Securities Alert: Proxy Access Becomes a Reality

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Mintz Levin to conduct free client webinar on new rule on October 27, 2010

In a much-anticipated and hotly debated development, the Securities and Exchange Commission (the "SEC" or the "Commission") has issued Rule 14a-11 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), facilitating access by shareholders to public companies' proxy statements in order to propose nominees for election to the Board of Directors. The rule, originally proposed by the SEC in May 2009 and explicitly authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), will take effect on November 16, 2010.[1] Therefore, companies that mailed their definitive proxy materials on or after March 15, 2010 will be subject to Rule 14a-11 for their 2011 annual meetings, since the nomination window (as described below) for such companies will be open for all or a portion of the time provided for nominations by Rule 14a-11. Mintz Levin's Securities Practice Group will conduct a free webinar on the new rule on October 27, 2010, which will include practical pointers and strategies for addressing the reality of proxy access for the 2011 proxy season.

The topic of allowing shareholders to use companies' proxy statements to propose their own nominees for director seats, as opposed to requiring shareholders to undertake the costly and time-intensive process of preparing and filing a separate proxy statement to propose a competing slate of directors, has been the source of intense debate in recent years. Advocates on both sides of the issue have been highly vocal, and the volume of comments submitted in response to the SEC's proposed proxy access rule was evidence of the ardor of the opposing camps. The enactment of the Dodd-Frank Act in July 2010 largely settled the question of whether proxy access would become a reality. Promulgation of a proxy access rule has been a top priority of the SEC, and there was no question that the SEC would act quickly on the invitation presented to it in the Dodd-Frank Act to implement this rule. As SEC Chairman Mary Schapiro noted in a statement on the issuance of the rule, "[a]s a matter of fairness and accountability, long-term significant shareholders should have a means of nominating candidates to the boards of the companies that they own."

In the Adopting Release for the new rule, the SEC acknowledged the past vigorous debate over whether regulating proxy access was within the SEC's scope of authority. However, the SEC also noted that the mandate provided by the Dodd-Frank Act "removed any doubt" as to the SEC's authority to adopt new Rule 14a-11. The SEC further stated its belief that the rule is appropriate in order to remove "significant obstacles to effectively exercising [shareholder] rights to nominate and elect directors to corporate boards." As a result of the legislative action by Congress and the regulatory action by the SEC, proxy access, while still controversial, is a development in shareholder suffrage whose time has come.

As noted earlier, the proxy access rule will take effect on November 16, 2010. As a result, because the rule requires shareholders to submit director nominations within a window starting 150 days before and ending 120 days before the anniversary of the date that the company mailed its proxy materials for the prior year's annual meeting, whether or not a company may receive director nominations under Rule 14a-11 for its next annual meeting will depend on when the company mailed its proxy materials for its last annual meeting. For example, if a company mailed the proxy materials for its last annual meeting on April 30, 2010, Rule 14a-11 nominations for that company would be due between December 1-31, 2010 (in time for Rule 14a-11 to apply to its 2011 annual meeting).

Inclusion of Shareholder Nominees in Company Proxy Statements

The Adopting Release creates new Rule 14a-11, which will allow eligible shareholders to include nominees for director in a company's own proxy materials, unless the shareholders are prohibited by state or applicable foreign law, or by a company's charter or bylaws, from nominating a candidate for election as a director.

Which companies are subject to the rule?

The proxy access rule applies to all domestic companies, including investment companies and controlled companies, which are required to file reports under the Exchange Act, other than companies whose only public securities are debt securities. Smaller reporting companies will be subject to the rule after a three-year phase-in period. Foreign private issuers will not be subject to the rule.

In a change from the proposed rule, the final rule does not permit a company to "opt out" of the proxy access requirements, nor does it require a company to "opt in" to the requirements. Rather, it requires that as long as a state's corporate law and a company's governing documents provide shareholders with the ability to make director nominations, new Rule 14a-11 will provide those shareholders with access to the company's own proxy statement for purposes of facilitating those nominations. Conversely, if a state's corporate law were ever to provide that shareholders did not have the right to nominate directors, Rule 14a-11 would no longer require companies incorporated in that state to include shareholder nominees in their proxy statements.[2]

Which shareholders may propose nominees under Rule 14a-11?

In order to take advantage of the right to include nominees in a company's proxy materials, a shareholder or group of shareholders must:

- own at least three percent (3%) of the total *voting and investment* power of the company's securities that are entitled to be voted on the election of directors at the annual meeting, as of the date on which the nomination is submitted. Shareholders will be able to form groups in order to aggregate their holdings to meet this threshold;[3]

- have held the qualifying amount of securities for at least three (3) years preceding the date on which the nomination is submitted; and
- continue to own at least the required amount of securities through the date of the meeting at which directors are elected.

Further, shareholders will not be eligible to use the rule if they are holding the securities for the purpose of changing control of the company, or to gain a number of seats on the board of directors that exceeds the number of nominees a company is required to include under Rule 14a-11, as described below. The nominating shareholder also may not have entered into any agreements with the company with regard to the nominations prior to filing the notice of proposed nominees. Discussions or negotiations between the nominating shareholder and the company with regard to potential nominees that do not result in the inclusion by the company in its proxy statement of the shareholder's nominees for director will not be considered an "agreement" for this purpose. However, if a shareholder files a notice of proposed nominees, and the company decides to include any of the shareholder's nominees in its proxy statement as company nominees (as opposed to presenting the nominees as shareholder-nominated candidates), then those nominees will count towards the limitation on the number of nominees under Rule 14a-11, as described below.

The 3% ownership requirement represents a significant change from the rule as originally proposed, which would have based eligibility to submit a nomination on tiered ownership thresholds, depending on the size of the company. Under the proposed rule, shareholders owning as little as 1% of a large accelerated filer (a company with a worldwide public float market value of $700 million or more) for one year could have proposed nominees.

For purposes of calculating the voting power owned in order to establish eligibility to submit a nomination, shareholders would be able to include securities that had been loaned to a third party, but would not be able to include securities that had been sold short. In addition, for this purpose, shareholders may not include securities that could be acquired under exercisable options or other convertible securities, but that have not yet been acquired. Shareholders may include votes attributable to shares that have been loaned out to third parties only if those shares may be recalled by the loaning shareholder, and the shareholder will recall those shares if the shareholder's nominees will be included in the company's proxy statement.

If a state's corporate law or a company's governing documents contain proxy access requirements that are more difficult for shareholders to satisfy than those set forth in Rule 14a-11, the more liberal requirements of Rule 14a-11 will apply instead. For example, if a company's certificate of incorporation were to provide for proxy access only if a shareholder owned 5% of a company's outstanding voting power, the effect of Rule 14a-11 would be to lower that threshold to 3%.

Would a shareholder proponent be required to have satisfied the 3% ownership threshold continually for three years?

No. The 3% voting and investment power threshold needs only to be satisfied as of the date of filing the Schedule 14N (described below). A disqualification would not result from the

shareholder's actual percentage ownership of the shares being less than 3% at any time during the three-year period. However, the shareholder will be required to have held the number of shares that satisfies the 3% ownership threshold as of the date of filing for a three-year period.

Are shareholder nominees under Rule 14a-11 required to be independent?

Shareholder nominees would be required to be independent of the company, as defined by the objective independence standards of the national securities exchange or national securities association on which the company's securities are listed. The final rule does not require the nominee to meet any subjective independence standards or any more stringent independence definitions that are applicable to committee members (such as the audit committee). If a company is not listed on a national securities exchange, this requirement would not apply to director nominations for that company under the rule.

Nominees also are not required to satisfy a company's director qualification standards in order to be nominated under Rule 14a-11. However, in the newly required disclosure document with respect to the nominations, Schedule 14N, the shareholders making the nominations are required to state whether, to the best of their knowledge, each nominee does meet those qualification standards, if any, as described in the company's governing documents.

Nominees are not required to be independent of the nominating shareholder. This represents a change from previously proposed proxy access rules. However, the Schedule 14N is required to disclose any relationships between the nominating shareholder and each nominee.

How many nominees can be proposed by shareholders under Rule 14a-11?

Rule 14a-11 sets a limit on the number of nominees that can be proposed by a shareholder equal to the greater of one nominee or up to 25% of the total seats on a company's board of directors. Accordingly, if a board is comprised of three members, one shareholder nominee could be included in the company's proxy materials. If a board is comprised of eight members, up to two shareholder nominees could be included under Rule 14a-11 in the company's proxy materials. If the 25% calculation does not result in a whole number, the maximum number of nominees allowable under Rule 14a-11 will be the closest whole number of nominees below 25%. For example, if a board has nine members, the maximum number of Rule 14a-11 nominees will be two. If a company has a staggered (or classified) board of directors, the number of potential director positions for which nominations can be made under Rule 14a-11 is still based on the total number of seats on the board of directors, not on the number of seats that are up for election at any given meeting.

If a company has a staggered board, and if the term of a director who was nominated to the board pursuant to Rule 14a-11 continues after the date of a shareholder meeting at which directors are to be elected, that director will count towards the total maximum number of directors that could be nominated pursuant to Rule 14a-11.

Rule 14a-11 does not limit the rights of shareholders to conduct "traditional" proxy contests, in which a shareholder proponent finances and files a proxy statement relating to the election of its

own competing slate of candidates. However, a shareholder proponent may not take part in more than one Rule 14a-11 nomination process per year for the same company.

Further, Rule 14a-11 does not impose a limit on the number of times that a nominee can be re-proposed as a candidate by the same shareholder or group of shareholders, even if the shareholder nominee does not garner a significant amount of support from the company's shareholders.

What process must be followed by a shareholder in order to propose a nominee under Rule 14a-11?

In order to propose director nominees pursuant to Rule 14a-11, the nominating shareholder or group will be required to submit a new filing, to be known as a *Schedule 14N*, to the SEC and to the issuer, including the following information:

- the amount and percentage of the voting power of the company's securities that is entitled to be voted by the nominating shareholder;
- how long the shareholder has owned those securities;
- information about the nominating shareholder and the shareholder's nominees, including a description of the relationship between the nominating shareholder and the nominees;
- whether each nominee satisfies the company's director qualifications, as outlined in the company's governing documents;
- a statement as to the shareholder's intent to continue to hold the securities through the date of the shareholder meeting, and a statement regarding the shareholder's intended ownership of the securities following the election of directors at the meeting;
- certifications to the effect that:
    - the nominating shareholder is not seeking to change the control of the company or to gain more than the maximum number of seats on the board of directors that the company could be required to include under Rule 14a-11;
    - the nominating shareholder satisfies the requirements of Rule 14a-11; and
    - each nominee's candidacy or board membership would not violate applicable state or federal law, or rules of a national securities exchange, and the nominee satisfies the objective criteria for independence applicable to the company under the rules of the national securities exchange on which the company's shares are listed; and
- if desired, a statement, not exceeding 500 words, of support for each shareholder nominee.

If the nominating shareholder is not the registered owner of the shares, the shareholder must also attach to the Schedule 14N a written statement, dated within seven calendar days of the date of filing of the Schedule 14N, from the registered holder, broker or bank verifying the shareholder's ownership of the shares. Alternatively, if the shareholder has filed a Schedule 13G, Schedule 13D, or Form 3, 4 or 5 reporting its ownership of the company's securities, those filings may be attached or incorporated by reference into the Schedule 14N as support for the ownership.

Any written material used by the nominating shareholder in soliciting votes for its nominees must be filed with the SEC under cover of a Schedule 14N, with copies sent to the company and the stock exchange on which the company's securities are listed, on the date of first use of the written material. Oral soliciting material is not subject to the same filing requirement, but shareholders must file notice of the commencement of oral solicitations under cover of Schedule 14N on the date such solicitations begin.

Rule 14a-11 provides that the nominating shareholder will be liable, for purposes of the securities laws, for any statement included in the Schedule 14N that is false or misleading with respect to any material fact, or that omits to state any material fact necessary to make the statements therein not false or misleading. Further, a company will not be responsible for any information that is provided by the nominating shareholder for inclusion in the company's proxy statement.

When must the Schedule 14N be filed by the nominating shareholder?

In order to be timely, the Schedule 14N will have to be filed with the SEC and transmitted to the company no earlier than 150 days prior to the anniversary of the company's mailing of its prior year's annual meeting proxy statement, and no later than 120 days prior to that date.

If the company did not hold an annual meeting during the previous year, or if the date of the annual meeting has changed by more than 30 calendar days from the previous year, the deadline for submitting a Schedule 14N will instead be "a reasonable time" before the company mails its proxy materials for that meeting. In order to establish the deadline to be used under these circumstances, the rules create a new Form 8-K requirement. New Item 5.08 of Form 8-K will require companies to disclose the date by which shareholders must submit a Schedule 14N, within four business days after the company determines the expected annual meeting date, if there was no meeting during the prior year or the date of the meeting has changed by more than 30 calendar days.

What if the company receives nominations from more than one shareholder?

Rule 14a-11 provides that if a company receives nominations from more than one eligible shareholder, the company will be required to include the nominee(s) proposed by the shareholder or shareholder group with the largest percentage of the company's voting power. This represents a change from the proposed rule, which would have given priority to the first shareholder to submit a nomination, and is designed to avoid a "race to the mailbox" by proposing shareholders.

If a nominating shareholder withdraws its nomination or is disqualified, and other shareholders have submitted nominations, the company will be required to include the nominee(s) submitted in a timely manner by the eligible shareholder or group having the next largest voting power percentage. However, once a company has started the printing of its proxy materials, it will no longer be required to include a substitute nominee.

What must a company do if it receives a notice on Schedule 14N?

Companies receiving a notice on Schedule 14N will need to evaluate whether or not the notice has included all required information as described above, and whether the shareholder is indeed eligible to make a nomination under Rule 14a-11. If the nominating shareholder fails to satisfy any of the eligibility requirements of Rule 14a-11, a company must notify the shareholder no later than 14 calendar days after the conclusion of the window period for submitting a nomination pursuant to Rule 14a-11. The nominating shareholder will then have 14 calendar days to respond to the deficiency notice and to cure the specified defects, if it is possible to do so.

If there are no deficiencies in the notice and the shareholder is eligible to submit nominations, the company will be required to include information with regard to each eligible nominee, including biographical information and the nominating shareholder's statement of support for the nominee, in its proxy statement. The company must also notify the nominating shareholder of its decision to include the nominees in its proxy statement no later than 30 calendar days before the company files its definitive proxy statement with the SEC. Note that if any shareholder nominees are included on the company's proxy card pursuant to Rule 14a-11, the company may not provide an option under which shareholders can vote for or against all company nominees as a group. Rather, in that circumstance the proxy card would be required to allow shareholders to vote for or against each nominee—whether nominated by the company's Board or by a nominating shareholder—individually.

If a company receives a notice on Schedule 14N, does that mean that it must file its proxy statement in preliminary form?

No. Inclusion of shareholder nominees for director under Rule 14a-11 will not require the company to file its proxy statement in preliminary form.

On what basis may a company exclude a nominee under Rule 14a-11?

The following grounds may be used to exclude a shareholder nominee under Rule 14a-11:

- Rule 14a-11 does not apply to the company;
- the nominating shareholder or group or nominee does not satisfy the eligibility requirements to use Rule 14a-11; or
- the number of individuals nominated exceeds the maximum number of nominees the company is required to include in its proxy statement under Rule 14a-11.

A nominee will not be required to be included in a company's proxy statement under Rule 14a-11 if his or her candidacy or board membership would violate federal law, state law, or applicable stock exchange requirements.

A company may also exclude a supporting statement provided by the shareholder proponent in support of a nominee if the statement exceeds 500 words for each nominee. If all other eligibility

requirements are satisfied, the company will still be required to include information about the nominee in its proxy statement, but will be permitted to exclude the supporting statement.

No later than 80 calendar days prior to the filing of the definitive proxy statement with the SEC, the company must notify the proposing shareholder of its intent to exclude the nominee or nominees and must notify the SEC of the basis for its decision. A company may, but is not required to, apply to the SEC for a no-action letter in connection with its decision to exclude a shareholder nominee.

Can shareholders form groups to propose nominees?

Yes. Under Rule 14a-11, shareholders may join together in groups, aggregating their shares in order to collectively satisfy the 3% test for nominations. In addition, as long as the procedures described below are satisfied, shareholders who wish to band together with others to propose nominees may solicit each other's participation in such a group without the need to file a proxy statement relating to that solicitation. In order to take advantage of this provision, shareholders must not have the intent to change the control of the company or to obtain a number of board seats that exceeds the maximum number allowable under Rule 14a-11. In addition, shareholders will lose the ability to use this provision if they undertake soliciting activities outside the scope of Rule 14a-11 or join a Section 13(d) group with others who are undertaking such activities.

What must shareholders do in order to form a group?

If a shareholder intends to solicit participation in a Rule 14a-11 nominating shareholder group, it must file a Schedule 14N with the SEC and with the company, including no more than the following information, no later than the date the soliciting material is first published, sent or given to shareholders:

- a statement of each soliciting shareholder's intent to form a nominating shareholder group under Rule 14a-11;
- a description of the nominating group's potential nominees or, if the group has not yet identified potential nominees, the characteristics of the nominees that the shareholders intend to nominate;
- the percentage of voting power that the soliciting shareholders hold as of the date of the Schedule 14N; and
- contact information for the soliciting shareholders.

If, however, a shareholder is soliciting a group of 10 or fewer people to participate in a nomination process pursuant to Exchange Act Rule 14a-2(b)(2), that shareholder will not be required to file a Schedule 14N relating to its solicitation of potential participants in the group, as long as the number of solicited participants remains not more than 10.

Shareholder Proposals to Modify Company Nomination Procedures

The rules also amend Exchange Act Rule 14a-8(i)(8) in order to provide that shareholders can require companies, under certain circumstances, to include proposals in their proxy materials that seek to establish procedures in companies' governing documents relating to nomination procedures. This would mean, for example, that shareholders could propose resolutions to require a company to amend its bylaws in order to specify particular procedures by which shareholders can propose director nominees. Prior to the amendments, Exchange Act Rule 14a-8(i)(8) allowed exclusion of shareholder proposals that "relate to an election." The changes to Rule 14a-8(i)(8) narrow this exclusion, and provide that companies must include proposals relating to such procedures as long as the procedural requirements of Rule 14a-8 are met and the proposal may not be excluded for any other substantive reason under that rule.

Under Rule 14a-8(i)(8) as revised, companies may only exclude shareholder proposals relating to an election if they:

- would disqualify a nominee who is standing for election;
- would remove a director from office before his or her term expires;
- 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; or
- otherwise could affect the outcome of the upcoming election of directors.

As an example of the effect that this rule as revised may have in practice, shareholders who believe that the 3% voting power threshold provided for in Rule 14a-11 is too high may propose amendments to a company's bylaws to provide for a lower threshold to apply to that company.

In order to submit a proposal under this amended rule, a shareholder proponent will be required to have continuously held at least $2,000 in market value (or 1%, whichever is less) of the company's securities entitled to be voted on the proposal at the meeting, for a period of one year prior to submitting the proposal. These are the same eligibility provisions currently set forth under Rule 14a-8 for shareholder proposals generally.

Steps to Consider Now

Evaluate whether your company is a likely target of proxy access, and consider outreach to potential shareholder dissidents. Based on commentary on this new rule to date, we believe that it is unlikely that large institutional investors and hedge funds will be the principal shareholders to take advantage of the rule, in part because those holders typically have the means to launch and conduct their own proxy contests without accessing the company's own proxy materials, and in part because those holders typically do not want to refrain from seeking to change the control of the companies they target. This likely leaves smaller investors, activist holders (such as unions and pension funds), and disgruntled investors of all backgrounds as the

potential users of this new power. Now is an opportune time to review your shareholder lists to determine which shareholders, who have owned your company's securities for at least three years, may have expressed dissatisfaction with the company and may be inclined to propose director nominees. Keep in mind that shareholders holding less than 3% of the voting power may band together to form a group holding more than the eligibility threshold in order to take advantage of the rule, so smaller shareholders should be identified for potential interaction as well. Proactively initiating a discussion about their concerns now may help to preempt a Schedule 14N filing. A proxy solicitor may also be able to provide further insight as to the likelihood of the usage of this new power by particular shareholders.

Review and consider revising advance notice bylaws. Companies should ensure that the provisions included in their bylaws with respect to shareholder proposals and nominations work together with the deadlines and procedures set forth in new Rule 14a-11. The new rule may create overlapping and even conflicting deadlines, and having a clear understanding in advance of which proposals may be submitted by which deadlines will be critical to a smooth annual meeting process. Note that any pre-existing advance notice bylaw provisions relating to director nominations will not trump or override Rule 14a-11, but rather will simply provide an alternative means of proposing director candidates (although one without the same leverage to require a company to include a nominee in the company's proxy statement).

Review director skills and qualifications, and evaluate current directors in light of those guidelines. Companies are now required to disclose the specific skills, qualifications and experience that each individual director brings to his or her service on the board. With the advent of the proxy access rule, which may facilitate the addition of potential new nominees at next year's annual meeting, now is a good time to consider whether the company truly does have the best mix of skills, backgrounds, and expertise represented on its board in order to serve the best interests of shareholders and to survive a potentially contested election. In addition, consider whether to add specific director qualifications to the company's bylaws, so that any failure of a Rule 14a-11 nominee to meet those qualifications can be described in the proxy statement as a reason why the nominee should not be elected.

Ensure that disclosure controls and procedures are updated to reflect the new Form 8-K reporting requirement. The new requirement under Item 5.08 of Form 8-K will necessitate the filing of a Form 8-K if the date of a company's annual shareholder meeting changes by more than 30 calendar days from the prior calendar year. A late Form 8-K filing would result in a company not being current or timely in its Exchange Act filings. Disclosure controls and procedures should be updated to ensure that any such change is noted and reported accordingly.

Review and consider revising nominating committee charters. Many companies' forms of nominating committee charter contain procedures, deadlines and ownership thresholds to be complied with by shareholders in submitting candidates to be considered as director nominees. Companies should consider clarifying in their charters that such procedures will not apply to nominations submitted pursuant to Rule 14a-11.

Review and consider input from institutional shareholder advisory groups, such as ISS. It remains to be seen whether and if so, to what extent, having received a negative corporate

governance rating from a service such as ISS may have an impact on the likelihood and/or success of any shareholder campaign under Rule 14a-11. However, companies should review any negative reports or assessments received from ISS or other, similar services with a view to anticipating and, if deemed appropriate, addressing any potential areas of vulnerability from a corporate governance standpoint that could become fodder for activist shareholders, who could use those areas as grounds on which to launch a Rule 14a-11 nomination process.

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We look forward to discussing further aspects of these rules at our webinar on October 27th. In the meantime, please contact the Mintz Levin attorney who handles your securities compliance matters if you have any questions regarding these new rules.

Endnotes

[1] Please see our July 21, 2010 Client Alert on these rules in their proposed form. The text of the Adopting Release is available at http://www.sec.gov/rules/final/2010/33-9136.pdf.

[2] The SEC notes in the Adopting Release that it does not know of any state with such a prohibition in its laws.

[3] As used herein, references to a nominating shareholder also refer to nominating shareholder groups, as appropriate.

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