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The SEC Proposes Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors

Introduction

In response to what it called “one of the most serious economic crises of the past century,” the Securities and Exchange Commission (the “SEC”) has recognized the need to improve the accountability of boards of directors to shareholders and proposed new proxy rules to improve shareholders’ oversight of management and decisions on compensation structures. Under current proxy rules, a shareholder seeking to nominate director candidates for election at a shareholders’ meeting must engage in a proxy contest at such shareholder’s own expense—an extremely costly and often difficult process. In response to this concern, on May 20, 2009, the SEC voted to propose rule amendments giving shareholders a right to include their director nominees in the company proxy that is sent to all voters, thereby exercising what the SEC called their “fundamental right” to nominate directors. In addition, the proposed rule amendments seek to increase the ability of shareholders to modify nomination procedures and other director nomination disclosure provisions. Because the SEC has not yet published the related final rules, this Securities Law Update is based on the approved rule proposal and the information provided at the SEC’s open meeting.

The appropriate level of shareholder access to public companies is an issue that has been given significant attention by the SEC over the past decade. Proponents argue for more shareholder accessibility to company proxy statements and opponents contend that these issues should be left to state corporate governance law. Delaware recently addressed this same issue by enacting Section 112 of the Delaware General Corporation Law on April 10, 2009. Section 112, which goes

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into effect on August 1, 2009, allows Delaware corporations to include in their bylaws provisions governing the inclusion of shareholder candidates in company proxy materials, subject to certain specified limitations and conditions.

and the design and implementation of comprehensive compliance programs.

The SEC's New Proposed Rules

In the release, the SEC outlined its proposed changes regarding shareholder access to company proxy materials, which would be included in a new Rule 14a-11 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") that would allow shareholders to include a nominee or nominees for director in company proxy materials. An amendment to Rule 14a-8(i)(8) of the Exchange Act would allow shareholders to require companies to include proposals in company proxy materials amending the company's governing documents to address the company's nomination procedures or other director nomination disclosure provisions.

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Director Nominations Under Rule 14a-11

Under the proposed Exchange Act Rule 14a-11, certain shareholders would be permitted to include their director nominees in the company's proxy solicitation materials so long as the shareholders in question are otherwise allowed to nominate a candidate for the board pursuant to the company's charter or bylaws or applicable state law. The proposed rule would apply to all companies that report under the Exchange Act with a class of registered equity securities, including investment companies. The proposal sets forth minimum ownership and duration of ownership requirements for shareholders wishing to include their candidates.

To be eligible under the new rule, a shareholder must hold a certain percentage of the company's voting securities, as follows:

- One percent or more of the voting securities of a "large accelerated filer" (a company with an aggregate worldwide market value of \$700 million or more) or of a registered investment company with net assets of \$700 million or more.
- Three percent or more of the voting securities of an "accelerated filer" (a company with an aggregate worldwide market value between \$75 million and \$700 million), or of a registered investment company with net assets between \$75 million and \$700 million.
- Five percent or more of the voting securities of a "non-accelerated filer" (a company with an aggregate worldwide market value of less than \$75 million) or of a registered investment company with net assets of

less than \$75 million.

Groups of shareholders would be permitted to aggregate their holdings to meet the ownership requirements. Director nominees must satisfy the independence standards of the company's applicable national securities exchange or association and must comply with all other applicable rules and laws. In addition, no direct or indirect agreement may be in effect between the company and the nominating shareholder regarding the director nominee(s). Shareholders, or groups of shareholders in the aggregate, would be permitted to nominate the greater of one nominee or up to 25 percent of the company's board of directors as long as the shareholders and the nominee(s) satisfy the foregoing requirements.

Shareholders would also be required to have held their securities for at least one year and certify on a new Schedule 14N to be filed with the SEC that their intent was to hold such securities until the annual meeting and that they were holding the securities not for the purpose of having their nominees gain more than a minority representation on the board or to effect a change of control of the company. Companies would also have to include in their proxy materials a disclosure about the nominating shareholder similar to the current disclosures required under the rules relating to contested elections.

Shareholder Proposals Under Revised Rule 14a-8(i)(8)

Under current Exchange Act Rule 14a-8(i)(8), the so-called "election exclusion" allows companies to exclude from their proxy materials election-related shareholder proposals. Under the new proposed rules, Rule 14a-8(i)(8) would be amended to narrow this exclusion to permit qualifying shareholders to submit proposals to amend, or request an amendment to, the company's governing documents relating to the director nomination process or other disclosure provisions regarding director nominations

Current Rule 14a-8(i)(8) eligibility provisions would apply such that shareholders seeking to make such proposals must have held the lesser of 1 percent or \$2,000 in market value of the company's securities for at least a year.

Conclusion

The new proposed rules and amendments present an entirely new approach to corporate governance and the relationship between corporations and their shareholders. This imposition of a federal law regime onto an area traditionally left

to state law and internal corporate governance documents represents a strong reaction to the recent turmoil and economic uncertainty of the markets. It will be important for public reporting companies to watch the developments during the upcoming comment period as the final rules are expected to be enacted in time for the 2010 proxy season.

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