

SEC Adopts “Proxy Access” – New Rules to Affect Many Companies in the 2011 Proxy Season

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In an open meeting held August 25, 2010, the Securities and Exchange Commission (SEC) adopted new rules which may require a public company's proxy materials to include information about and the ability to vote for shareholder-nominated director candidates. The new rules will be effective November 15, 2010; companies that mailed this year's proxy materials or notice of internet availability prior to March 15, 2010 will not be subject to shareholder nominations under the new Rule 14a-11 described below until the proxy for the annual meeting held in 2012. The entire adopting release can be found [here](#).

HIGHLIGHTS OF NEW RULES

Under new Rule 14a-11:

- Shareholders (or shareholders forming a group) who have held continuously for three years shares with at least 3% of the investment and voting power of a company's voting securities will have the right to designate nominees for director and have such nominees appear on the company's proxy card and to include a 500 word supporting statement in the proxy statement.
- The number of directors that may be placed on the company's proxy card by shareholders is capped at 25% of the total number of board directors (1 director minimum).
- The time window in which a shareholder or a shareholder group must give notice (on a new Schedule 14N) of director nominations is 120-150 days prior to the anniversary of the mailing date of the previous year's proxy statement.
- Effectiveness of the new rules for smaller reporting companies is delayed for three years.
- The new rules do not apply to foreign private issuers or “debt-only” issuers; they do apply registered investment companies and to voluntary filers.

Under amendments to Rule 14a-8:

- Companies will be required to include shareholder proposals that seek to establish proxy access for shareholder nominees (unless the proposal would eliminate the Rule 14a-11 regime described above). Such proposals were previously excludable under SEC rules because they “relate to an election.”

SHAREHOLDER RIGHT TO ACCESS COMPANY PROXY

For the first time U.S. public companies may be forced, at their own expense, to include nominees for director submitted by eligible shareholders or shareholder groups on the company's own proxy card and to include statements regarding these nominees in the company's own proxy statement. New Rule 14a-11 will not apply when applicable state or

foreign law, or a company's governing documents, prohibit shareholder nominations completely (currently no U.S. state laws have such a prohibition and most public company charter documents allow shareholders to propose nominees).

APPLICABILITY; NO "OPT OUT"

The proxy access rules will apply to all companies (including investment companies and controlled companies) subject to the Securities Exchange Act of 1934, as amended (Exchange Act) proxy rules, other than companies subject to the rules solely because they have registered debt securities – this includes voluntary filers who register a class of securities under Section 12(g). Foreign private issuers, who are not subject to Exchange Act proxy rules, are exempt. The SEC omitted any "opt out" provisions from the final rules.

The SEC also exempted smaller reporting companies from the new rules for the first three years. The effective date of Rule 14a-11 for smaller reporting companies will be November 15, 2013.

SHAREHOLDER ELIGIBILITY

To qualify to submit shareholder nominees, shareholders (or groups of shareholders) must certify that they hold both investment and voting power of at least 3% of the shares eligible to vote in director elections. The shares must be held continuously for three years prior to the submission of nominees and continue to be held through the annual meeting in question. Shares loaned to third parties can be included in the calculations only if they can be recalled (and must be recalled if the shareholder's nominees are on the company proxy card). Short positions are netted against long positions and any borrowed shares are excluded from the calculations. If multiple eligible shareholders or groups submit timely notice, the company is required to include only the nominees of the shareholder or group with the largest ownership percentage calculated in accordance with the rules.

Nominating shareholders must disclose their intent regarding continued ownership of the required holdings after the meeting. Further, any shareholders who hold securities for purposes of changing control of the company or to cause the election of more directors than the limits discussed below are not eligible to take advantage of Rule 14a-11.

NUMBER OF SHAREHOLDER NOMINEES; CLASSIFIED BOARDS

Shareholders will be permitted to include nominees of up to 25% of the total number of directors, with a minimum of one. If the eligible shareholder or shareholder group with the largest ownership position nominates the maximum allowable number of candidates, a company will be permitted to exclude any other shareholder's or group's nominees from the company's proxy materials, but must allow a second (or third) group's candidates if groups holding larger share positions nominate less than the maximum.

The SEC's adopting release clarifies that companies should ignore the effects of a classified board when calculating the maximum number of shareholder nominees (i.e., 25% of the total number of directors, not 25% of the number up for an election at a given meeting). However, if the maximum allowable number of shareholder director nominees are existing directors, the new rules allow companies to exclude additional shareholder director nominees.

DIRECTOR QUALIFICATIONS

The director nominees submitted by shareholders under Rule 14a-11 must meet the objective independence standards of the exchange (or exchanges) upon which a company's securities are listed. A company will not be able to exclude a shareholder nominee because it has determined that a particular nominee fails to meet a subjective independence standard (for example, the major exchanges require that the board of directors or any group or committee of the board of directors make a determination that the nominee has no material relationship with the listed company). The adopting release notes that even though the company could not exclude a shareholder nominee that fails to satisfy a subjective independence standard, there is nothing prohibiting the company from providing disclosure in the proxy statement detailing the effect of such a nominee's election to the board (such as excluding such a director from certain committees, creating a need to expand the board size, adding burdens to other independent directors, etc.).

If a company (other than an investment company) is not subject to the standards of a national securities exchange or national securities association, then it cannot exclude a shareholder nominee on the basis that the nominee is not independent since the company is not subject to any objective independence requirements.

In order to eliminate the risk that a nominating shareholder or shareholder group is merely acting as a surrogate for a company, if any nominee or nominating shareholder (including any member of the nominating shareholder group) has any direct or indirect agreement with the company regarding the nomination prior to the filing of the Schedule 14N (described below), then such nominee will not be considered a Rule 14a-11 nominee and other qualifying shareholders or shareholder groups may seek to nominate directors under Rule 14a-11. However, if after the filing of the Schedule 14N, the company and the shareholder enter into negotiations that result in the company including a nominee, such nominee will count towards the 25% limitation described above.

NOTICE REQUIREMENTS; TIMING

The eligibility requirements discussed above, as well as certain information regarding the shareholder or shareholder group and the proposed nominees and statements in support of the nominees (not exceeding 500 words per nominee) are all required to be included on a new Schedule 14N to be filed by the shareholder or shareholder group with the SEC and which will immediately be publicly available.

Shareholders or shareholder groups will be liable for any statement in the Schedule 14N or any other related communication that is false or misleading with respect to any material fact, or fails to state any material fact necessary to make the statements in the communication not false or misleading, regardless of whether that information is ultimately included in the company's proxy statement. In addition companies will not be responsible for any information provided by Rule 14a-11 shareholders or shareholder groups and included in their proxy statements.

The Schedule 14N must be filed with the SEC and delivered to the company no sooner than 150 days prior to the anniversary of the date on which the company mailed the proxy materials for the prior year's annual meeting and no later than 120 days before such date¹. This 150-120 day window and the November 15, 2010 effective date of the new rules means that a company that mailed this year's proxy statement prior to March 15, 2010 is not subject to proxy access until its proxy statement for the 2012 annual meeting.

The SEC also adopted new Rule 14a-18 for shareholders submitting nominations who are not relying on Rule 14a-11, but rather are acting pursuant to a provision in state or foreign law or a company's governing documents that provides for shareholder nominations. These shareholders now must make certain disclosures pursuant to a Schedule 14N filing by the date specified in the company's advance notice bylaw provision, or where no such provision is in place, no later than 120 calendar days before the date the company mailed its proxy materials for the prior year's annual meeting. Such disclosures with respect to the nominating shareholder or shareholder group and director nominee are the same, with certain exceptions, as the disclosures required to be made in a Schedule 14N by a shareholder or shareholder group nominating a director nominee pursuant to Rule 14a-11, as discussed above.

SHAREHOLDER EXEMPTIONS FROM PROXY SOLICITATION RULES

In connection with new Rule 14a-11, the SEC also adopted two new exemptions from the proxy solicitation rules for shareholders or shareholder groups using the new nomination process. The first exemption applies to written and oral solicitations by or on behalf of shareholders who are seeking to form a nominating shareholder group. In order to qualify for this exemption:

¹ If a 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, then the company will be required to file a Form 8-K under new item 5.08 within 4 business days of determining the anticipated date of the annual meeting which must set forth the date by which a shareholder or shareholder group must submit notice to include a nominee in the company's proxy materials, and such date must be a reasonable time before the company mails its proxy materials.

- the soliciting shareholder must not 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 25% maximum under Rule 14a-11;
- the content of written communications must be limited to certain information specified in the rule;
- a Schedule 14N must be filed by the shareholder no later than the first communication and any written solicitation material must be attached; and
- the shareholder must not be involved in other solicitations in connection with the subject election of directors other than pursuant to the provisions of Rule 14a-11 and the other exemption described below.

The second new exemption applies to written and oral solicitations by or on behalf of a nominating shareholder or group whose nominee or nominees are or will be included in the company's proxy materials under new Rule 14a-11. Such written or oral solicitations may be in support of shareholder nominees or for or against company nominees. In order to qualify for this exemption:

- the soliciting party must not seek the power to act as a proxy for a shareholder;
- written communications must disclose certain information (including the identity of each nominating shareholder and a prominent legend that a shareholder nominee will be included in the company's proxy statement); and
- the nominating shareholder must file all written soliciting materials sent to shareholders in reliance on the exemption with the SEC under cover of Schedule 14N at first use.

The exemption is available only after the company notifies the nominating shareholder that its nominee will be included in its proxy materials.

SHAREHOLDER REPORTING REQUIREMENTS; AFFILIATE STATUS

Under the new rules, shareholders or shareholder groups who nominate directors will not lose the "passive investor" status that permits them to use the abbreviated Schedule 13G instead of the more onerous Schedule 13D when they hold more than 5% of a registered class of a company's securities. They can also maintain the status so long as their solicitation for their nominees (or against company's nominees) follows the guidelines set out above and may also maintain the status even if their nominee is elected to the board.

The beneficial reporting and trading restrictions of Section 16 will apply to shareholders and shareholder groups formed to nominate directors under Rule 14a-11. Such shareholder groups will need to apply the Section 16 beneficial ownership rules (which differ from the Rule 14a-11 rules) to their holdings to determine if they cross the 10% beneficial ownership threshold in those rules and therefore need to file Section 16 reports and track trading activities to avoid potential profit disgorgement issues.

The SEC's July 2009 proposal on proxy access included a safe harbor that would have potentially prevented nominating shareholders or shareholder groups from being deemed "affiliates" under the securities laws. Being deemed an affiliate affects the application of a number of the securities laws and rules (for example, affiliates are subject to additional requirements under the Rule 144 safe harbor when selling restricted securities). This safe harbor was not adopted in the final rules, so shareholders and shareholder groups will continue to apply a facts and circumstances analysis as to whether they are affiliates of the company.

AMENDMENTS TO RULE 14a-8

The SEC also approved amendments to Rule 14a-8(i)(8) under the Exchange Act – the so called "election exclusion" – to enable shareholders to require companies to include in their proxy materials shareholder proposals that would amend a company's governing documents regarding nomination procedures or disclosure related to shareholder nominations. Under the former Rule 14a-8(i)(8), companies could exclude shareholder proposals that related to the nomination or election of directors.

In order to be included in a company's proxy statement, such shareholder proposals and their proponents have to meet the procedural requirements of Rule 14a-8 and the shareholder proposals must not conflict with Rule 14a-11 or state law. A

shareholder proposal that seeks to provide more liberal access to a company's proxy materials would not be deemed to conflict with Rule 14a-11 simply because it would establish lower eligibility thresholds (e.g., 1% ownership threshold) than would be required under Rule 14a-11.

In the adopting release, the SEC reaffirmed its position that, under certain circumstances, companies have the right to exclude proposals related to particular elections and nominations for director from company proxy materials where those proposals could result in an election contest between company and shareholder nominees without the protection provided in the proxy rules. As a result, the SEC codified certain prior staff interpretations with respect to the type of proposals that continue to be excludable pursuant to Rule 14a-8(i)(8), including those that would:

- disqualify a nominee who is standing for election;
- remove a director from office before his or her term expired;
- question the competence, business judgment, or character of one or more nominees or directors;
- seek to include a specific individual in the company's proxy materials for election to the board of directors; or
- otherwise affect the outcome of the upcoming election of directors.

The SEC did not adopt any new substantive disclosure requirements for a shareholder that submits a proposal that would amend a company's governing documents regarding nomination procedures or disclosure related to shareholder nominations.

CONSIDERATIONS FOR COMPANIES

Companies that are subject to the rules for the upcoming proxy season should consider some possible action items:

- Advance notice bylaws and shareholder nomination provisions of governing documents should be examined to determine how they will interact with new rules. Companies may also wish to harmonize information requirements of the new rules and any existing bylaw provisions concerning shareholder nominees.
- Any majority voting provisions should be examined to see how they are implicated by a successful Rule 14a-11 nomination that may create a "contested" election.
- Examine the shareholder base and identify holders that already satisfy the 3% threshold or other large holders who may solicit others to form a qualifying group. Are there larger institutional holders who may step in to "trump" smaller shareholders or shareholder groups?
- Nominating committee procedures and timelines should be examined to ensure that they are prepared to properly evaluate and deal with shareholder nominees.
- The timeline for the preparation of the proxy materials and other annual meeting preparations should allow time to evaluate shareholder nominees and to work through the SEC's process for disputes regarding shareholder or director qualifications under the rules.