares sold short must be excluded, the rule does not require exclusion of shares hedged by other methods, such as through derivatives or swaps. As a result, nominating shareholders will be able to satisfy the voting and investment power requirements while still hedging their economic risk.

Limitation on Number of Nominees

A company will be required to include the greater of one shareholder nominee or a number of nominees that represents up to 25 percent of the company's board of directors. In the case of a classified board, the percentage is calculated based on the total number of seats, not the number of seats being voted on. A director who was previously elected pursuant to the proxy access rule and whose term continues past the date of the meeting would count against the 25 percent cap. As a result, companies with classified boards are not disadvantaged by the rule.

The nominating shareholder or group may not have any agreement with the company or its management regarding the nomination of a director nominee. This prohibition is intended to prevent nominating shareholders or groups from acting as surrogates for the company and blocking use of the 25 percent allowance by other shareholders. The rules do not impose any limits on the relationship between the nominating shareholder and the nominee (theoretically not precluding a shareholder from nominating himself or herself).

Settlements with Activist Shareholders

A company that reaches an agreement to include a shareholder nominee on its board of directors can count that nominee towards the 25 percent limit provided the company (i) reached that agreement with the shareholder after it filed a Schedule 14N and (ii) did not have any discussions with the shareholder about such nomination before the filing.

Commentary. As a result of the foregoing requirement, a company is generally disincentivized from negotiating with a dissident shareholder that has held at least 3 percent of its voting securities for at least three years until the shareholder files Schedule 14N. However, companies should act with care when negotiating with any shareholder and should include a provision that any settlement agreement providing for nomination of a shareholder director to the board will be revoked if the shareholder subsequently uses Rule 14a-11 to nominate additional directors.

Priority of Shareholder Nominees

If multiple shareholders seek to nominate candidates in excess of the 25 percent cap, the shareholder with the highest qualifying voting percentage will be given priority. This represents a change from the original proposal which would have given priority to the first group to file and addresses concerns over the original proposal's effect of allowing a smaller shareholder to capture all available nominee slots from a larger shareholder by submitting its notice early.

If a nominating shareholder withdraws its candidate or its candidate is disqualified after the company has provided notice that it intends to include the candidate in its proxy materials (e.g., because the shareholder fails to continue to hold the required number of shares), the company is required to include nominees from the shareholder with the next-highest voting percentage that timely filed a Schedule 14N. The company is not required to do this, however, after it has commenced printing its proxy materials.

Commentary. The withdrawal or disqualification provisions effectively require companies to review and, if necessary, engage in a no-action exclusion process for director nominees from shareholders who initially may not be able to include shareholders within the 25 percent cap. Failure to do so would leave the company vulnerable to including ineligible nominees if a nominating shareholder with priority withdraws or its candidate is disqualified.

Notice Requirements

A nominating shareholder is required to provide to the company a notice of intent to use Rule 14a-11. Such notice, on a new Schedule 14N, is required to be filed on EDGAR and transmitted to the company on the same date. Specific requirements for the content of the notice include:

- Biographical and other information about the nominating shareholder or group and the nominee or nominees, similar to the disclosure currently required in a proxy contest (including disclosure as to whether the nominee meets the company's director independence and director qualification standards).
- Information regarding the amount of securities held by the nominating shareholder or group and the length of time those securities have been held.
- Certifications that:
  - the nominating shareholder does not intend to gain control of the board or to gain a number of seats on the board that is more than the number of nominees a company could be required to include in its proxy materials under Rule 14a-11.
  - the nominating shareholder or group otherwise satisfy the requirements of Rule 14a-11, as applicable.
  - the nominee or nominees satisfy the requirements of Rule 14a-11, as applicable.

- A statement of the shareholder's intent to hold those securities through the date of the meeting and following the election of directors.
- A statement that the nominee meets the company's director qualifications, if any, as set forth in the company's governing documents.
- A statement that the nominee consents to be named in the company's proxy materials and, if elected, to serve on the board of directors.
- Disclosure regarding any relationships between the nominating shareholder or group, the director nominee and the company or any affiliate of the company, including any agreement, pending or threatened litigation or other material relationship.
- Disclosure of any web site address on which the nominating shareholder or group may publish soliciting materials.
- An optional statement of support for the nominee that is no longer than 500 words.

It should be noted that a Schedule 14N is also required to be filed if a shareholder or group submits a nomination proposal pursuant to state or foreign law or a company's governance documents and not pursuant to Rule 14a-11.

A Schedule 14N must be amended promptly in the event of any material change to the information disclosed in it. Material changes include withdrawal of a nominating shareholder or group, or any member of a group, or of a director nominee. The nominating shareholder or group must also file a final amendment to Schedule 14N within 10 days of the final results of the election in order to disclose its intention with regard to continued ownership of its shares.

Disclosure and Liability

A company that receives a notice on Schedule 14N from an eligible nominating shareholder will be required to include in its proxy statement specific disclosures concerning the nominating shareholder and the director nominee, and include on its proxy card the name of the shareholder nominee. The nominating shareholder will be liable for any material misstatements or omissions contained in a Schedule 14N notice or in related communications, regardless of whether that information is ultimately included in the company's proxy materials. While the company will not be responsible for any information provided by the shareholder for inclusion in the company's proxy materials, it will not be able to omit information provided by a nominating shareholder from its proxy materials even if it believes that such required representation or certification was materially false or misleading. Instead, a company is required to address any concerns regarding false or misleading disclosures through its own disclosures, as is the case in a traditional proxy contest.

Dispute Resolution and Limited Exemptions

If a company determines that any nominating shareholder or nominee does not meet the Rule 14a-11 eligibility requirements, the company must provide notice of deficiency to the nominating shareholder no later than 14 calendar days after the company received the Schedule 14N. The nominating shareholder's response must be transmitted no later than 14 calendar days after receipt of the company's notification. The company must provide notice of its intent to exclude the nominating shareholder's nominee no later than 80 calendar days before the company files its definitive form of proxy statement with the SEC and, if desired, seek no-action relief from the SEC in a similar manner to those sought in connection with Rule 14a-8. The nominating shareholder or group may submit a response to the company's notice to the SEC within 14 calendar days after the receipt of such notice.

Exemptions to Proxy Rules to Facilitate Communications

The new rules outline two narrow exemptions relating to solicitations:

First, new Rule 14a-2(b)(7) permits oral and written solicitations in connection with the formation of a nominating group provided that (i) the shareholder is not holding the company's securities with the purpose or effect of changing control of the company or to gain a number of seats in excess of 25 percent of the board, and (ii) any written communication is limited to a statement of the shareholder's intent to form the group and other limited information, and is filed with the SEC under cover of Schedule 14N. In addition, a shareholder that engages purely in oral solicitation in reliance on the rule must file a notice of commencement of the oral solicitation on Schedule 14N.

Second, new Rule 14a-2(b)(8) permits oral and written communications by a shareholder or group in support of its nominee once the shareholder or group has received notice that the nominee will be included in a company's proxy materials provided that shareholder or group is not seeking proxy authority. Written materials would need to include the identity of the shareholder or group, disclosures regarding security holdings and a legend advising shareholders to read the company's proxy statement. Written materials would also need to be filed with the SEC under cover of Schedule 14N.

Beneficial Ownership Reporting

The formation of a shareholder group solely for the purpose of nominating one or more directors pursuant to Rule 14a-11 or soliciting activities in connection with such a nomination will not result in a nominating shareholder or group losing eligibility to report their ownership on a Schedule 13G. However, a nominating shareholder or group would need to reassess whether it continues to be a passive investor following the election of its nominee to the board. The SEC has not provided any exemption with respect to the formation of a group under Section 13 or Section 16, or resolved the question of whether a nominating shareholder or group is an affiliate of a company, and those determinations continue to be governed by existing rules and interpretations.

Rule 14a-8—Limited Private Ordering

Under revised Rule 14a-8(i)(8), shareholders will be able to submit for inclusion in a company's proxy statement proposals that seek to amend provision in the company's bylaws relating to proxy access standards. While such proposals may provide for more liberal proxy access rights, they may not restrict the Rule 14a-11 regime. This limited "private ordering" provision (i.e., only with respect to more permissive proxy access provisions) is likely to result in activist shareholders seeking to relax the 3 percent and three-year thresholds contained in new Rule 14a-11. Rule 14a-8 does not provide for a three-year phase-in with respect to the amended Rule 14a-8(i)(8) for smaller issuers. Therefore, proxy access bylaw proposals, including at smaller issuers, may be filed by shareholders in the upcoming 2011 proxy season.

Conclusion

The new proxy access rules are likely to be challenged notwithstanding the authorizing provisions of the Dodd-Frank Act. SEC Commissioner Casey went so far as to state that "the rule is so fundamentally and fatally flawed that it will have great difficulty surviving judicial scrutiny." Nonetheless, companies should assume that the rules will be effective for the 2011 proxy season and, accordingly, should start educating their nominating committees and other board members, and evaluating whether they have any shareholders who meet the eligibility requirements to submit a nominee.

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