ALERTS AND UPDATES

SEC Adopts New Rules Providing Proxy Access for Shareholders

September 10, 2010

The U.S. Securities and Exchange Commission (the "SEC") has adopted new rules providing shareholders access to the proxy statements of public companies for the purpose of nominating and soliciting support for a limited number of director nominees.[1] Companies may not, by shareholder action or otherwise, "opt out."[2] For virtually every public company, these rules can have significant effects on the proxy process. Therefore, now is the time for companies to begin planning for the 2011 proxy season.

Effective for 2011 Proxy Season

The new rules will be operative for the 2011 proxy season.[3] The submission of shareholder nominees for inclusion in a company's proxy materials is permitted only during a window period beginning 150 calendar days before the anniversary of the date that the company mailed its proxy materials for the prior year's annual meeting and ending 120 calendar days before that anniversary.[4] If any part of the 2011 window period is open for a subject company after the effective date of the new rules, shareholders of that company will be able to utilize the new rules to submit director nominees for the company's 2011 annual meeting during the remaining window period.

Companies Subject to the Rules

The rules apply to all public companies that are subject to the proxy rules promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"), including registered investment companies, controlled companies and those companies that choose to voluntarily register a class of equity securities under section 12(g) of the Exchange Act. The rules do not apply to foreign private issuers (because their securities are exempt from the proxy solicitation rules) and debt-only registrants.[5]

Rule 14a-11

New Rule 14a-11 permits a shareholder or group of shareholders owning at least 3-percent of the voting power[6] of a company's equity securities entitled to be voted on the election of directors to submit for inclusion in the company's proxy materials one or more nominees for election to the company's board of directors. The shareholder or group will launch this process by filing a Schedule 14N with the SEC and providing a copy of the Schedule to the company. The shareholder or group is entitled to include in the Schedule 14N a supporting statement of up to 500 words for each nominee. Consistent with the SEC's stated goal of making this proxy access regime available to shareholders with a long-term commitment and interest in the company, a shareholder or group must: (i) have held[7] the securities relied on to meet the 3-percent ownership requirement continuously for at least three years as of the date of filing the Schedule 14N with the SEC; (ii) continue to hold those securities through the date of the election of directors;[8] and (iii) disclose in the Schedule 14N the intention of the shareholder or group with respect to continued ownership of the securities after the election.[9]

Maximum Number of Director Nominees; Staggered Boards

Rule 14a-11 requires a company to include in its proxy materials not more than the greater of one shareholder nominee or the number of director nominees that represents up to 25-percent of the company's board of directors.[10] The SEC has clarified that, in the case of a staggered (or classified) board, the limit will be calculated based on the total number of board seats, not on the lesser number that are being voted upon.

If a company has a director currently serving on its board who was elected under 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 (as in the case of a company with a classified board), that director will be counted as a shareholder nominee in determining how many, if any, shareholder nominees the company will be required to include in its proxy materials. The SEC believes this limitation reduces the possibility that a nominating shareholder or group will be able to use Rule 14a-11 to effect a change in control of the company by repeatedly nominating additional candidates for director.

No Change-of-Control Intent

In order to limit Rule 14a-11 manipulation of the shareholder-nominee process, the SEC has adopted the requirement of a certification by a nominating shareholder or group and the condition that the shareholder or group not use Rule 14a-11 for the purpose, or with the effect, of changing the control of the company or gaining a number of seats on the board that exceeds the maximum number of shareholder nominees the company is required to include in its proxy materials under the Rule.[11]

"Ownership" Means Both Investment and Voting Power

The nominating shareholder or, in the case of a nominating shareholder group, each member of the group, must hold both investment *and* voting power,[12] either directly or through a person acting on their behalf, of the securities being relied upon to satisfy the 3-percent ownership requirement in Rule 14a-11.[13] The SEC has adopted specific rules for loaned securities,[14] borrowed securities[15] and any securities that the nominating shareholder or group has sold short.[16]

Multiple Groups; Withdrawal or Disqualification of Shareholder/Group and of Nominee

If more than one shareholder or group would be eligible to have its nominee(s) included, the company will be required to include all the nominees (up to the maximum under the Rule) of the shareholder or group with the highest qualifying percentage of voting power.[17] Where the shareholder or group with highest qualifying percentage of voting power does not nominate the maximum number of directors allowed under the Rule, all the nominees (up to the maximum under the Rule) of the shareholder or group with the next highest percentage of qualifying voting power (that is otherwise eligible to use the Rule) are required to be included in the company's proxy materials, and so on until the maximum number of nominees under the Rule is reached or until the company exhausts the list of eligible nominees. If the number of eligible nominees submitted by the next highest qualifying shareholder or group exceeds the maximum number permitted under Rule 14a-11, that shareholder or group will have the option to specify which of its nominees will be included in the company's proxy materials.[18]

Eligibility of Shareholder Nominee(s)

Rule 14a-11 provides that the director nominees of a shareholder or shareholder group must meet the *objective*[19] "independence" criteria of applicable national securities exchange or national securities association rules, but such

nominees are not required to meet *subjective* independence standards. The SEC notes that, if elected, the director will be subject to state law fiduciary duties to the company and its shareholders. In its Schedule 14N, a nominating shareholder or group must disclose whether, to the best of its knowledge, its nominee meets the *objective* independence standards of any applicable exchange or association rules. While Rule 14a-11 does not allow exclusion of nominees who do not meet a company's director qualification requirements, a nominating shareholder or group must disclose in its Schedule 14N whether, to the best of its knowledge, the nominating shareholder's or group's nominee meets the company's director qualifications, if any, as set forth in the company's governing documents. Where a company believes a nominee does not meet its director qualifications (*e.g.*, a requirement in a governing document consistent with state law that would preclude the company from seating a person who does not meet the requirement), it may choose to provide appropriate disclosure in its proxy statement on whether it believes the nominee satisfies the company's director qualifications, as is currently done in a traditional proxy contest.

Agreements and Negotiations Between the Company and Nominating Shareholder(s)

Because the limits on the number of nominees that a company is required to include in its proxy materials present the possibility that a nominating shareholder or group could act as a surrogate for the company or its management in order to block usage of Rule 14a-11 by another nominating shareholder or group, a nominating shareholder or group using the Rule may not have an agreement with the company or its management.[20] Where a company negotiates with an eligible nominating shareholder or group that has filed a Schedule 14N before beginning any discussion with the company about the nomination, and the company agrees to include the nominating shareholder's or group's nominee on the company's proxy card as a company nominee, the nominee *will* count toward the number of shareholder nominees permitted by Rule 14a-11.[21]

Rule 14a-2 Amendments Regarding Communications with Other Shareholders

New exemptions to Rule 14a-2 permit shareholders to engage in communications, including certain oral communications, with other shareholders in an effort to form a nominating group to aggregate their securities holdings to meet the 3-percent threshold requirement.[22]

Under new Rule 14a-2(b)(7), written communications for purposes of Rule 14a-11 may include *no more than* a statement of the shareholder's intent to form a nominating shareholder group; identification of, and a brief statement regarding, the potential nominee(s) (or, where no nominee(s) have been identified, the characteristics of the nominee(s) that the shareholder intends to nominate, if any); the percentage of voting securities that each soliciting shareholder holds or the aggregate percentage held by any group to which the shareholder belongs; and the means by which shareholders may contact the soliciting party. Any written information published, sent or given in reliance on Rule 14a-2(b)(7) must be filed with the SEC on Schedule 14N no later than the date the material is first published, sent or given to shareholders.

Rule 14a-2(b)(7) also exempts oral communications to form a group, which are not limited in content in the way written communications are limited. In order to rely on the exception for oral solicitations, a shareholder seeking to form a nominating shareholder group must file with the SEC a notice of commencement of the oral solicitation on Schedule 14N no later than the date of the first oral communication made in reliance on this exemption.

New Rule 14a-2(b)(8) provides an exception from proxy solicitation prohibitions for solicitations by or on behalf of a nominating shareholder or group in support of its nominee(s). The exception may be used only when the speaker is not

seeking proxy authority. Written solicitations must include specified disclosures, including the identity of the nominating shareholder or group; a description of his or her direct or indirect interests, by security holdings or otherwise; and a specified legend. These written communications must be filed with the SEC on Schedule 14N no later than the date the material is first published, sent or given to shareholders. There is no filing requirement for oral communications in support of nominees. A shareholder may begin these communications only after being notified that its nominee(s) will be included in the company's proxy statement.

In an effort to prevent these communications from being the first stage in a contest for control, the SEC established that both the exemption in Rule 14a-2(b)(7) and the exemption in Rule 14a-2(b)(8) will be lost if a shareholder or group engages in any proxy nomination or solicitation outside the scope of a Rule 14a-11 nomination or solicitation in the subject election. Likewise, these exemptions will be lost if the shareholder or group becomes a member of a group as determined under section 13(d)(3) of the Exchange Act and Rule 13d-5(b)(1) thereunder. The SEC believes this will greatly limit a shareholder's or group's ability to solicit with respect to nominees advanced by another shareholder or group through a traditional proxy contest or to participate in a traditional proxy contest.

Company Exclusion of Shareholder Nominees

A company may seek to exclude a shareholder nominee because: (i) Rule 14a-11 is not applicable to the company; (ii) the nominating shareholder or group or nominee failed to satisfy the eligibility requirements of the Rule; (iii) including the nominee would exceed the maximum number of shareholder nominees the company is required to include in its proxy statement; or (iv) the statement in support of the nominee exceeds 500 words.[23]

If a company determines that it can exclude a nominee, it will be required to notify the nominating shareholder, members of the nominating shareholder group or, where applicable, the nominating shareholder group's authorized representative of a deficiency in its notice on Schedule 14N, and provide the nominating shareholder or group the opportunity to respond. The company also will be required to submit a notice to the SEC, stating its intent to exclude the nominee, and may seek a "no-action" letter from the SEC.[24]

Liability for Statements in the Proxy Statement

A nominating shareholder or group relying on Rule 14a-11 – and not the company – will be liable for any material misstatement or omission included in its Schedule 14N or other related communications, whether or not included in the company's proxy materials.[25]

However, companies may want to be prudent, because the SEC has expressly provided that to the extent a company specifically incorporates by reference, or otherwise adopts as its own, the information provided by a shareholder, group or nominee, the SEC will consider the company's disclosure of that information as the company's own statements for purposes of the anti-fraud and civil liability provisions of the Securities Act of 1933, the Exchange Act and the Investment Company Act of 1940, as applicable to the company.

Changes to the Form of Proxy

Under the new rules, a company that is required to include shareholder nominee(s) in its proxy statement and therefore on its form of proxy may: (i) identify the shareholder nominee(s) as such; (ii) recommend, on the form of proxy, whether

shareholders should vote for, against or withhold votes on those nominee(s); and (iii) determine the order in which its nominee(s) and any shareholder nominee(s) are listed in the form of proxy. However, the company is otherwise required to present the nominee(s) in an impartial manner in accordance with Rule 14a-4. Under a new amendment to Rule 14a-4, when a company's form of proxy includes shareholder nominee(s) (whether pursuant to Rule 14a-11, an applicable state law provision, the company's governing documents or foreign law), the company may not provide a "short-cut" option whereby its shareholders can vote for or withhold authority to vote for the company's nominees as a group. Rather, the company must require that its shareholders vote on each director nominee separately.[26]

Rule 14a-8 Amendments

Prior to the effectiveness of the new rules, a company was permitted to exclude from its proxy statements shareholder proposals, including amendments to a company's governing documents, relating to procedures for the inclusion of shareholder director nominees in the company's proxy materials. Rule 14a-8 has been amended to remove this exclusion, thereby giving shareholders the ability to propose amendments to a company's governing documents providing for greater proxy access, as long as the proposal does not conflict with Rule 14a-11. A shareholder proposal will conflict with Rule 14a-11 to the extent that the proposal purports to prevent a shareholder or group that meets the requirements of Rule 14a-11 from having their nominee(s) for director included in the company's proxy materials.[27] Revised Rule 14a-8 will allow a proposal to amend a company's governing documents to establish different procedures for the inclusion of one or more shareholder nominees for director, but, if adopted, the changes will be in addition to, and not a substitute for, or a restriction on, the availability of Rule 14a-11 to the company's shareholders.[28] Rule 14a-8(i)(8), as adopted, permits a company to exclude a shareholder proposal pursuant thereto if it: (i) would disqualify a nominee who is standing for election; (ii) would remove a director from office before his or her term expires; (iii) questions the competence, business judgment or character of one or more nominees or directors; (iv) seeks to include a specific individual in the company's proxy materials for election to the board of directors; or (v) otherwise could affect the outcome of the upcoming election of directors.

For Further Information

If you have any questions regarding the proxy disclosure and solicitation rules discussed in this *Alert*, including how they may affect your company, please contact one of the members of the Securities Law Practice Group or the lawyer in the firm with whom you are regularly in contact.

Notes

1. Final Rule: Facilitating Shareholder Director Nominations, SEC Release Nos. 33-9136; 34-62764; IC-29384; File No. S7-10-09 (Aug. 25, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240 & 249).
2. There is no exception or relief to the company from the new proxy access regime due to the fact that the company may be concurrently engaged in a traditional proxy contest.
3. The new rules will be effective 60 days after their publication in the *Federal Register*, but "smaller reporting companies" that qualify as such on the effective date of the rules will not be subject to the new Rule 14a-11 until three years after the effective date. Smaller reporting companies are, generally, companies with a public float of less than $75 million (excluding investment companies, asset-backed issuers and majority-owned subsidiaries of a parent that is not a smaller reporting company).
4. The submission notice and disclosure on Schedule 14N must be filed by the nominating shareholder or group with the SEC and provided to the company on the same day.

5. Companies with a class or classes of debt, but no equity, registered under section 12 the Exchange Act. *See also* note 3 above regarding "smaller reporting companies."
6. This was modified from the proposed rule, which required a percentage of *securities* (not a percentage *voting power* of securities) entitled to be voted on the election of directors. Because the 3-percent ownership requirement relates to "voting power" rather than the number of securities, it does not disenfranchise classes of securities with super-voting rights. If a company has multiple classes of securities with unequal voting rights and the classes vote together on the election of directors, then voting power is calculated based on the collective voting power of all the classes. If a company has multiple classes of securities that do not vote together in the election of all directors (where, for example, each class elects a subset of directors), then voting power will be determined in each case only on the basis of the voting power of the class (or classes) that have a right to vote in that particular election, rather than the voting power of all the classes.
7. Rule 14a-11 requires that the nominating shareholder or group must hold both voting and investment power, either directly or through any person acting on their behalf, of the securities relied on to meet the Rule's ownership threshold *continuously* for at least three years as of the date of the notice on Schedule 14N. In the case of a shareholder group, each member of the group must have held the amount of such member's securities that are relied on to satisfy the ownership threshold continuously for at least three years as of the date of the notice on Schedule 14N.
8. This was modified from the proposed rule, which required the shareholder only to "intend to continue to hold." The final rule is available only to shareholders who do in fact continue to hold them (*i.e.*, "must continue to hold").
9. It should be noted that a nominating shareholder's or group's ability to use Rule 14a-11 is not impacted by its prior use of the Rule.
10. For example, that equates to one shareholder nominee under Rule 14a-11 for a board with seven members, but two shareholder nominees for a board with eight members. Incumbent directors who were originally nominated pursuant to the new proxy access regime and who have been nominated for reelection by the company will not count toward the maximum number of shareholder nominees.
11. The SEC also added an instruction that, in order to rely on Rule 14a-11, the nominating shareholder may not be, nor may any member of the nominating shareholder group be, a member of any other group with persons engaged in solicitations or other nominating activities in connection with the subject election of directors; may not separately conduct a solicitation in connection with the subject election of directors (other than the related Rule 14a-2(b)(8) exempt solicitation); and may not act as a participant in another person's solicitation in connection with the subject election of directors.
12. This varies from Exchange Act Rule 13d-3, which required investment *or* voting power, not investment and voting power.
13. Voting power includes the power to vote, or to direct the voting of, such securities; and investment power includes the power to dispose, or to direct the disposition, of such securities. Investment and voting power does not exist over securities that a shareholder or member of the group merely has the right to acquire, such as securities underlying options that are currently exercisable but have not yet been exercised. The SEC avers that the language "directly or through any person acting on their behalf" is intended to account for the common situation when financial intermediaries, such as banks or brokers, hold securities on behalf of their clients. It also clarifies that financial intermediaries, such as banks or brokers, that may hold securities on behalf of their clients cannot themselves use the provisions of Rule 14a-11.
14. Because the SEC recognizes that share lending is a common practice and is not inconsistent with a long-term investment in a company, securities that have been loaned to a third party by or on behalf of the nominating shareholder or member of the nominating shareholder group are to be counted toward the 3-percent ownership

requirement, but only if the shareholder or member both has the right to recall the loaned securities and will in fact recall the loaned securities upon being notified that any of the nominees of that shareholder or group will be included in the company's proxy materials. Thus, where its recall provisions are satisfied, the SEC has decreed that a nominating shareholder's or group's lending of securities on those terms will not constitute an interruption of the "continuous ownership" of those securities for purposes of determining compliance with Rule 14a-11.

15. As a contradistinction to the inclusion of loaned shares (subject to the conditions above), borrowed shares are excluded from the calculation of total voting power.
16. In aggregating a shareholder's or group's total voting power, such voting power must be reduced by the voting power of any of the company's securities that the nominating shareholder or any member of a nominating shareholder group has sold in a short sale during the three-year period. Likewise, a person whose ownership of shares arises solely from borrowing them for purposes of short sale would be deemed to have no ownership of the borrowed shares for purposes of the ownership requirements of Rule 14a-11.
17. This is in opposition to the "first-in" standard, as was initially proposed by the SEC in the June 10, 2009 rule proposal.
18. If a *nominating shareholder or group* withdraws or is disqualified after the company has provided notice to that nominating shareholder or group of its intent to include the shareholder's or group's nominee(s) in its proxy materials, the company will be required to include in its proxy materials the nominee(s) of the nominating shareholder or group with the next highest voting power percentage, and so on until the maximum number of permitted shareholder nominees is reached or until the company exhausts the list of eligible nominees. If a *nominee* withdraws or is disqualified *after* the company provides notice to the nominating shareholder or group of the company's intent to include the nominee in its proxy materials, the company will be required to include in its proxy materials: (i) any other eligible nominee submitted by that nominating shareholder or group, followed by (ii) the nominee(s) of the nominating shareholder or group with the next highest voting power percentage, and so on until the maximum number of permitted shareholder nominees is reached or until the company exhausts the list of eligible nominees. However, in order to address practical considerations, the Rule provides that once a company has commenced printing its proxy materials, it will not be required to include a substitute nominee or nominees. At this point, the company may determine whether it wishes to print (and furnish) additional materials and a proxy card, delete the disqualified or withdrawn nominee, or instead provide disclosure through additional soliciting materials informing its shareholders about the change.
19. The NYSE listing standards include several specified relationships with the company that can be determined by a "bright-line" objective test. On the other hand, as an example of a subjective standard, under the NYSE listing standards, no director will qualify as "independent," unless the board of directors "affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)."
20. In the June 10, 2009 proposed rule, this was merely a representation in Schedule 14N, but it is now included as a condition to being able to use Rule 14a-11. In addition, to avoid any uncertainty about the breadth of this requirement, the SEC has included an instruction to the Rule noting that prohibited agreements will not include unsuccessful negotiations with the company to have the nominee included in the company's proxy materials as a management nominee, or negotiations that are limited to whether the company is required to include the shareholder nominee in the company's proxy materials under Rule 14a-11.
21. In the SEC's view, such an agreement will constitute a termination of the Rule 14a-11 nomination, requiring the shareholder or group to file an amendment to Schedule 14N to disclose the termination of the nomination as a result of an agreement with the company.

22. The SEC has also adopted an exception to the requirement to file a Schedule 13D (and permits filing on the shorter Schedule 13G) for activities undertaken solely in connection with a nomination under Rule 14a-11. However, the standards for determining whether a shareholder is subject to the reporting requirements under section 16 of the Exchange Act by virtue of being the beneficial owner of 10-percent or more of a class of voting securities registered under the Exchange Act are *not* affected by the new rules. Accordingly, the relationship of shareholders in a Rule 14a-11 nominating group may be considered in determining whether a holder is part of a "group" (as defined under section 13(d) of the Exchange Act) that is a 10-percent or greater beneficial owner. In addition, and in a departure from the June 10, 2009 proposed rules, there will be no "safe harbor" for Rule 14a-11 activities from the definition of "affiliate" for purposes of the securities laws. Hence, activities of shareholders carried out under Rule 14a-11 may be taken into account in the facts and circumstances determination of whether a shareholder is an affiliate.
23. In a change from the June 10, 2009 rule proposal, the final rule provides that a company may not exclude a nominee or a statement in support on the basis that, in the company's view, the Schedule 14N (which will include the statement in support) contains materially false or misleading statements. Rather, the SEC states that a company can include its own "factual" statement in its proxy statement to counter the nominating shareholder's or group's statement.
24. While the SEC has the power to take enforcement action, the SEC notes that questions concerning the nomination may also be resolved by the parties outside the staff process, including through private litigation where necessary.
25. Thus, a company will not be responsible for information that is provided by the nominating shareholder or group under Rule 14a-11 and then repeated by the company in its proxy materials. A company will not be required to recirculate or correct proxy materials if it learns that the materials provided to its shareholders included false or misleading information from the nominating shareholder or group. A company may not omit information provided by a nominating shareholder or group from its proxy materials on the grounds that it is materially misleading. Instead, the Rule allows the company to include disclosure in the proxy statement commenting on the nominating shareholder's or group's disclosure.
26. In the SEC's view, the grouping option is not appropriate because such grouping of the company's nominees may make it easier to vote for all of the company's nominees rather than to vote for the shareholder nominee(s) in addition to some of the company's nominees, which would result in an advantage to the company's nominees and would be inconsistent with the goals of Rule 14a-11. The SEC believes that any potential confusion that could result from not providing the option to vote for the company's slate as a group can be mitigated by clear voting instructions, particularly with respect to the number of candidates for which a shareholder can vote. If a proxy solicitation that includes Rule 14a-11 shareholder nominee(s) includes a number of nominees that exceed the number of directorships being voted upon, the company should, prominently and in bold type on the form of proxy, provide clear disclosure as to how the company will deal with a situation where a shareholder votes for more than the total number of directorships being voted upon. Consistent with the SEC's belief that voting the proxy should reflect an impartial approach, in such a case, the company should not state that the proxies will be voted for the company's nominees; but, rather, should consider adopting a policy that disqualifies and discards such "over-voted" proxies.
27. A shareholder proposal that seeks to provide an additional means for including shareholder nominees in the company's proxy materials pursuant to the company's governing documents will not be deemed to conflict with Rule 14a-11, the SEC states, "simply because it would establish different eligibility thresholds or require more extensive disclosures about a nominee or nominating shareholder than would be required under Rule 14a-11."
28. For example, a proposal may be submitted under Rule 14a-8 that would, if approved, allow shareholders to submit nominees under a procedure with more liberal provisions than those in Rule 14a-11 (*e.g*, a 1-percent share

ownership requirement or a one-year holding period) so long as the proposal does not purport to restrict shareholder access to Rule 14a-11.