

## SEC ADOPTS NEW PROXY ACCESS RULES

September 9, 2010

Last month, after years of controversy, the SEC adopted new rules facilitating the rights of shareholders to nominate directors of corporate boards.<sup>1</sup> Under the new rules, in certain circumstances, shareholders will be able to have their nominees included in the company proxy materials that are sent to all voters. Additionally, qualifying shareholders will be able to use the shareholder proposal process to establish procedures for the inclusion of shareholder director nominations in company proxy materials. The new rules were proposed in 2009<sup>2</sup> in response to concerns about the accountability and responsiveness of corporate boards, particularly in light of the recent financial crisis. The SEC received approximately 600 comments on the proposals, sharply divided on the necessity and workability of the proposed rules. Subsequently, the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in July 2010, expressly authorized the SEC to adopt proxy access rules. After a three-to-two vote, the SEC adopted the new rules, substantially as proposed with a few modifications. As described below, the proxy access rules will be effective for next year's proxy for many larger filers. Smaller reporting companies will not be subject to the new rules for three additional years.

### Including Nominees in the Company's Proxy Materials

Under new Rule 14a-11 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), shareholders (of all Exchange Act reporting companies, including voluntary registrants and investment companies, but excluding debt-only companies) meeting the requirements below will be able to include their nominees for director in the company's proxy materials unless the shareholders are otherwise prohibited from nominating a candidate by applicable state or foreign law or the company's governing documents. Under Rule 14a-11, nominating shareholders must:

- Own, either individually or together with other members of a shareholder group,<sup>3</sup> at least three percent of the total voting power of the company's securities that are entitled to be voted on the election of directors at the annual meeting;<sup>4</sup>

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<sup>1</sup> The SEC press release, including a link to the 451-page adopting release, is available at <http://www.sec.gov/news/press/2010/2010-155.htm> (August 25, 2010). As further evidence of its focus on the importance of shareholder voting rights, the SEC also earlier this summer issued a concept release as part of a comprehensive review of the U.S. proxy voting system. Our client alert on the proxy voting release may be found at <http://www.wcsr.com/resources/pdfs/cs080510.pdf>.

<sup>2</sup> Facilitating Shareholder Director Nominations, Release No. 33-9046 (June 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>. Our client alert on the 2009 proposals may be found at <http://www.wcsr.com/resources/pdfs/cs052709.pdf>.

<sup>3</sup> Unless otherwise noted, references to a "nominating shareholder" in this alert also apply to a nominating shareholder group.

<sup>4</sup> For purposes of the three percent calculation, borrowed stock or stock held short must be excluded, but stock loaned to others may be included if it can and will be recalled if the nominee is included.

- Have held the qualifying amount of shares continuously for at least three years;
- Continue to own the required amount of shares through the meeting at which the directors are elected;
- Not hold any of the company's stock with the purpose, or with the effect, of changing control of the company or to gain more seats on the board than the maximum provided for under Rule 14a-11;
- Not have an agreement with the company regarding the nomination; and
- Provide a notice to the company on new Schedule 14N, and file the notice with the SEC, 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.<sup>5</sup>

In addition to the requirements regarding nominating shareholders described above, the following eligibility requirements apply to the nominees:

- The nominee's candidacy or, if elected, board membership must not violate federal law, state law or applicable exchange requirements, if any;
- The nominee must satisfy objective (but not subjective) independence standards of the applicable national securities exchange or national securities association; and
- The nominee may not have an agreement with the company regarding the nomination of the nominee.

A nominating shareholder may include no more than one shareholder nominee, or a number of nominees that represents up to 25% of the company's board of directors, whichever is greater, in the company's proxy materials. Where the term of a director that was nominated pursuant to Rule 14a-11 continues past the meeting date, that director would continue to count for purposes of Rule 14a-11. In the event that a nominating shareholder files a Schedule 14N and the company subsequently agrees to include the nominee on the company's proxy card as a company nominee, that nominee will count toward the 25% maximum set forth in the rule.

In the event that more than one shareholder is eligible to have its nominees included in the company's proxy materials, the company will be required to include the nominee or nominees of the nominating shareholder with the highest qualifying voting power percentage. Where that nominating shareholder does not nominate the maximum number of directors allowed under Rule 14a-11, the nominee or nominees of the nominating shareholder with the next highest qualifying voting power percentage would be included in the company's proxy materials, continuing until the company includes the maximum number of nominees required under Rule 14a-11.

#### Contents of Schedule 14N

As described above, a nominating shareholder must provide a notice to the company on new Schedule 14N of its intent to require the company to include that shareholder's nominee in the company's proxy materials. The Schedule 14N must also be filed with the SEC on EDGAR on the date that it is first sent to the company, and nominating shareholders will be subject to liability under Rule 14a-9 for false or misleading statements on the form. Required Schedule 14N disclosure includes, among other items:

- The name and address of the nominating shareholder;
- Disclosure of the amount and percentage of securities held and entitled to vote on the election of directors at the meeting;

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<sup>5</sup> If the company did not hold an annual meeting during the prior year, or if the meeting date has been changed by more than 30 calendar days from the prior year, then the nominating shareholder must provide notice a reasonable time before the company mails its proxy materials. In that case, the company will be required to disclose the date by which the shareholder must submit the Schedule 14N in a Form 8-K filed pursuant to new Item 5.08 within four business days after the company determines the anticipated meeting date.

- A written statement from the registered holder of the shares held by the nominating shareholder, or the brokers or banks through which such shares are held, verifying that, within seven calendar days prior to the date of submission of the Schedule 14N, the shares have been continuously held by the shareholder for at least three years;
- A written statement that the nominating shareholder intends to continue to hold the securities through the date of the meeting and a statement concerning the shareholder's intent with respect to continued ownership after the meeting;
- The nominee's consent to be named in the company's proxy materials and, if elected, to serve on the board of directors;
- Identification of the nominee and disclosure about the nominee consistent with the proxy statement disclosure requirements for company nominees, including whether the nominee meets the director qualification requirements set forth in the company's governing documents, if any.
- Disclosure about the nature and extent of the relationships between the nominating shareholder, the nominee and/or the company and its affiliates;
- An optional statement of support for the nominee, not exceeding 500 words; and
- Certifications of the nominating shareholder.

#### Company Response to Schedule 14N

After receiving a Schedule 14N, if a company decides to include the nominee, the company must notify the nominating shareholder in writing no later than 30 days prior to the date the company files its definitive proxy statement with the SEC. If the company determines that it can exclude the shareholder nominee, it must notify the nominating shareholder or group no later than 14 days after the close of the window period for Schedule 14N submissions. After providing such notice to the nominating shareholder and affording the nominating shareholder 14 days to respond and cure any deficiencies, the company must provide a notice to the SEC regarding its intent not to include a shareholder nominee no later than 80 days before the definitive proxy statement is filed. The company may, but is not required to, seek a no-action letter from the SEC staff with respect to its decision to exclude the nominee.

Under Rule 14a-11, a company may exclude a shareholder nominee because:

- Rule 14a-11 is not applicable to the company;
- The nominating shareholder or nominee failed to satisfy the eligibility requirements of Rule 14a-11; or
- Including the nominee would result in the company exceeding the maximum number of nominees it is required to include in its proxy materials.

#### Information Required in Company Proxy Materials

A company that is including a shareholder director nominee in its proxy materials must include disclosure about the nominating shareholder and nominee based on the information provided in the Schedule 14N. The company will not be responsible for this disclosure; rather, the nominating shareholder will have liability for any false or misleading statements. In addition, the company must include disclosure about the nominating shareholder and the nominee similar to the disclosures currently required in contested elections. The company must include a nominating shareholder's statement in support of its nominee, if the statement does not exceed 500 words. The company may also include a statement of support for the management nominees.

On the proxy card, the company would be permitted to identify each shareholder nominee as such and recommend how shareholders should vote with respect to that nominee. However, when shareholder nominees are included in a proxy card, the company may not provide shareholders with the option to vote for or withhold authority to vote for the company nominees as a group.

## Soliciting Materials for Formation of Nominating Shareholder Group

The SEC has also adopted two new exemptions from the applicable disclosure, filing and other requirements of the proxy rules for limited communications by any qualifying shareholder in connection with the formation of a nominating shareholder group or in support of a nominee placed on a company's proxy card pursuant to Rule 14a-11. Under these exemptions, the nominating shareholder or group must not be seeking proxy authority and must file the communications with the SEC no later than the date they are first published, sent or given to shareholders.

## Allowing Shareholder Proposals

Under current Exchange Act rules, companies are allowed to exclude from their proxy statements a shareholder proposal if it "relates to a nomination or an election for membership on the company's board of directors."<sup>6</sup> Under the new rules, this "election exclusion" has been narrowed and companies may not exclude proposals made by qualifying shareholders that seek to establish a procedure in the company's governing documents for the inclusion of shareholder director nominees in company proxy materials. A company would not be required to include in its proxy materials a shareholder proposal that seeks to limit the availability of Rule 14a-11. Qualifying shareholders must have continuously held at least \$2,000 in market value (or 1%, whichever is less) of the company's securities entitled to be vote on the proposal at the meeting, for a period of one year prior to submitting the proposal.

## Effective Date and Transition Issues

The new rules will be effective 60 days after the date of publication of the final rules in the Federal Register (which should occur soon). Smaller reporting companies, as that term is defined in Rule 12b-2 under the Exchange Act, will not be subject to Rule 14a-11 until three years after the effective date.

Rule 14a-11 contains a window period for submission of shareholder nominees of no earlier than 150 days, and no later than 120 days, before the anniversary of the company's proxy mailing date for the prior year's annual meeting. Shareholders seeking to use Rule 14a-11 would be able to do so if the window period is open after the effective date of the rules. If the window period closes before the effective date of the new rules, shareholders would not be permitted to submit nominees under Rule 14a-11 for the 2011 proxy season. If the rules become effective during an open window period, shareholders may submit a nominee between the effective date and the close of the window period.

## Conclusion; Contact Information

The new rules have the potential to significantly impact the director election process and the composition of company boards. Companies should review their bylaws and other governing documents to determine the possible impact of the new rules on upcoming proxy statements. The new rules will also necessitate an increased focus on investor relations, including an assessment of the company's shareholder base.

If you have any questions regarding the proxy access rules, please contact Meredith Burbank (<http://www.wcsr.com/MeredithBurbank>), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/default.asp?id=1099&objId=10>.

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<sup>6</sup> Exchange Act Rule 14a-8(i)(8).

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