

SEC Adopts Rules for Shareholder Proxy Access in Director Elections

On August 25, 2010, the Securities and Exchange Commission (SEC) adopted rules requiring U.S. public companies to provide access to their proxy cards and proxy statements in director elections to shareholders or groups of shareholders who satisfy certain criteria.¹ While the SEC had originally proposed rules for shareholder proxy access in October 2003, the financial crisis, together with the explicit authority that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) provided to the SEC, finally provided the SEC with sufficient momentum to implement proxy access, albeit with a close 3-2 vote by the SEC commissioners to adopt the rules.

The rules provide two ways for shareholders to nominate directors. First, Rule 14a-11 will provide a mandatory procedure for shareholders or groups of shareholders who meet certain minimum requirements to nominate directors for inclusion in the company's proxy materials. Second, Rule 14a-8, the existing rule for shareholder proposals, has been amended to prevent companies from excluding shareholder proposals by qualifying shareholders that seek to establish a procedure under a company's governing documents for the inclusion of shareholder director nominees in the company's proxy materials. If such a procedure were adopted by a company, it would be an alternative to the mandatory procedure in Rule 14a-11.

Background

Because the shares of most public companies are held through dispersed ownership, it is generally not practical for shareholders to attend meetings in person to vote their shares. As a result, shareholder voting for public companies is largely conducted through the solicitation of proxies which give a few persons authority to vote in person at the meeting as instructed by the shareholders. Since the adoption of the Securities Exchange Act in 1934 (the Exchange Act), the SEC has had the authority to regulate the proxy solicitation process for public companies. It has done so principally by requiring that disclosure be provided in connection with the solicitation of proxies through a proxy statement and an annual report to shareholders and by regulating the form of the proxy card. Management prepares and delivers proxy materials to shareholders each year for the annual meeting at the expense of the company. The board nominates its own

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slate of directors, proposes other business to be considered at the meeting and uses its proxy card to allow shareholders to vote on the proposed business.

A shareholder or other party may solicit proxies in opposition to management, such as for a competing slate of directors, generally only by incurring the expense of preparing and delivering its own proxy materials. Given the expense, time and burden involved, it is rare for a proxy contest to be launched against management, and in most director elections management's nominees run unopposed.

A shareholder can avoid the expense of preparing and delivering its own proxy materials if it can require the company to include a shareholder proposal in the company's proxy statement and proxy card. Historically, SEC Rule 14a-8 has provided that access. Rule 14a-8 requires a company to include a shareholder proposal in the company's proxy statement and proxy card relating to an annual meeting if the proposal is submitted by a shareholder who has beneficially owned at least \$2,000 or 1% of the issuer's stock for at least one year and will continue to do so through the meeting date, the proposal is submitted by the applicable deadline (generally 120 days prior to the anniversary of the date of the proxy statement for the previous year's meeting), the proposal does not fall within certain prohibited categories and the shareholder submitting the proposal satisfies a number of other procedural requirements. The prohibited categories of shareholder proposals under Rule 14a-8 have included a proposal relating to a nomination or election for membership on the company's board of directors. The SEC has interpreted this rule to not only prohibit the use of Rule 14a-8 to propose nominees for election in opposition to management's nominees but also to prohibit the use of Rule 14a-8 to propose the adoption of a process that would allow access to the company's proxy materials for shareholder nominations (e.g., a proposal to amend a company's bylaws to provide access).

In recent years, corporate governance activists have pushed for proxy access to allow shareholders to include their own director nominees in the company's proxy materials. The SEC originally proposed a rule for shareholder access in October 2003, but had not adopted the rule following strong opposition from business groups. After the 2008 financial crisis, on June 10, 2009 the SEC took another shot at proposing a shareholder access rule (the June 2009 Proposal). Section 971 of the Dodd-Frank Act, which was adopted in July 2010, specifically authorized the SEC to adopt such a rule and the SEC has now done so.

New Shareholder Access Rule

The SEC adopted new Rule 14a-11 to provide shareholder access to a company's proxy materials to nominate directors in opposition to management's nominees.

Application of Rule 14a-11. Rule 14a-11 applies with respect to annual meetings at which directors are elected and is mandatory for all companies subject to the SEC's proxy rules. There is no requirement to opt into the rule and no ability to opt out of it. Rule 14a-11 will also apply even if a company is engaged in a concurrent proxy contest. One exception applies in the rare circumstance where applicable state or foreign law or the company's governing documents prohibits shareholders from nominating candidates for the board of directors.

Companies Subject to Rule 14a-11. Rule 14a-11 applies to all companies subject to the SEC's proxy rules under the Exchange Act (including investment companies registered under the Investment Company Act of 1940). Foreign private issuers are exempt from the proxy rules, and therefore Rule 14a-11 would not apply to foreign private issuers. In addition, companies subject to the proxy rules solely because they have a class of debt registered under Section 12 of the Exchange Act would not be subject to Rule 14a-11. Rule 14a-11 will apply to smaller reporting companies, but only starting on the third anniversary of the effective date of the rule.

Minimum Ownership to Nominate Directors. To submit a director nomination under Rule 14a-11, a shareholder or group of shareholders must hold at least 3% of the voting power of the company's securities that are entitled to be voted on the election of directors. Unlike the June 2009 Proposal, the 3% standard applies to all companies subject to the rule regardless of size.

The ownership of the shareholder or group of shareholders must be of a class of securities subject to the SEC's proxy rules and the shareholder or group must hold both investment power and voting power over all of the securities counted toward the 3% standard, either directly or through any person acting on their behalf. Securities that they merely have a right to acquire, such as securities subject to an option or warrant, are not counted. The rule also explicitly excludes any securities that have been sold short and any borrowed shares. Securities loaned to another party may be counted if the shareholder has the right to recall the loaned securities and will recall the loaned securities upon being notified that any of the nominees will be included in the company's proxy materials.



Where a company has multiple classes of stock with unequal voting rights and the classes vote together, voting power is calculated based on the collective voting power of all of the classes that vote together. If there are multiple classes that do not vote together (e.g., where each class votes on different directors), then voting power would be determined only on the basis of the voting power of the class of stock that would vote together on the directors that are to be nominated under Rule 14a-11.

In determining the total voting power of the company's securities, the shareholder or group under Rule 14a-11 may rely on the most recently filed quarterly, annual or current report of the company unless the nominating shareholder or a member of the group knows or has reason to know that the information in the report is inaccurate.

The shareholder or group must also adequately demonstrate its ownership to the company. The ownership of a record holder can be demonstrated through the company's stock records. For other holders, ownership can be demonstrated through SEC filings including a Schedule 13G, Schedule 13D, Form 4 or Form 5 or by delivering a statement from the registered holder, bank or broker dated within seven calendar days of the date the nominating shareholder or group delivers its notice of nomination to the company on Schedule 14N (see below).

Minimum Holding Period. The shareholder must beneficially own the shares exceeding the minimum ownership threshold continuously for at least three years prior to the date of the notice of nomination to the company. In addition, the shareholder must represent that it intends to continue to hold those securities through the date of the shareholders meeting. In the case of a shareholder group, each member of the group must meet the holding period requirements for the securities that are used for purposes of meeting the ownership threshold.

Maximum Number of Nominees. The maximum number of director nominees a company is required to include in its proxy materials under Rule 14a-11 is the greater of one nominee or the number of nominees that represents 25% of the company's board of directors. If 25% of the board does not result in a whole number, then you round down to the closest whole number below 25%. As a result, any board with seven or fewer members would allow one shareholder nominee and a board with eight members would allow two shareholder nominees.

Where more than one shareholder or group of shareholders provides proper



notice of nominees, then the company must include the nominees from the shareholder or group with the highest percentage of voting power. If such shareholder and group did not make the maximum number of nominations, then the nominees of the shareholder or group to properly provide notice with the next highest percentage of voting power are included up to the maximum number of nominations.

In the case of a staggered board, the 25% limit would be calculated based on the total number of board seats rather than the lesser number up for election. Where a company has multiple classes of stock and shareholders have the right to elect a subset of the board, the 25% limit still applies to the entire board but is capped at the number of directors in the subset that the shareholders can elect. If a shareholder or group has filed a notice on Schedule 14N and then begins discussions with the company that results in the company agreeing to include one or more of the eligible nominees as company nominees, those nominees would count towards the 25% limit. This would not apply if discussions with the company begin before the filing of the Schedule 14N.

An incumbent director that was originally elected as a shareholder nominee under Rule 14a-11 but is renominated by the company would not count toward the 25% limit when renominated.

No Change of Control Intent or Agreements with the Company. To rely on Rule 14a-11, a nominating shareholder or group must not be holding the company's securities for the purpose of, or with the effect of, changing control of the company or to gain more than the maximum number of board seats under the rule. In addition, a nominating shareholder or group will not be eligible to use Rule 14a-11 if there is an agreement with the company regarding the nomination of the nominee.

Shareholder Nominee Requirements. A company is not required to include in its proxy materials a nominee if the nominee's candidacy or board membership would violate controlling state, federal or foreign law or the rules of an exchange (other than the exchange's rules regarding the independence of directors) and such violation cannot be cured. With respect to independence, the nominee must be in compliance with the objective independence standards of the applicable exchange. There would be no requirements regarding the satisfaction of any subjective standards for independence² or for the satisfaction of special independence standards for serving on the audit committee or another board committee.

Withdrawal or Disqualification of a Nominee or a Nominating Shareholder

or Group. If a nominating shareholder or group withdraws or is disqualified, the company would be required to include in its proxy materials the nominee or nominees of the nominating shareholder or group with the next highest voting power percentage that is otherwise eligible to use the rule and that filed a timely notice in accordance with the rule, if any. If a nominee withdraws or is disqualified, the company would be required to include in its proxy materials any other qualified nominees timely submitted by that shareholder or group or, if there are none, from the shareholder or group the nominee or nominees with the next highest voting power percentage that is otherwise eligible to use the rule and that filed a timely notice in accordance with the rule, if any. Once the company has commenced printing its proxy materials, it will not be required to include a substitute nominee or nominees.

Notice and SEC Filing Requirements. Rule 14a-11 requires that the nominating shareholder or group provide a notice on Schedule 14N to the company of its intent to require that the company include its nominee or nominees in the company's proxy materials. The Schedule 14N also must be filed with the SEC. Information required in the Schedule 14N would include:

- the name of the nominating shareholder or each member of the nominating shareholder group and the address and telephone number of the nominating shareholder or each member of the nominating shareholder group (or an authorized representative if applicable);
- information regarding the amount of the company's voting securities held by the nominating shareholder or members of the nominating shareholder group;
- evidence of ownership by the nominating shareholder or members of the nominating shareholder group consisting of (1) if the shareholder or any member of the group is a registered holder of the shares, a statement to that effect, (2) one or more written statements from the record holder of the shares (usually brokers or banks) verifying that, within seven days of the filing of the Schedule 14N, the shareholder or member of the group continuously held the applicable securities for a period of at least three years (there is a sample form of letter with the rules) or (3) if the ownership is shown pursuant to a filing of a Schedule 13D, Schedule 13G, Form 4 and/or Form 5, a statement to that effect;
- a written statement of the nominating shareholder's or group's intent to continue to beneficially own shares in excess of the requisite threshold until the

- meeting at which directors are elected and regarding the shareholder's or group's intent with respect to continued ownership after the election;
- a statement that the nominee consents to be named in the company's proxy statement and to serve on the board if elected;
 - disclosure about the nominee complying with certain requirements of Schedule 14A for inclusion in the company's proxy statement;
 - disclosure regarding the nominating shareholder or members of the group relating to interests in the solicitation, methods of solicitation, estimate of amount to be spent in the solicitation and who will bear the cost, certain legal proceedings, and the nature and extent of certain relationships between the nominating shareholder or group and nominee and the company or any affiliate of the company;
 - disclosure about whether, to the knowledge of the nominating shareholder or group, the nominee meets the director qualifications, if any, set forth in the company's governing documents;
 - a statement that, to the knowledge of the nominating shareholder or group, the nominee meets the objective criteria for independence that are set forth in the applicable listing standards;
 - information regarding the nature and extent of relationships between the nominating shareholder or group, the nominee and/or the company or any affiliate of the company;
 - disclosure of any website address on which the nominating shareholder or group may publish soliciting materials;
 - if desired to be included in the company's proxy statement, any statement in support of the shareholder nominee or nominees, which may not exceed 500 words for each nominee;
 - a certification that the nominating shareholder or each member of the nominating shareholder group is not holding the company's securities for the purpose of, or with the effect of, changing the control of the company or gaining more than the maximum number of seats on the company's board of directors permitted under Rule 14a-11;
 - a certification that the nominating shareholder or group otherwise satisfies the

requirements of Rule 14a-11(b);

- a certification that the nominee or nominees satisfies the requirements of Rule 14a-11(b); and
- a certification that the information set forth in the Schedule 14N is true, complete and correct.

A Schedule 14N, with similar disclosure requirements, would also be filed if a shareholder or group uses a procedure set forth under applicable state or foreign law or a company's governing documents rather than Rule 14a-11 to access a company's proxy materials to nominate directors.

The Schedule 14N would be required to be filed with the SEC on EDGAR, which would require that the nominating shareholder or group and any nominee that does not already have EDGAR codes obtain them by electronically filing a Form ID. The Schedule 14N must be amended promptly for any material change in the information set forth in the filing, including any withdrawal of a nomination. A final amendment must be made within 10 days of the final results of the election disclosing the nominating shareholder's or group's intention regarding continued ownership of its shares.

Inclusion of Shareholder Nominees in the Proxy Materials. If one or more shareholder nominees are to be included in the proxy materials, the proxy card can identify the shareholder nominees as such and include the board's recommendation of whether shareholders should vote for, against or withhold votes on those nominees and on the management nominees. In addition, when a shareholder nominee is included on a company's proxy card, proposed Rule 14a-11 would not allow a company to provide shareholders with the option of voting only for (or withholding authority to vote for) all of the company's nominees as a group. Instead, each nominee must be voted on separately. The company's proxy statement must include specific disclosures regarding the nominees as well as the nominating shareholder's or group's statement in support of its nominee or nominees as long as it does not exceed 500 words. A company may not exclude a nominee or statement in support if it believes the Schedule 14N contains false or misleading statements. The rules provide that the nominating shareholder or group is responsible for any false or misleading statements in the Schedule 14N and companies will not be responsible for any information contained in the Schedule 14N.

Deadline for Nominations. In order to properly make a nomination, a shareholder or group must provide the notice on Schedule 14N not less than 120 days and not more than 150 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, then the company must file a Form 8-K within four business days of determining the annual meeting date and the shareholder or group must provide notice on Schedule 14N a reasonable time before the company mails its proxy materials. The SEC also amended Rule 14a-5 to require disclosure in a company's proxy materials of the deadline for submitting nominees for the next annual meeting of shareholders.

Process to Exclude Nominations. Under Rule 14a-11, a company may exclude a shareholder nominee for the following reasons: (1) Rule 14a-11 is not applicable to the company, (2) the nominating shareholder or group or nominee failed to satisfy any of the eligibility requirements in Rule 14a-11(b), or (3) including the nominee would result in the company exceeding the maximum number of nominees it is required to include. A company may also exclude a statement in support of a nominee, but not the nominee, if the statement exceeds the 500 word limit for a nominee.

The SEC proposed a dispute-resolution process similar to that used in connection with Rule 14a-8. Important steps in the process would include the following:

- if the company will include the nominee(s) in the proxy materials, it must so notify the shareholder or group making the nomination not later than 30 days before it files its definitive proxy statement;
- if the company determines that any of the eligibility requirements have not been satisfied and it intends to seek to exclude the nominee(s), it must provide notice of its basis for exclusion to the shareholder or group making the nomination no later than 14 days after the deadline for nominations;
- the shareholder or group has 14 days from receipt of the company's notice to respond, and it can make certain changes in response to the company's notice (although it cannot change the composition of the group making the nomination or the identity of the nominee(s));
- if after reviewing the response of the shareholder or group the company determines that the nomination(s) may still be excluded, the company must

provide notice of the basis for its determination to the SEC no later than 80 days before it files its definitive proxy statement;

- the nominating shareholder or group may submit a response to the SEC not later than 14 days after receipt of the company's notice to the SEC;
- if requested by the company, the SEC staff would, at its discretion, provide a no-action letter as an informal statement of its views; and
- promptly following receipt of the SEC staff's informal statement of its views, the company would give final notice of its intent to include or exclude the nominee(s) to the shareholder or group making the nomination.

Solicitations by Nominating Shareholder or Group. Shareholders may engage in communications relating to nominees under Rule 14a-11 to attempt to form a group. Such communications would normally constitute proxy solicitations subject to the SEC's proxy rules. As part of its new access rules, the SEC adopted Rule 14a-2(b)(7) to provide an exemption from the applicable proxy requirements for communications in connection with the formation of a nominating shareholder group, as long as (1) the shareholder making the communication is not holding the company's securities with a purpose, or with the effect, of changing control of the company or gaining a number of board seats in excess of the maximum number under Rule 14a-11, and (2) any written communications are limited to certain specified content. Any such written soliciting material must be filed on Schedule 14N with the SEC no later than the date first published, sent or given to shareholders. In addition, a Schedule 14N must be filed upon the commencement of any oral solicitation.

The SEC also adopted an exemption from its proxy soliciting rules to allow communications by a nominating shareholder or group in support of its nominee(s) after the shareholder or group has received notice that its nominee(s) will be included in the company's proxy materials. Rule 14a-2(b)(8), which provides the exemption, does not allow the soliciting party to seek directly or indirectly any power to act as a proxy. Each written communication must contain certain information, and any written communication must be filed with the SEC on a Schedule 14N.

Effective Date of Proxy Access. The proxy access rules will be effective 60 days after publication of the rules in the Federal Register, which should result in an effective date in early November. Rule 14a-11 will apply immediately for any

meeting as to which the 120- day deadline to submit nominees has not passed, as long as the 120-day deadline is met.

Amendment to Rule 14a-8(i)(8)

In addition to Rule 14a-11 to provide shareholder access to nominate directors, the SEC also amended Rule 14a-8(i)(8). Rule 14a-8(i)(8) allows a company to exclude from its proxy materials a shareholder proposal that relates to a nomination or election for membership on the company's board of directors or a procedure for such nomination or election. In November 2007 the SEC had adopted an amendment to explicitly provide that shareholder access proposals can be excluded under Rule 14a-8. The SEC has now reversed its November 2007 rule change and amended Rule 14a-8(i)(8) to explicitly permit shareholder proposals relating to proxy access in the form of bylaw amendments and requests for bylaw amendments. The amendment to Rule 14a-8(i)(8) also provides that a company may exclude a shareholder proposal under Rule 14a-8(i)(8) if the proposal: (1) would disqualify a nominee who is standing for election, (2) would remove a director from office before his or her term has expired, (3) questions the competence, business judgment or character of one or more nominees, (4) seeks to include a specific individual in the company's proxy materials for election to the board, or (5) otherwise could affect the outcome of the upcoming election of directors.

¹ The SEC's promulgating release, "Facilitating Shareholder Director Nominations," Release No. 33-9136, weighs in at over 450 pages.

² For example, NASDAQ Rule 5605(a)(2) excludes from the definition of "independent director" any person who has a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

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