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[SEC Adopts Mandatory Proxy Access Rule for Shareholder Director Nominations -- Applicable for 2011 Proxy Season](#)

On August 25, 2010, the Securities and Exchange Commission voted 3-to-2 along party lines to adopt a controversial proxy access regime to facilitate shareholders' ability to nominate a limited number of candidates for election as directors. The new rules, which are primarily contained in new Rule 14a-11 promulgated under the Securities Exchange Act of 1934, will permit a single shareholder or group of shareholders owning at least 3% of the shares entitled to vote for directors to nominate, in accordance with applicable state corporate law, a number of directors up to 25% of the number of authorized directors and have such nominees included in the company's proxy statement.

Although legal challenges are expected, the rules are intended to be effective for the 2011 proxy season, and we advise all public companies (other than foreign private issuers, who are exempt, and smaller reporting companies, who are exempt for the first three years) to consider immediately the impact of proxy access on the upcoming 2011 proxy season.

Background

The SEC has been exploring means of facilitating shareholder nominees of directors for decades. In the aftermath of the corporate scandals of the early 2000s, the SEC proposed in October 2003 a right for shareholders to force companies to include shareholder nominees in the company's proxy statement if certain "triggers" occurred, such as a director candidate receiving a set percentage of withhold votes in an election. The 2003 proposal generated significant comments and controversy and the Commission did not adopt it. With another set of financial scandals occurring later in the decade, the SEC took up the issue again.

The proxy access rules adopted on August 25, 2010 were proposed on June 10, 2009. The June 2009 proposal prompted hundreds of comment letters from concerned corporations and other interested parties. Activist shareholders, labor unions and pensions supported the proposed rules.

Proxy access rules have been adopted in a different environment than when first seriously proposed in October 2003. Most larger public companies have now adopted a majority voting requirement for the

election of directors, which provides shareholders an opportunity to show opposition to the board's candidates. Under most majority voting regimes, a candidate who fails to receive a majority of the votes cast must tender his/her resignation and the board or a committee will decide whether or not to accept the resignation. In 2009, the New York Stock Exchange amended its Rule 452 to prohibit brokers who trade on the New York Stock Exchange from exercising discretionary authority to vote shares held in street name in favor of director candidates in uncontested elections. The amendment to Rule 452 eliminated a reliable "head start" companies had toward achieving the majority voting requirement. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") also prohibits broker discretionary voting on the election of directors.

In the years following the aborted 2003 proxy access proposal, proxy contests to elect a minority of directors saw a dramatic increase. Despite the cost of these campaigns, hedge funds began aggressively targeting underperforming companies, deliberately accumulating positions in such companies and then launching campaigns to unseat a minority of the directors and replace them with directors with an agenda to improve shareholder value, generally in the short term. While the financial meltdown may have temporarily reduced the growth pace of this industry, hedge fund activism is alive and well and several high profile campaigns are underway at the date of this article.

Finally, the Dodd-Frank Act has mandated say-on-pay and say-on-golden parachutes shareholder votes (see our prior blog articles [Senate Passes Dodd-Frank Wall Street Reform and Consumer Protection Act](#) and [The Regulatory March to Reform Executive Compensation Practices Takes Another Step Forward](#)). Most commentators believe that such votes will provide a significant opportunity for shareholders to express their views on the performance of company management and discipline boards to give greater consideration in advance to the likely reaction of shareholders to compensation-related decisions. Such decisions are often at the heart of shareholder concerns over management.

Despite all of these changes favoring the shareholder franchise, a majority of the Commissioners determined that direct access to a company's proxy statement for shareholder nominees is in the best interests of the investing public. The rules adopted make a number of important changes to the June 2009 proposed rules, many of which are summarized below.

While new SEC rules do not change any state or foreign corporate law rules governing the nomination and election of directors, they do provide for the inclusion of nominees properly nominated in accordance with state law in the company's proxy statement, and in so doing, they reduce substantially the costs for shareholders to have nominees considered for election.

Together with other recent rulemaking, institutional shareholders and special interests will be newly empowered in the 2011 proxy season to directly influence issuers through director elections, while issuers,

incumbent directors and management will likely be forced to redirect significant time and resources to the process.

What Changes Now

Rule 14a-11

New Rule 14a-11 will apply to companies reporting under the Exchange Act, including companies subject to the Investment Company Act of 1940. However, as with other proxy rules, Rule 14a-11 will not apply to foreign private issuers. Large accelerated filers and accelerated filers will be required to comply in time for the 2011 proxy season (see discussion of effective date below). Rule 14a-11 will eventually apply to smaller reporting companies, but not until three years after the effective date.

Subject to the phase-in rule for smaller reporting companies, Rule 14a-11 is mandatory for all subject companies. A company may not opt out of or increase the thresholds for proxy access, even with the approval of its shareholders. As discussed further below, companies may adopt proxy access rules that are more permissive of proxy access than Rule 14a-11.

Rule 14a-11 requires a company to include in its proxy statement director candidates nominated by a shareholder or a group of shareholders holding in the aggregate at least 3% of a company's outstanding shares entitled to vote on the election of directors, who have held such number of shares continuously for at least three years. The maximum number of candidates a company must include is 25% of the number of directors (and always at least one director).

- These ownership and holding period thresholds represent a departure from the June 2009 proposal, which called for scaled ownership requirements of 1%, 3% and 5% based on company size and a 1-year holding period. The number of directors is consistent with the June 2009 proposal.
- In calculating the 3% ownership requirement of the Rule, ownership is reduced by any shares that a nominating shareholder has sold in a short sale. Shares borrowed by a nominating shareholder are excluded from the calculation but shares loaned to others count towards the total, provided that the lender has the right to recall such shares and will do so upon being notified that its shareholder nominee(s) will be included in the company's proxy statement.
- The three-year holding period is measured from the date the shareholder files notification of its intent to use the proxy access rules on Schedule 14N (discussed below) with the SEC. The shareholder must continue to own the shares through the date of the meeting at which directors are elected, and must state its intent to continue to hold such shares after the election. If a shareholder

group files, the rules are applicable to each member of the group.

- If 25% of the number of authorized directors is not a whole number, the number of nominees that must be included is rounded down to the nearest whole number.
- The number of directors that shareholders may nominate is not reduced for a classified board election of a subset of directors. However, where any continuing directors who are not up for election in a given year were elected as a shareholder nominee pursuant to Rule 14a-11, such continuing directors will count toward the 25% maximum.

If multiple shareholders or groups propose candidates, the nominees of the nominating shareholder or group with the highest qualifying voting power percentage will be included. If that number of nominees is less than the maximum number that must be included, the nominee(s) of the next largest shareholder or group must be included, and so on until the maximum number of nominees is included. If, prior to the printing of proxy materials, a director candidate is disqualified or becomes unavailable, the same order of priority must be used to put a replacement candidate in the proxy. Once a company has begun printing its proxy materials, it does not need to include replacement nominees.

- Priority based on holdings represents a departure from the "first-in" standard in the June 2009 proposal, which would have given priority to the first shareholder or group that filed its notice of intent.

Nominee Eligibility

No intent to influence control

A nominating shareholder or member of a group may not use Rule 14a-11 if it holds any of the company's securities with the purpose or the effect of changing control of the company or to gain a number of seats on the board that exceeds the maximum number of nominees permitted under Rule 14a-11. Each nominating shareholder or group member must certify to the absence of such intent in the Schedule 14N. The SEC clarified in the final rule that the absence of an intent to change control of the company is a condition for use of Rule 14a-11. Accordingly, a company that believes that a nominating shareholder or group member has an intent to change control or to pursue further nominees, has the opportunity to exclude the nominees using the SEC's informal process (discussed below) or litigation.

No agreements with the company

In addition, a nominating shareholder or member of a group may not have an agreement with the company regarding director nominations prior to filing a Schedule 14N. This rule is designed to prevent collusion

among the company and friendly shareholders to nominate candidates that the board approves. This rule does not prohibit negotiations among the nominee, the nominating shareholder or group and the nominating committee or board of directors of the company regarding the nominee's inclusion in the company's proxy statement as a company supported nominee, where those negotiations are unsuccessful, or negotiations that are limited to whether the company is required to include the shareholder nominee in the company's proxy statement in accordance with Rule 14a-11.

Independence requirement and violations of applicable law

Companies whose securities trade on a national securities exchange or a trading system subject to national securities association rules need only include a shareholder nominee in the proxy statement if the nominee meets the exchange's objective criteria for independence. NYSE and Nasdaq also have subjective criteria for independence, and heightened independence requirements for audit committee members,^[1] but nominees do not need to meet these criteria as a condition to inclusion in the company's proxy statement.

A company may also exclude a nominee if it believes the nominee's inclusion on the board of directors would violate federal, state or foreign law, or the rules of the applicable national securities exchange, other than rules related to independence (which are addressed as described above).

Companies may not exclude nominees that do not meet director qualification requirements set forth in the company's organizational documents. If a nominee does not meet such requirements, the company can include that fact or belief in the proxy statement, which presumably would influence the vote on that nominee. If a nominee who does not meet qualification requirements is nonetheless elected, then under state law, the nominee would not in fact take a board seat, and applicable state law would govern what happens with respect to that seat. Although governing document qualifications cannot disqualify a nominee from being named in the company's proxy statement, governing document qualifications may still be a powerful tool for companies to ensure that directors meet minimum standards important to the company.

Exclusion Procedure

The SEC will have an informal procedure for companies to use when they believe a purported Rule 14a-11 nominee may be excluded. No later than 14 calendar days after the close of the nomination window period, an issuer must notify the nominating shareholder(s) of a determination not to include one or more nominees. The nominating shareholder(s) will have 14 days after receipt of such notice to respond and, where applicable, cure any defects in the nomination. No later than 80 calendar days before filing its definitive proxy statement with the SEC, the company must notify the SEC of its intent to exclude a Rule 14a-11 nominee and the basis for its determination. The company may (but is not required to) seek a no-action letter from the SEC staff to support its determination. Nominating shareholder(s) will have 14 days

after receipt of the company's notice to the SEC to submit a response to the SEC staff. If requested by the Company, the SEC staff may at its discretion and as soon as practicable provide an informal statement of its views to the company and the nominating shareholder(s). Promptly following receipt of the SEC staff's views (if provided), the company must provide notice to the nominating shareholder(s) whether it will include or exclude the nominee.

Schedule 14N

Nominating shareholders and groups will be required to provide a notice on Schedule 14N to the company of an intent to exercise nomination rights under the Rule.

- The Schedule 14N must be delivered to the company and to applicable securities exchanges and concurrently filed with the SEC.
- Disclosure required by Schedule 14N includes information evidencing that the nominating shareholder(s) and the nominee(s) satisfy the eligibility requirements of Rule 14a-11, the extent and nature of relationships between the nominating shareholder(s) and the nominee(s) and the beliefs of the nominating shareholder(s) as to whether the nominee(s) satisfy any board qualification requirements in the company's governing documents. There are no restrictions on relationships between the shareholder(s) and the nominee(s). However, we would expect that shareholders who wish to avoid restrictions on trading in the company's securities would avoid proposing a nominee who would make the shareholder subject to the company's insider trading policy or to reporting and short-swing liability under Section 16 of the Exchange Act.
- Schedule 14N may include a supporting statement not longer than 500 words per nominee, which the company must include in its proxy statement. A company will not be subject to any liability under the securities laws for incorrect information contained in the supporting shareholder statement.
- The Schedule 14N must be filed 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. If the company did not hold an annual meeting during the prior year, or if the date of the meeting has changed by more than 30 calendar days from the prior year, the company will be required to disclose the filing date, which must be reasonable, in a Form 8-K filed pursuant to new Item 5.08 within four business days after the company determines the anticipated meeting date.

Amendments to Rule 14a-8 (Shareholder Proposals)

Prior to the adoption of these new rules, the so called 'election exclusion' provided by Rule 14a-8 permitted companies to exclude shareholder proposals to amend the company's organizational documents to establish procedures for the inclusion of shareholder director nominees in the company proxy materials proposals. Rule 14a-8 will be amended to remove that basis for exclusion. Accordingly, a shareholder may propose amendments to charter documents providing for more liberal rules of proxy access, such as reduced ownership thresholds, reduced holding periods, and the like. If the proposed amendments are to the bylaws, under Delaware and other state laws, the action may be direct rather than advisory.

Amendments to Rule 14a-2 (Proxy Solicitation Rules)

The SEC also amended Rule 14a-2 to permit shareholders to solicit other shareholders to form a nominating group for Rule 14a-11 purposes and to campaign for shareholder nominees without running afoul of the proxy rules.

Rule 14a-2(b)(7) provides an exception from proxy solicitation prohibitions for oral and written communications solicitations by or on behalf of any shareholder in connection with the formation of a nominating shareholder group. To be eligible to use this exemption, a shareholder cannot be holding the company's securities with the purpose, or with the effect, of changing control of the company or to gain a number of seats on the board of directors that exceeds the maximum number of nominees that the company could be required to include under Rule 14a-11.

Written communications may include no more than a statement of the shareholder's intent to form a nominating shareholder group, identification of and a brief statement regarding the potential nominee(s) (or, where no nominee(s) have been identified, the characteristics of the nominee(s) that the shareholder intends to nominate, if any), the percentage of voting securities that each soliciting shareholder holds or the aggregate percentage held by any group to which the shareholder belongs, and contact information. Such written information must be filed with the SEC under cover of Schedule 14N on the day first used.

The exception also covers oral solicitations, which are not limited in content. In order to rely on the exception for oral solicitations, the shareholder must file a notice of commencement of oral solicitations on Schedule 14N.

Rule 14a-2(b)(8) provides an exception from proxy solicitation prohibitions for solicitations by or on behalf of a nominating shareholder or group in support of its nominee(s). The exception may be used only when the speaker is not seeking proxy authority. Written solicitations must include specified disclosures, including the identity of the nominating shareholder or group, a description of his/her/its direct or indirect interests, by

security holdings or otherwise, and a specified legend. These written communications must be filed with the SEC under cover of Schedule 14N on the day first used. There is no filing requirement for oral communications in support of nominees. A shareholder may begin these communications immediately upon being notified that such shareholder's nominee(s) will be included in the company's proxy statement.

Neither rule discussed above provides an exemption for communications in connection with non-Rule 14a-11 proxy contests, such as those that occur under the director nomination provisions of a company's governance documents. Moreover, both rules provide the exemption will be lost retroactively if the shareholder or group subsequently engages in a non-Rule 14a-11 nomination or solicitation in connection with the subject election of directors. The retroactive loss of the exemptions is designed to prevent exempt Rule 14a-11 solicitations from being used as a first stage in a more aggressive proxy contest.

No Preliminary Proxy Statement for 14a-11 Nominees

The inclusion of shareholder nominees in a proxy statement pursuant to Rule 14a-11 will not, on its own, require the filing of a preliminary proxy statement.

Additional Deadline Disclosure under Rule 14a-5

In addition to the shareholder proposal and advance notice bylaw deadlines already required to be disclosed under Rule 14a-5, companies must disclose the deadline for submitting nominees for inclusion in the company's proxy materials for the company's next annual meeting.

Continuation of Use of Schedule 13G

A shareholder eligible to report beneficial ownership on Schedule 13G rather than the longer form Schedule 13D will not be precluded from using Schedule 13G merely because a holder engages in a Rule 14a-11 process to nominate a director for inclusion in the company's proxy statement.

No Effect on Section 16 or Affiliate Status

The standards for determining whether a shareholder is subject to reporting under Section 16 of the Exchange Act by virtue of being the beneficial owner of 10% or more of a class of voting securities registered under the Exchange Act will not change as a result of the new rules. Accordingly, joining a Rule 14a-11 nominating group may be considered for purposes of determining whether a holder is part of a "group" (as defined under Section 13(d) of the Exchange Act) that is a 10% or greater beneficial owner.

Similarly, there is no "safe harbor" associated with Rule 14a-11 activities for determination of whether a

shareholder is an “affiliate” for purposes of the securities laws. Accordingly, Rule 14a-11 activities may be taken into account in the facts and circumstances determination of whether a shareholder is an affiliate. The lack of a safe harbor from the affiliate definition is a departure from the June 2009 proposal.

No Limitation on Repeated Nominations

The new rules contain no limitations on the ability of shareholders to nominate previously unsuccessful candidates. A 3% or greater shareholder is free to nominate the same candidates every year despite unsuccessful prior elections, provided the conditions of Rule 14a-11 are satisfied each year.

What will be the effect of the Rule?

The ramifications of the proxy access rules are likely to be significant.

It is unclear the extent to which institutional investors that have not previously pursued proxy contests will avail themselves of Rule 14a-11. It is also unclear whether individual investors will be able to organize groups large enough to meet the 3% ownership threshold, and if they do, whether larger investors will step in and propose nominees that “trump” the nominees of smaller investors for the limited Rule 14a-11 space on the proxy statement.

Most majority voting provisions provide that they do not apply in contested elections for directors. Accordingly, one effect of Rule 14a-11 will be to restore plurality voting for directors in most elections where shareholders avail themselves of Rule 14a-11.

It is clear that proxy access presents a significant change to the prevailing order of the board nomination process. Where a Rule 14a-11 candidate is elected, board communications will likely be affected, at least at the outset. The traditional board nomination process allows management and the continuing directors significant opportunity to get to know a new board member. That process usually involves the existing directors and the new director getting comfortable that they will operate harmoniously together. Rule 14a-11 directors that were opposed by the current board will lack the trust built through the traditional nomination process, and depending on the nature of the campaign, may be affirmatively distrusted and even disliked by the other directors. Of course, this kind of disruption is not new - boards that have seen successful activist shareholder campaigns have been through it. Rule 14a-11 has the potential to expand the universe of boards that experience such a shift to include more companies and particularly companies that in the past were not at significant risk of activist shareholder attack.

The risk of shareholder nominees could affect future management decisions. That is, management at some companies might find incentive to make decisions to satisfy the concerns of small constituencies of

shareholders who might otherwise disrupt the proxy process by nominating dissident directors. It remains to be seen whether directors hostile to management or otherwise unwelcome by other board members will improve corporate governance, accountability and performance, as the SEC hopes. In any case, incumbent boards and company management will likely be required to spend significant additional time and resources on the director nomination and election process. Some, including dissenting Commissioner Kathleen L. Casey, argue that this new proxy access regime may reduce the competitiveness of U.S. corporations.

When is the New Rule Effective?

The new rules will become effective 60 days after publication in the Federal Register. The publication date is uncertain, but the new rules should be in effect approximately November 1, 2010. Smaller reporting companies will be exempt from the Rule until three years after the effective date.

To determine whether the new rules will affect a company's 2011 proxy season, subtract 120 days from the anniversary of the date the 2010 proxy materials were mailed to shareholders. If the resulting date is on or after the effective date of the new rules, the new rules will be in effect for the company's 2011 proxy season. For example, if a company released its proxy statement to shareholders on March 1, 2010, the new rules will apply to the company's 2011 annual meeting if the new rules become effective by November 1, 2010.

What should you do now?

We recommend that companies subject to the new rules quickly evaluate the impact of the new rules, considering the following:

- Who are the company's 3% or greater shareholders and which might be interested in nominating a director?
- Which shareholders below 3% might be expected to solicit for formation of a 14a-11 group to nominate directors?
- Are the company's advance notice bylaws compatible with Rule 14a-11, including its notice provisions and information requirements?[\[2\]](#)
- Does the company have director qualification requirements in its charter or bylaws, and are such requirements sufficient to prevent persons unsuitable to serve from joining the board?

- Will majority voting provisions cease to apply in a Rule 14a-11 contested election of directors, and if not, are the procedures for majority voting in a contested election workable?

What if you have questions?

For any questions or more information on these or any related matters, please contact any attorney in the firm's corporate and securities practice group.

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[1] The Dodd-Frank Act requires the SEC to require that the national securities exchanges and national securities associations determine rules relating to independence of compensation committee members. Because the definition of independent is not specified in the statute and requires SEC rulemaking, it is unknown whether compensation committee members will also need to meet heightened independence requirements. The instructions to Rule 14a-11 state that the heightened requirements for audit committee members are not to be considered but does not address heightened requirements for other committee members.

[2] The adopting release indicates that where provisions of a company's governing documents are more restrictive than the requirements of Rule 14a-11, the company must still include nominees that are submitted in accordance with the requirements of Rule 14a-11.