MORRISON | FOERSTER

Legal Updates & News

Legal Updates

SEC Issues Proposing Release for Rules to Permit Shareholder Access to a Company's Proxy Statement for Director Nominations

June 2009
by Lawrence R. Bard, David M. Lynn

Related Practices:

- Corporate
- Public Companies & Corporate Governance

On May 20, 2009, a divided Securities and Exchange Commission (the "SEC") proposed changes to the federal proxy rules to permit shareholders to include their director nominations in a public company's proxy statement under certain conditions.[1] The proposal was approved by a 3-2 vote along party lines.

The proposal would create a new Rule 14a-11 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and modify Exchange Act Rule 14a-8(i)(8). Under proposed new Rule 14a-11, certain shareholders would have access to a company's proxy statement to nominate director candidates, unless the shareholders are otherwise prohibited from doing so by either state law or the company's charter or bylaws. Under the proposed amendment to Rule 14a-8(i)(8), qualifying shareholders would be able to submit shareholder proposals seeking to amend, or request an amendment of, provisions of the company's governing documents addressing the company's director nomination procedures.

On June 10, 2009, the SEC posted the proposing release, titled "Facilitating Shareholder Director Nominations," to its website.[2] At 250 pages, the Proposing Release is a comprehensive review of the topic and includes close to 500 questions on which the SEC has requested comment. This alert provides the background of the proposed rules and discusses the highlights of the Proposing Release.

Background

Shareholder access is one of the most significant corporate governance issues today. Proponents of shareholder access have been demanding increased access, while companies vigorously assert that shareholders are adequately protected by existing corporate governance standards. Under the current proxy rules, shareholders do not have the right to include director nominees in a company's proxy statement. Instead, a shareholder seeking to nominate its own directors must engage in a potentially expensive proxy contest using the shareholders' own proxy materials.

The SEC most recently attempted to address this issue in both 2003 and 2007 by proposing rules that

would have granted shareholders access rights, or the right to propose bylaw amendments that would permit shareholders to have director nominees included in the company's proxy statement. The 2003 proposal would have required companies to include up to three director nominees proposed by shareholders in the company's proxy statement upon the occurrence of specified triggering events (e.g., the receipt of greater than a 35% "withhold" vote in a director election, or the approval of a shareholder proposal to require access). The 2007 proposal would have required companies to include shareholder proposals for bylaw amendments regarding director nomination procedures in the company's proxy statement if the nominating shareholder owned more than 5% of the voting securities of the company, held such securities for more than one year, and was eligible to file a Schedule 13G.

In both 2003 and 2007, after receiving strong criticism of the proposals from, among others, those who perceived the SEC to be encroaching on an area of corporate governance better left to state law, the SEC chose not to adopt the proposals. Instead, the SEC adopted an alternative proposal in 2007 that amended the proxy rules to clarify that Rule 14a-8(i)(8) permits companies to exclude from their proxy statement any shareholder proposals that would result in a contested election in the year of the proposal or in future years.

On April 10, 2009, Delaware addressed the shareholder access debate by enacting new Section 112 of the Delaware General Corporation Law, which will allow Delaware corporations to adopt bylaws requiring the company to include in its proxy materials one or more candidates nominated by shareholders for election to the company's board of directors. Bylaws adopted under new Section 112, which will become effective on August 1, 2009, may include conditions related to such shareholder nominations, including minimum stock ownership, duration of ownership, and a limitation on the number of directors that can be nominated.

On May 19, 2009, a day before the scheduled meeting at which a divided SEC approved the rule proposal, the far-reaching "Shareholder Bill of Rights Act of 2009" was introduced in the U.S. Senate, which would establish, among other things, parameters for the SEC to set rules allowing easier shareholder access to company proxy solicitation materials for purposes of nominating directors.[3]

Highlights of the SEC's Proposal

The proposed requirements related to shareholder access would be included in a new Rule 14a-11 and the proposed changes regarding shareholder proposals would be included in an amendment to Rule 14a-8(i)(8). The Proposing Release draws heavily upon the public record from the SEC's 2003 and 2007 proposals, as well as from Roundtables held by the SEC in connection with both proposals.

1. Proposed Rule 14a-11

Under Proposed Rule 14a-11, companies would be required, under certain circumstances, to include shareholder nominees for directors in the companies' proxy materials. Proposed Rule 14a-11 would apply to all Exchange Act reporting companies with a class of equity securities registered under the Exchange Act, other than companies that are subject to the proxy rules solely because they have a class of debt registered under Section 12 of the Exchange Act. The requirement to include shareholder nominees in a company's proxy materials would apply unless state law or the company's governing documents prohibited shareholders from nominating directors. As discussed below, under proposed revisions to Rule 14a-8(i)(8), if a company's governing documents prohibit shareholder nominations, shareholders may submit a shareholder proposal to amend those prohibitions.

The proposal includes both a minimum level of ownership requirement, which would be scaled based on the size of the company, and a duration of ownership requirement. In particular, shareholders would be eligible to have their director nominees included in the company's proxy materials if they own:

- 1% or more of the securities entitled to be voted on the election of directors of a company that is a "large accelerated filer" as defined in Exchange Act Rule 12b-2 (companies with an aggregate worldwide market value of $700 million or more) or a registered investment company with net assets of $700 million or more;
- 3% or more of the securities entitled to be voted on the election of directors of a company that is an "accelerated filer" as defined in Exchange Act Rule 12b-2 (companies with an aggregate

worldwide market value of $75 million to less than $700 million) or a registered investment company with net assets of $75 million to less than $700 million; or

- 5% or more of the securities entitled to be voted on the election of directors of a company that is a "non-accelerated filer" as defined in Exchange Act Rule 12b-2 (companies with an aggregate worldwide market value of less than $75 million) or a registered investment company with net assets of less than $75 million.

Shareholders would be permitted to aggregate their holdings to meet the threshold requirements. In addition, a shareholder (or each shareholder in the case of a group) would be required to have held their securities for at least one year as of the date the shareholder provides notice on proposed new Schedule 14N, and represent that they will hold their shares through the annual meeting (or special meeting) to be eligible to include their nominees in a company's proxy materials. The proposed rules also would require a nominating shareholder (or group) to state their intent with respect to continued ownership of their shares after the election.

The proposal contains other important limitations on shareholder eligibility for access. Among other requirements, the nominating shareholder (or group) must:

- Not acquire or hold the securities for the purpose of or with the effect of changing control of the company or to gain more than a limited number of seats on the board;

- Provide and file with the SEC a notice to the company on Schedule 14Nof the nominating shareholder's (or group's) intent to require that the company include that nominating shareholder's (or group's) nominee in the company's proxy materials by the date specified by the company's advance notice provision;[4] and

- Include in the shareholder notice on Schedule 14N representations required by the new Rule 14a-18 as discussed below.

A company would not be required to include a shareholder nominee in its proxy materials if the nominee's candidacy or, if elected, board membership would violate controlling state law,federal law,or rules of a national securities exchange or national securities association (together, "Listing Standards").[5] With respect to the director independence requirements of applicable Listing Standards, the proposed rules would provide an important exception. In particular, to the extent a Listing Standard has an independence requirement based on a subjective determination by the board or committee of the board, such as requiring that the board of directors make a determination that the nominee has no material relationship with the listed company, this element of an independence requirement would not have to be satisfied. Instead, the application of the independence requirement is limited to a representation from the nominating shareholder (or group) that to the knowledge of the nominating shareholder (or members of the group) the nominee is in compliance with the generally applicable objective requirements included in the independence requirements of the listing standards.[6]

The maximum number of director candidates that all shareholders would be allowed to nominate is capped at the greater of 25% of the company's board of directors and one director. In the event more than one qualified shareholder is requesting nominations, and the number of shareholder nominees would exceed this cap, the company would be required to include the nominee(s) of the first qualified shareholder from which the company received timely notice of an intent to nominate a director(s). If the first such shareholder does not nominate the maximum number of directors, the nominee(s) of the next such shareholder would be included.[7] To prevent the company and its management from blocking usage of the proposed rule by causing shareholders to submit company-backed nominees, each nominating shareholder (or each member of the group) would be required to represent on its Schedule 14N that neither the nominee nor the shareholder (or member of the group) has an agreement with the company regarding the nomination.

Proposed Schedule 14N – Notice and Disclosure

As noted above, proposed Rule 14a-11 would require that a nominating shareholder (or group) provide a notice to the company on new Schedule 14N, which also would be required to be filed with the SEC. The

new Schedule 14N would require:

- The name and address of the nominating shareholder (or each member of the group);
- Information regarding the amount and percentage of securities beneficially owned and entitled to vote at the meeting;
- Where the nominating shareholder is not a registered holder of the shares, a written statement from the record holder of the shares beneficially owned by the nominating shareholder (or each member of the group) verifying that, as of the date of the shareholder notice on Schedule 14N, the shareholder continuously held the securities for at least one year;[8]
- A written statement of the nominating shareholder's (or group's) intent to continue to own the requisite shares through the shareholder meeting at which directors are elected. Additionally, the nominating shareholder (or group) would provide a written statement regarding the nominating shareholder's (or group's) intent with respect to continued ownership after the election;
- A certification that to the best of the nominating shareholder's (or group's) knowledge and belief, the securities are not held for the purpose of, or with the effect of, changing the control of the issuer or gaining more than a limited number of seats on the board of directors;
- A representation that the nominating shareholder (or group) is eligible to submit a nominee under Rule 14a-11;
- A representation that, to the knowledge of the nominating shareholder (or group), the candidate's nomination or initial service on the board, if elected, would not violate controlling state law, federal law, or applicable Listing Standards (other than standards relating to independence as discussed above);
- A representation that the nominee meets the objective criteria for independence from the company that are set forth in applicable Listing Standards;
- A representation that neither the nominee nor the nominating shareholder (or any member of the group) has an agreement with the company regarding the nomination of the nominee;
- A statement from the nominee that the nominee consents to be named in the company's proxy statement and to serve on the board if elected;
- Certain disclosures about the nominee and nominating shareholder (or group members) complying with existing requirements of Exchange Act Schedule 14A;
- Disclosure about whether the nominating shareholder or member of a nominating shareholder group has been involved in any legal proceeding during the past five years, as specified in Item 401(f) of Regulation S-K;
- Certain disclosures regarding the nature and extent of the relationships between the nominating shareholder (or group) and nominee and the company or any of its affiliates;
- Disclosure of any website address on which the nominating shareholder or group may publish soliciting materials; and
- If desired for inclusion in the company's proxy statement by the nominating shareholder, a statement of up to 500 words in support of the nominee(s).

Company Requirements

A company that receives a shareholder nomination pursuant to proposed Rule 14a-11 would need to determine if there was a basis to exclude the shareholder nominee from the company's proxy materials. An elaborate set of procedural requirements would govern the process for exclusion of a nominee, comparable to the process for seeking to exclude shareholder proposals under Rule 14a-8. If the company determines that the shareholder or nominee is not eligible, it would be required to notify the shareholder, with an explanation of the basis for exclusion, within 14 calendar days. The nominating shareholder would then have 14 calendar days to respond and correct any eligibility or procedural deficiencies. Changes to the members of the group or the nominee cannot be made in order to correct a deficiency. If the company determines that it still may exclude the nominee, it must provide notice to the SEC and the shareholder no later than 80 calendar days (subject to extension for good cause) before it files its definitive proxy statement with the SEC. The nominating shareholder could submit a response to that notice within 14 calendar days and the SEC staff would, in its discretion, provide an informal statement of its views (a no-action letter) to the company and the shareholder. The company would then provide a final notice to the shareholder of whether it will include the nominee(s), no later than 30 calendar days before it files its definitive proxy statement.[9] All materials submitted to SEC would be publicly available upon submission.

If the shareholder nominee(s) will not be excluded, the company would disclose information regarding the nominee in the company's proxy statement and include the name of the nominee on the company's proxy card. The company would be permitted to identify the nominee(s) as a shareholder nominee(s) and recommend that shareholders vote for, vote against, or withhold votes on the nominees, but otherwise would be required to present the nominees in an impartial manner. Where a shareholder nominee is included, the company would not be able to follow current practice of providing the option to vote for, or withholding authority to vote for, the company's nominees as a group. If requested by the nominating shareholder, the company also would be required to include a statement by the shareholder in support of the nominee.

Within the limits of the proxy rules, both the company and the shareholder would be permitted to solicit in favor of the nominees outside of the proxy statement.[10] Any soliciting materials would be required to be filed with the SEC on the date of first use.

2. Proposed Narrowing of "Election Exclusion"

The SEC also proposes to amend Rule 14a-8(i)(8), which governs the exclusion of shareholder proposals related to director elections. The proposed amendment to Rule 14a-8(i)(8) would narrow the current "election exclusion," such that all shareholder proposals by qualified shareholders that would amend, or request an amendment to, provisions of a company's governing documents concerning director nomination procedures or other director nomination disclosure provisions (provided that those disclosure provisions do not conflict with proposed Rule 14a-11) would not be excludable. The shareholder proposal would still need to meet the procedural requirements of Rule 14a-8 and not be subject to one of the other exclusions.

Codification of Prior Staff 14a-8(i)(8) Interpretations

In addition to narrowing the scope of the election exclusion, the SEC proposes to amend Rule 14a-8(i)(8) to expressly allow companies to exclude certain types of proposals that historically have been excludable pursuant to prior staff interpretations. In particular, a company would be able to exclude a proposal under revised Rule 14a-8(i)(8) if the proposal:

- Would disqualify a nominee who is standing for election;
- Would remove a director from office before his or her term expired;
- Questions the competence, business judgment, or character of one or more nominees or directors;

- Nominates a specific individual for election to the board of directors, other than pursuant to Rule 14a-11, an applicable state law provision, or a company's governing documents; or

- Otherwise could affect the outcome of the upcoming election of directors.

3. Disclosures Related to Other Shareholder Nominations

The Proposing Release notes that as a result of shareholder proposals, state law, or provisions adopted by the company, shareholders may have the right to nominate directors that otherwise would not be permitted under Proposed Rule 14a-11. In order to provide full disclosure in such situations, the proposed rules would require the nominating shareholder to file a Schedule 14N that includes specified information regarding the shareholder and the nominee, which information would be required to be included in the company's proxy materials.

4. Other Rule Changes

Several proposed rules or new instructions provide guidance and relief for the interaction between the proposed rules related to shareholder nominations and existing provisions of the federal securities laws. Some of these important changes are discussed below.

New Schedule 13D Exception

The Proposing Release reminds shareholders who come together for the purpose of forming a nominating group that they need to consider whether they have formed a group under Exchange Act Section 13(d)(3) and Rule 13d-5(b)(1). Generally, a person who beneficially owns more than 5% of a class of equity securities registered under Section 12 of the Exchange Act must file a Schedule 13D with the SEC unless they acquired the securities with neither the purpose nor the effect of changing or influencing control of the company. A passive investor may be eligible to report its ownership on a short form Schedule 13G instead of a Schedule 13D.

Under the proposed revisions to these rules, the activities of shareholders or groups solely in connection with a nomination under Rule 14a-11 would not be considered in determining whether a shareholder acquired the securities with neither the purpose nor the effect of changing or influencing control of the company. Notably, this exception applies only to activities in connection with nominations under Rule 14a-11, and would not apply after the election of a director nominated pursuant to Rule 14a-11, or to nominations outside of Rule 14a-11.

"Affiliate" Status Under the Securities Act

Proposed Rule 14a-11(a) addresses whether a nominating shareholder will be considered an "affiliate" of the company under the Securities Act of 1933, as amended. In that regard, an instruction to Rule 14a-11 would provide that a nominating shareholder will not be deemed an affiliate of the company solely as a result of nominating a director or soliciting for such director or against the company's nominees. In addition, the shareholder will not be deemed an affiliate following the election of the shareholder's nominee solely as a result of having nominated that director, if the nominating shareholder does not have an agreement or relationship with that director other than relating to the nomination.

Impact on Proposed Changes to NYSE Rule 452

The New York Stock Exchange ("NYSE") has filed with the SEC a proposed change to amend NYSE Rule 452 related to broker discretionary voting. Under existing NYSE Rule 452, brokers are permitted to use their discretion to vote shares they hold in street name in uncontested director elections. The proposed change to NYSE Rule 452, which was published in the Federal Register in March 2009, would eliminate this authority. As NYSE Rule 452 applies to registered brokers, its application potentially impacts director elections at all public companies and not just companies listed on the NYSE. The Proposing Release requests comment on the impact of the proposed amendment to NYSE Rule 452 in light of the anticipated operation of proposed Rule 14a-11.

Next Steps – SEC Comment Period

As noted above, the Proposing Release includes close to 500 requests for comment. Comments on the proposal are due by August 17, 2009, and commenters should try to respond by that deadline, given the speed with which the SEC is moving forward on rule proposals. Anyone wishing to comment on the proposal should follow the instructions provided by the SEC at: http://www.sec.gov/rules/submitcomments.htm.

The proposal represents a very significant departure from the current proxy rules. Given the populist anger underlying the current debate that is driving a good deal of the political attention on corporate governance, companies should pay close attention to what will certainly be a heated debate during the comment period. While it is difficult to predict what form the rules may ultimately take (if adopted at all), we believe that the SEC will be working toward's putting rule changes in place in anticipation of next year's proxy season.

Footnotes

[1] The SEC's press release, "SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholder to Nominate Directors," dated May 20, 2009, is available at http://www.sec.gov/news/press/2009/2009-116.htm and the Morrison & Foerster legal update discussing the SEC meeting can be found at http://www.mofo.com/news/updates/files/15621.html.

[2] Release No. 34-60089, June 10, 2007, available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf (the "Proposing Release").

[3]For our discussion on the proposed Shareholder Bill of Rights, see "Far-Reaching Shareholder Bill of Rights Introduced in Senate." On June 12, 2009, Congressman Gary Peters (D-MI) introduced the "Shareholder Empowerment Act of 2009," which includes a provision that would direct the SEC to adopt rules requiring companies to identify and provide security holders with an opportunity to vote on candidates for the board of directors who have been nominated by shareholders holding at least 1% of the issuer's voting securities for at least two years prior to a record date established by the company for a meeting of security holders.

[4]If the company does not have an advance notice provision, the deadline would be no later than 120 calendar days before 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 days from the prior year, then the company must provide notice of the date by which a shareholder must submit a notice pursuant to Rule 14a-11, which date shall be a reasonable time before the company mails its proxy materials. The notice must be filed under cover of Form 8-K under proposed new Item 5.07 within four business days after the company determines the anticipated meeting date.

[5] The shareholder nominee would not need to meet the director qualification criteria established by the company's nominating committee or the board of directors.

[6] An example of such objective standards are in Section 303A.02(b) of the NYSE Listed company manual, which provides that a director is not independent if he or she has any of several specified relationships with the company that can be determined by a "bright-line" objective test.

[7] Proposed Rule 14a-1(d)(2) provides that where a company already has a director (or directors) serving on its board who was elected as a shareholder nominee pursuant to Rule 14a-11, and the term of that director extends past the date of the meeting of shareholders for which the company is soliciting proxies for the election of directors, the company would not be required to include in its proxy materials more shareholder nominees than could result in the total number of directors serving on the board that were elected as shareholder nominees being greater than the cap.

[8] This requirement would not be applicable where the shareholder has filed a Schedule13D, Schedule 13G, Form 4, and/or Form 5, or amendments to those documents.

[9] The rules would not require a company to file a preliminary proxy statement solely by virtue of the fact that a shareholder nominee(s) is on the proxy.

[10] The Proposing Release notes that the SEC expects that shareholders would often engage in communications with other shareholders in an effort to form a nominating group that would be deemed solicitations under current proxy rules. To facilitate those communications, the SEC is proposing an exemption from the proxy rules for certain solicitations by or on behalf of a nominating shareholder (or group) that are limited in content and filed with the SEC.
