INSIGHTS

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CORPORATE GOVERNANCE

SEC Publishes Proposed Rules on Stockholder Proxy Access

A new administration, a year-long economic downturn, and a shift in public opinion have coalesced to foster an atmosphere conducive to serious discussions regarding stockholder proxy access rules. Rules allowing greater access to proxies have long been championed by activist stockholders and maligned by companies' managements. The SEC now believes that such proxy access rules will be an effective step toward restoring marketplace stability and investor confidence and to these ends has proposed a new Rule 14a-11 and an amended Rule 14a-8(i)(8).

by Jerry J. Burgdoerfer, Elaine Wolff, Brandon J. Dodgen, and Matthew R. Kopp

On June 10, 2009, the Securities and Exchange Commission (SEC) published proposed stockholder proxy access rules[1] following a history of unsuccessful prior proposals. Stockholder proxy access has been a topic of debate for decades. The SEC previously proposed amending the federal proxy rules in 2003 and 2007.[2] The economic crisis has given the amendment process new life due to what is perceived by some as boards not exercising proper oversight. Consequently, there now is increased focus on boards of directors, especially in the areas of executive compensation and risk management. Stockholder rights advocates point to the current economic and political climate to raise support for new rules that are intended to increase boards' accountability to their stockholders.

At its open meeting on May 20, 2009, the SEC (by a 3–2 vote) voted to propose rules intended to provide stockholders with greater access to corporate proxies.[3] The two rules discussed were:

1. New Rule 14a-11 which would, under certain circumstances, allow stockholders to include director nominees in the company's proxy materials. This is the so-called stockholder proxy access rule.
2. Amended Rule 14a-8(i)(8) which would, under certain circumstances, allow stockholders to require the company to include in its proxy materials proposals to amend, or request an amendment to, the company's governing documents (charter and bylaws) relating to nomination procedures or the company's disclosures related to stockholder nominations. This is the narrowing of the so-called election exclusion rule.

Following the open meeting, on June 10, 2009, the SEC published the proposed rules. Public comments are due August 17, 2009.

Below are set forth highlights of the proposed rules published in the SEC's June 10th 250-page release, together with a summary of key additions to and elaborations on the proposals as originally outlined in the SEC's open meeting on May 20th. Provided is an overview of the controversies and concerns surrounding the proposed rules and the

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debate over proxy access. Also included are some action items that companies should start considering now in the wake of the proposed rules.

New Rule 14a-11—Proxy Access

The SEC's proposed new Rule 14a-11 would allow a stockholder or group of stockholders to include their proposed nominees for up to 25 percent of the board in the company's proxy statement and on the company's proxy card, unless applicable state law or the company's governing documents prohibit stockholder director nominations in general. State law or a company's governing documents may adopt provisions providing for even greater proxy access (*e.g.*, lower ownership thresholds), but proposed Rule 14a-11 would, in the SEC's view, preempt any state law or company governing document that establishes more restrictive proxy access provisions (*e.g.*, higher ownership thresholds).

Stockholder Requirements

In order to include a nominee in a company's proxy materials, a stockholder must own, for a minimum of one year (and through the date of the meeting), voting securities of at least:

- 1 percent in a large accelerated filer, or a registered investment company with net assets of $700M or more;
- 3 percent in an accelerated filer, or a registered investment company with net assets of $75M or more and less than $700M; or
- 5 percent in a non-accelerated filer, or a registered investment company with net assets of less than $75M.

The combination of a one-year ownership period and minimum-ownership thresholds is intended to help ensure that only those stockholders with a long term economic interest in a company have access to that company's proxy materials.

Stockholders may aggregate their holdings with other stockholders to meet these ownership thresholds. Stockholders would not be deemed "affiliates" of the company and would not lose eligibility to file abbreviated beneficial ownership reports as passive investors pursuant to Schedule 13G solely as a result of nominating directors, soliciting in favor of a nominee or having a nominee elected to the board.

Nominations

Once a stockholder or stockholder group has met the requirements for eligibility to nominate director candidates, the stockholder or group may nominate the greater of one (1) nominee or the number of nominees that is 25 percent of the company's total directors (hereinafter Allowable Stockholder Nominees). If the number of nominees from all stockholders is greater than the number of Allowable Stockholder Nominees, the nominees would be included on the ballot on a first nominated, first included basis. Under the proposed rules, a stockholder nominee previously elected under Rule 14a-11 whose term extends past the meeting would count toward the number of Allowable Stockholder Nominees.

Stockholders are not restricted from nominating directors with whom they have a relationship and may even nominate themselves or family members. The SEC believes that any potential conflicts that could arise from stockholder nominee relationships would be adequately addressed by state law fiduciary duties.

Nominee Requirements. In order to be included on the ballot, stockholder nominees must also meet the following requirements:

- A nominee's candidacy and board membership must not violate applicable laws and regulations;
- A nominee must satisfy the general objective independence standards of the applicable national securities exchange or national securities association that apply to board members generally (but not the standards that apply to audit committee members), and nominating stockholders (but not the nominees themselves) must represent to such fact in Schedule 14N (the new schedule to be filed for director nominations); and
- Stockholders and their nominees may not have a direct or indirect agreement with the company regarding the nomination of the nominee, and nominating stockholders must represent to such fact in Schedule 14N.

Timetable and Procedures. Stockholders must provide the company notice of a nomination no later than 120 calendar days before the date that the company mailed its proxy materials for the prior year's annual meeting and file a Schedule 14N with the SEC, unless the company's governing documents provide for a different date.

If the company determines it may exclude the stockholder nominee it must notify the nominating stockholder in writing no later than 14 days after the company receives the nominating stockholder's notice to include its nominee. The company must provide the nominating stockholder an explanation for its determination to exclude the nominee from its proxy materials.

The nominating stockholder has 14 days after receipt of the company's notice of exclusion to correct any eligibility or procedural deficiency. However, neither the composition of the nominating stockholders nor the stockholders' nominees may be changed as a means to correct a deficiency.

After the 14 day period, if any deficiencies have not been remedied, the company must provide notice of the basis for its determination to exclude any nominees to the SEC no later than 80 days before filing its definitive proxy statement. The SEC would then review the company's notice to exclude through a process modeled after the staff no-action process used in connection with stockholder proposals under Rule 14a-8.

Finally, when the company determines whether it will include the stockholder nominee in its proxy materials, it must notify the nominating stockholder in writing no later than 30 days before it files its definitive proxy statement.

The company must present stockholder nominees included in its proxy materials in an impartial manner, but may recommend a "vote for," a "vote against" or a "withhold vote."

Disclosure and New Schedule 14N

Nominating stockholders must file with the SEC and submit to the company a new Schedule 14N, which would include, but would not be limited to, the following disclosures:

- The name and address of the nominating stockholder;
- The amount and percentage of securities owned;
- The length of ownership of securities, or if the stockholder is not the record holder, a statement from the record holder verifying that the stockholder has continuously held the securities for at least one year;
- A statement of intent to continue to hold the securities through and after the date of the annual meeting;
- A certification that the stockholder is not seeking to effectuate a change in control of the company or to gain more than a limited number of seats on the board; and
- A supporting statement of 500 words or less.

In addition to the initial 14N filing, the nominating stockholder must file amendments with respect to withdrawals and material changes in facts. A final amendment must be filed within 10 days of the final results of the election.

When a stockholder or stockholder group nominates director candidates, the company also would be required to include disclosures for both the stockholder and the stockholder's nominees in its proxy materials. The disclosures that the stockholder would be required to provide would be similar to those currently required in a proxy contest and would include, without limitation, disclosure of:

- Biographical information,
- Amount of securities owned,
- Substantial interests during the election,
- Details of stock trades during the past two years,
- Criminal convictions, and
- Arrangements or understandings with respect to future employment or transactions.

Stockholders who communicate with the limited purpose of forming a nominating stockholder group may be exempt from filing a proxy statement if each of their written communications includes no more than:

- A statement of the stockholder's intent to form a nominating stockholder group;
- An identification of, and a brief statement regarding, the potential nominees;
- The percentage of securities the stockholder beneficially owns or the aggregate percentage owned by any group to which the stockholder belongs; and
- The means by which the stockholders may contact the soliciting party.

Any written solicitation materials published, sent, or given to stockholders pursuant to the exemption must be filed with the SEC by the nominating stockholder under the company's Exchange Act file number no later than the date the materials are published, sent or given to stockholders.

Nominating Stockholder Liability

It is the SEC's intent that nominating stockholders or stockholder groups, and not companies, be liable for any materially false or misleading statements in information provided by a nominating stockholder or stockholder group to a company (in its stockholder notice on Schedule 14N) that is then included in the company's proxy materials.

The SEC proposed an amendment to Rule 14a-9 that explicitly would prohibit any nominee or nominating stockholder from causing any false or misleading information to be included in a company's proxy materials. Under proposed new Rule 14a-11(e), however, a company would be held liable if it knows or has reason to know that the information is false or misleading.

Under the proposed rules, any information provided to a company in a notice from a nominating stockholder or stockholder group under Rule 14a-11 and then included in a company's proxy materials would not be incorporated automatically by reference into any filing under the Securities Act, the Exchange Act, or the Investment Act. A company may, however, elect to incorporate that information by reference or otherwise adopt the information as its own, in which case a company's disclosure of that information would be considered to be the company's own statement for purposes of the antifraud and civil liability provisions of the Securities Act, the Exchange Act, or the Investment Company Act.

Amended Rule 14a-8(i)(8)—Narrowing the Election Exclusion

Currently, companies may exclude stockholder proposals under Rule 14a-8(i)(8), the "election exclusion," that relate to a nomination or election or procedures for nominations or elections. Amended Rule 14a-8(i)(8) would narrow the scope of the exclusion and provide stockholders the opportunity to require the company to include in its proxy materials proposals that would amend, or request an amendment to, the company's governing documents relating to nomination procedures or the company's disclosures related to stockholder nominations. In order to utilize this rule, stockholders continuously must have held company voting securities of at least $2,000 or 1 percent in market value (whichever is less) for a period of at least one year prior to submitting the proposal.

Companies may still exclude stockholder proposals if they:

- Disqualify a nominee who is standing for election;
- Remove a director from office before his or her term expired;
- Question the competence, business judgment, or character of one or more nominees or directors;
- Nominate a specific individual for election to the board, other than pursuant to Rule 14a-11, an applicable state law provision, or a company's governing documents;
- Conflict with proposed Rule 14a-11 or state law; or
- Otherwise could affect the outcome of the upcoming election of directors.

It should be noted, however, that the last exception is not intended to be an expansive catch-all, but is designed to address other proposals that eventually may develop that are comparable to the first four traditional categories listed above and that would undermine the purpose of the exclusion.

If stockholders are successful in having their procedures and disclosures adopted through a

stockholder proposal under Rule 14a-8, they must wait for two proxy seasons before utilizing the new procedures. The first season would be spent establishing the stockholder director nomination procedure, and during the second season the stockholder's proposed directors would be nominated for election.

Controversies and Concerns

The proposed amendments have been criticized by the two dissenting Commissioners, practitioners, and academics in a continuation of the heated debate over proxy access. The following is a representative selection of topical criticisms.

The Premise of the Proposed Amendments

Throughout the proposal process, several commentators expressed disagreement with the SEC's premise that greater stockholder oversight could have prevented or mitigated the current financial crisis. They were skeptical about whether independent, outside directors would be as aware of the risks inherent in a company's business as management representatives on a board would be. These commentators believe that the SEC's proposed rules are misguided and will weaken, not bolster, companies' boards.

Conflict with Current State Regulation

Another objection is that the SEC's proposed rules overreach the SEC's stated goals. Critics believe that the same ends can be accomplished with measures that intrude less on state law and that are less heavy-handed.

The proposed amendments have been criticized as stymieing state initiatives in expanding proxy access. For example, Delaware recently amended its corporation law (April 10, 2009) to permit companies to allow stockholder proxy access through changes in their bylaws.[4] Other states were expected to follow suit,[5] but now what might have been valuable state experiences with the issue could be preempted.

The Delaware amendments, unlike proposed Rule 14a-11, do not provide stockholders automatic access to the company's proxy materials.[6] Instead, similar to proposed Rule 14a-8(i)(8), the Delaware amendments permit amendments to a company's bylaws to allow greater proxy access. These amendments can be effectuated by either the stockholders or the board of directors.

Some commentators, legal scholars, and SEC Commissioners believe the SEC should adopt a policy position similar to that of Delaware and amend only Rule 14a-8(i)(8), allowing stockholders and boards to determine on a company by company basis whether to allow greater access to company proxy materials.

Unintended Consequences

Because Delaware's amendment expressly authorizing bylaw changes to permit stockholder proxy access becomes effective August 1, 2009,[7] the effects of increased stockholder proxy access largely are speculative at this time. The SEC's proposed rule changes are more extensive than Delaware's amendment and more likely to produce unintended consequences, some of which are described below.

The SEC's rules may cause a proliferation in the number of candidates for board elections which, when combined with plurality voting, could result in situations in which the threshold amount of votes needed for election is pushed so low that a small but committed voting block has a large influence in an election. On the other hand, in light of the trend toward majority voting and the SEC's approval of the change to the New York Stock Exchange rules to eliminate broker discretionary voting in director elections,[8] the proposed rules could lead to unfilled board seats.

The rules might position stockholders or groups of stockholders against each other. The number of stockholder nominees that can be included in the company's proxy materials overall is limited. If one stockholder or stockholder group nominates the maximum allowable number of candidates, any other stockholder's or group's nominees are not required to be set forth in the same proxy statement. Over time, special and disparate stockholder-nominated

directors could distract corporate boards, turning them into political bodies and threatening the ability of management and boards to focus on long term value creation for stockholders. Boards split among various stockholder groups may foster an adversarial, tension-filled, and unproductive environment.

The proposed rules could increase the likelihood that a stockholder with interests adverse to a company's financial well being will be able to nominate directors. The expansion of trading in derivatives has caused an increase in the number of shares voted at meetings through proxies when the voting derivative owners have financial interests opposed to the other stockholders in the company. For example, the proliferation of credit default arrangements may lead to some voters having a larger interest in the failure of the company than in the appreciation of the value of shares.

Additionally, it is unclear how the requirement that stockholders relying on proposed Rule 14a-11 to nominate directors may not do so "for the purpose of or with the effect of changing control" of the company will apply in practice. Directors are charged with managing the business and affairs of a company and directors nominated by stockholders or groups of stockholders could control decisions by important board committees or situations in which management directors need to abstain. The application of the "no control purpose" requirement could greatly increase or reduce the impact of the proposed rules, and it is unclear how narrowly or broadly this standard would be interpreted.

Companies might seek to limit the effect of stockholder-nominated directors under the proposed rules by expanding board size to dilute the influence of stockholder-nominated directors. Companies might also choose to provide the entire board with less information due to a concern that stockholder-nominated directors would misuse the information.

SEC Regulatory Authority

The SEC's primary function is to oversee and facilitate the disclosure of information to investors in publicly traded securities. Opponents of proxy access argue against the legality of the proposed rule changes on the grounds that the SEC's authority to regulate proxy disclosures does not extend to mandating inclusions of stockholder director nominees on the company's proxy materials. Indeed, one of the dissenting SEC Commissioners specifically stated that the SEC's authority in adopting these rules is questionable.

Senator Schumer recently introduced a bill, the "Shareholder Bill of Rights Act of 2009,"[9] which would confirm the SEC's ability to mandate stockholder proxy access for board election matters and further expand stockholder rights, including mandating non-binding say-on-pay votes.[10] The passage of this bill would militate against an invalidation of SEC action by the courts.

Financial and Other Concerns

SEC regulations translate into operational costs for companies, and commentators have expressed concern over the price of compliance with the SEC's proposed rules. The SEC has attempted to estimate the cost to businesses of accommodating greater stockholder access to proxies, and provisionally has determined that the anticipated benefits of greater stockholder access outweigh the millions it would cost corporations to comply with the proposed regulations.

Potential sources of increased costs include:

- Companies accustomed to uncontested director elections may incur substantial costs of changing their practices.
- Companies may incur costs in attempting to institute policies and procedures they believe will address stockholder concerns instead of focusing on strategic or long-term issues.
- For companies that already have well-functioning boards, dissent can be counterproductive and could delay the board's decisionmaking process.
- Companies may expend significant resources on efforts to defeat the election of stockholder nominees.
- Additional costs could arise from the potential election of directors who have insufficient experience or capabilities to serve effectively.

- To the extent disputes on whether to include particular nominees or proposals are not resolved internally, companies and/or stockholders might seek recourse in courts.
- Increased complexity in the director nomination and election process.
- Increased costs to companies related to reviewing and processing proposals to determine matters such as stockholder eligibility, and whether there is a basis for excluding proposals under Rules 14a-8 or 14a-11.
- All stockholders of a given company effectively may pay to subsidize the proxy contest of activist stockholders who continuously nominate directors, have social instead of profit-maximizing agendas, or who are seeking publicity.

Other Considerations

The proposed rules leave open a number of other considerations. Among these are:

- How would the proposed rules affect staggered boards?
- How would the proposed rules affect companies with different classes of stock, each of which is entitled to elect a specified number or percentage of directors? Companies with non-voting stock?
- How would the proposed rules affect companies with stockholders who have contractual rights to nominate directors? Controlled companies?
- Should the SEC consider making the rules applicable only once a triggering event occurs?
- If a stockholder's intent not to seek a change of control changes over time, what are the repercussions for the stockholder and its nominee?
- If a nominee fails to get a certain percentage of votes, should the nominating stockholders be precluded from nominating another candidate during the next election and/or reimburse the company for costs incurred?
- If a company has more stringent director qualification requirements than the SEC, must the stockholder nominee comply with the company's requirements?
- Should the proposed rule be amended to permit negotiations between the nominating stockholder and the board of directors?
- Would the "first nominated, first included" standard create a counterproductive incentive for a "race to nominate?"
- What are the consequences of a nominating stockholder including materially false information or a materially false representation?
- Should a nominating stockholder be required to disclose holdings of a 5 percent or greater interest in a competitor?
- Should the proposal be amended to allow companies to provide stockholders the option of voting for the company's slate of nominees as a whole?

Action Items to Consider

Although the proposed rules may change significantly prior to adoption, it is likely that the SEC will soon adopt proxy access rules in some form. It is important to prepare now so that, when final rules are adopted, companies and boards can adapt appropriately in a timely manner. In preparation for the expected enactment of stockholder proxy access rules, companies should consider the following action items:

- Discuss with company boards, and the appropriate board committees, the repercussions of the proposed rules. The rules have the potential to drastically alter board dynamics and may even prompt some companies to alter board structures or voting procedures.
- Submit comment letters to the SEC. The unusually large number of questions solicited by the SEC indicates that it is aware that the issues addressed by the proposed rules are controversial and is willing to consider alternatives. Comment letters likely will play a significant role in shaping the final rules. Comments are due on August 17, 2009.
- Obtain a better understanding of the composition of company stockholder bases. Regardless of any changes prior to adoption, any form of proxy access rules likely will give stockholders more influence in and over company boards. It is important that companies know who holds their stock—not only to anticipate nominations and proxy amendments from stockholders—but also to proactively foster communication with

stockholders in order to help ensure that the appropriate persons are nominated.
- Assess the likelihood that stockholders will nominate a director. Companies with large "activist" stockholder bases particularly will be susceptible to stockholder nominees. Such companies may wish to open channels of communication with these stockholders.
- Review investment relations programs with an aim to ensure that investor confidence is high. If large institutional investors believe that the board takes their concerns seriously, proxy access might be used rarely and succeed even more infrequently.
- Amend committee charters to reflect the need for the additional process of sifting through stockholder nominations to determine whether they meet the requirements of Rule 14a-11.
- Amend advance notice bylaws to require longer notice of director nominations. As discussed, stockholders must submit nominations by the deadline established in a company's bylaws or, in the absence of a bylaw, 120 days before the date on which the company submitted its final proxy materials to the SEC the prior year. Many company bylaws that address the issue require advance notice of nominations no later than 60 days prior to last year's annual meeting. However, taking advantage of the SEC's no-action process requires initiating the process approximately 120 days prior to the filing of the company's definitive proxy materials with the SEC. Issuers with bylaws addressing advance notice should consider amending their bylaws to incorporate the Rule's 120-day default date.
- Discuss whether to adopt a bylaw addressing stockholder proxy access in order to avoid a stockholder submission on the issue.

Conclusion

In its release, the SEC stated that "amending our rules to provide for the inclusion of stockholder nominees for directors in a company's proxy materials is a significant change. Given the novelty of such a change, we believe it is appropriate to take an incremental approach as a first step and reassess at a later time to determine whether additional changes would be appropriate." Many would argue that the proposed rules represent more than an incremental approach, while others may claim that the proposed rules are insufficient.

Because of the complexity and controversial nature of these proposals, the SEC has requested comments on hundreds of specific questions set forth in its release. With groups such as the US Chamber of Commerce questioning the authority of the SEC to adopt these rules and committing to challenge them and Senator Schumer and Representative Peters proposing legislation, the issue of stockholder proxy access has not been settled. The comments received on the proposals will no doubt shape the final rules, as stockholder proxy access continues to be a hot topic in the current political and economic climate.

NOTES

1. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (SEC proposed June 10, 2009), available at *http://sec.gov/rules/proposed/2009/33-9046fr.pdf*.

2. The 2003 proposal would have allowed holders of more than 5 percent of a company's shares to include up to three director nominees in the company's proxy materials if (A) at least one of the company's director nominees received withhold votes from over 35 percent of stockholders or (B) holders of at least 1 percent of the company's shares proposed that the company be subject to the proxy access rules and that proposal received more than 50 percent of the votes. *See* Release No. 34–48626 (proposed Oct. 14, 2003), available at *http://sec.gov/rules/proposed/34-48626.pdf*. In 2007, the SEC proposed two alternative amendments to Rule 14a-8(i)(8), one of which would have permitted holders of 5 percent of a company's voting shares to propose a proxy access bylaw and another which clarified that a company could exclude a proposed proxy access bylaw from its proxy materials. The SEC only adopted the latter of the two proposed amendments. *See* Release No. 34-56160 (proposed July 27, 2007), available at *http://sec.gov/rules/proposed/2007/34-56160.pdf*; Release No. 34-56161 (proposed July 27, 2007), available at *http://sec.gov/rules/proposed/2007/34-56161.pdf*.

3. The Commissioners' speeches from the open meeting are available at *http://sec.gov/news/speech.shtml*.

4. Del. Codetit. 8, § 112 (effective Aug. 1, 2009).

5. The American Bar Association's Committee responsible for the Model Business Corporation Act is considering similar changes to the Model Act. *See* American Bar Association, Section of Business Law, "Corporate Laws Committee To Address Current Governance Issues," April 29, 2009 (noting that Delaware's recent statutory amendments and other developments "are being actively considered by the Committee") (available at *http://abanet.org/abanet/media/release/news_release.cfm?releaseid=662*). Thirty (30) states have adopted the Model Act in whole or in part.

6. However, in 2007, North Dakota amended its corporate code to permit shareholders or a group of shareholders of a publicly-traded corporation who have held 5 percent of the shares for at least two years to provide a notice of intent to a company to nominate directors and require the company to include such shareholder nominees in its proxy statement and form of proxy. North Dakota Publicly Traded Corporations Act, N.D. Cent. Code § 10-35-08 (2009).

7. *See* Del. Codetit. 8, § 112 (effective Aug. 1, 2009).

8. SEC Release No. 34-60215 (July 1, 2009).

9. S. 1074, 111th Cong. (1st Sess. 2009).

10. Representative Peters has introduced a similar bill in the House, the "Shareholder Empowerment Act of 2009," H.R. 2861, 111th Cong. (1st Sess. 2009).

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