

July 9, 2009

## SEC Proposes Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors

On June 10, 2009, the U.S. Securities and Exchange Commission (the "SEC") proposed a series of amendments to rules promulgated under the Securities Exchange Act of 1934 (the "Exchange Act") to facilitate shareholders' rights to nominate directors. See Release Nos. 33-9046, 34-60089, and IC-28765; <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.<sup>1</sup> The three-to-two vote on the proposed rules marks the third time in the last six years that the SEC has addressed a debate of more than 30 years – shareholders' access to company proxy materials to nominate their own directors to a company's board of directors.

### Background

The debate on increased shareholder proxy access generally focuses on the need for greater director accountability and responsiveness to shareholders, versus the importance of allowing directors to focus their energies on leading the company. On the one hand, shareholders want some degree of oversight; on the other, directors who are overly preoccupied or hampered by having to cater to shareholder demands may not be able to maximize shareholder value to the same extent they would otherwise.

The purpose of the federal proxy process is to replicate the conditions of a shareholder meeting as closely as is practical without requiring attendance of a large and widely dispersed group of shareholders. Currently, a company's proxy materials need provide only for the election of those directors nominated by the incumbent board. Shareholders may submit their own slate of nominees to be voted upon by the shareholders, but this requires a very costly process of preparing and distributing separate proxy materials. It is also possible to attend an annual meeting and present an opposing slate of nominees to be voted upon, though at that point many proxy votes have already been cast. The push for an efficient, less costly approach to exercising a shareholder's right to nominate a director is key to this debate.

Many recent market events have helped spur the SEC to action. The SEC cites what it describes as one of the most serious economic crises of the past century and a resulting loss of investor confidence as the impetus for its proposed amendments. Additionally, recent complaints that directors are too cozy with management resulting in trillions of dollars of write-downs and losses, as well as corporate scandals over the last several years, have provided support for finding more effective ways to hold directors accountable and motivate the board to monitor and reign in management.

The goal of the proposed amendments is to provide more viable means for shareholders to exercise their rights under state law to nominate directors. The amendments do not empower shareholders seeking to change the control of the company. Rather, they are to allow shareholders limited access to the company's proxy statement by submitting a short slate of director nominees to be nominated at the expense of the company. While the SEC acknowledges there are several costs associated with shareholder access to the company's proxy materials, it anticipates the proposed amendments will result in a reduction of the cost to shareholders of soliciting votes for a nominee and improved board performance.

<sup>1</sup> Except where otherwise noted, this alert discusses the proposed amendments as if adopted as presently written in the SEC's release, though the amendments have not yet been adopted and are still subject to change.

### Rule 14a-11

If approved as presently written, this new rule will apply to all companies subject to the Exchange Act proxy rules other than those companies that are subject to the proxy rules solely because they have registered debt<sup>2</sup> and will allow certain shareholders to include their nominees for director in the proxy materials prepared by the company, subject to the following conditions:

- Nominating shareholders must beneficially own a minimum percentage of the company's shares for at least one year before submitting a nomination (shareholders may aggregate holdings to meet the appropriate threshold):<sup>3</sup>
  - One percent of the voting securities of a company with a non-affiliate worldwide market value of \$700 million or more;
  - Three percent of the voting securities of a company with a non-affiliate worldwide market value of \$75 million or more, but less than \$700 million; and
  - Five percent of the voting securities of the voting securities of a company with a non-affiliate worldwide market value of less than \$75 million;
- The nominee's candidacy or board membership must not violate applicable laws and regulations (other than subjective rules of applicable securities exchanges or associations regarding director independence, as discussed below); and
- The nominating shareholders must provide timely notice of such nomination to the company on Schedule 14N (as well as file it with the SEC on the same date it is provided to the company), as discussed below.

If the nominating shareholders meet all the requirements for nominating a director, the company is required to include the nominee in the proxy statement it prepares. It is also required to include various disclosures in the proxy statement related to information provided by the nominating shareholders. To the extent this information is included in the proxy statement, nominating shareholders will be liable for any false or misleading statements, while the company is only liable for information it knows or has reason to know is false or misleading. This information will not be incorporated by reference into other filings except where the company specifically chooses to do so.

It is important to note that the nomination of directors under proposed Rule 14a-11 is limited to the greater of one director or the number of directors that represent up to 25 percent of the board. Thus, if the board consists of seven or fewer members, shareholders could nominate one director in the company's proxy materials. If the board consists of eight members, shareholders could nominate two directors. Directors who have been elected pursuant to Rule 14a-11 and whose term extends past the date of the election (i.e., if the company has a staggered board) count towards the 25 percent maximum and accordingly decrease the number of nominees shareholders may make under Rule 14a-11 for an election.

The nomination by shareholders under Rule 14a-11 is done on a first-come, first-serve basis based on the filing of a Schedule 14N. To the extent that the first nominating shareholder or group of nominating shareholders does not nominate the maximum number of shareholder nominees permitted to be included in the company's proxy

<sup>2</sup> The reach of the proposed rules includes investment companies. The proposed rules contain several provisions related specifically to investment companies to address regulations unique to such companies; however, the treatment of investment companies under the proposed rules is largely similar to that of non-investment companies.

<sup>3</sup> The proposed rules base thresholds on status as a "large accelerated filer," "accelerated filer," and "non-accelerated filer;" however, these classifications are consistent with the non-affiliate worldwide market values listed as thresholds in this alert.

statement, the nominees of the next nominating shareholder who provided timely notice on a Schedule 14N shall be included in the proxy materials, up to the total number of shareholder nominees permitted to be included. The rules do not provide any statement or limitation on how far in advance of an election a Schedule 14N may be filed.

Rule 14a-11 states that it applies, except to the extent that applicable state law or the company's governing documents prohibit the shareholder from nominating a candidate for election as a director. The proposed rule does not, as presently written, limit the adoption of a provision in the company's governing documents that limits or prohibits inclusion of a shareholder nominee in the company's proxy statement, even if such provision is in direct opposition to Rule 14a-11. As described below, the use of Rule 14a-8 to propose alternate nomination procedures is limited to procedures that do not preclude nominations under Rule 14a-11. Changes to the company's governing documents that prohibit or restrict the use of Rule 14a-11 must be brought about in some form other than a Rule 14a-8 proposal.

#### **Timeline**

If the company determines that it may exclude a shareholder nominee from the proxy materials, it must notify the nominating shareholders in writing no later than 14 days after it receives the Schedule 14N. The nominating shareholders then have 14 days from receipt of such notice to respond to and correct any eligibility requirements.

If, after the above notice and response, the company determines that it may exclude a shareholder nominee, the company must provide notice of the basis for such determination to the SEC and the nominating shareholders no later than 80 days before it files its definitive proxy statement with the SEC. The nominating shareholders may submit a response to the SEC no later than 14 days after receipt of such notice from the company. The SEC staff may provide an informal statement of its views to the company and the nominating shareholders. In any event, the company must provide the nominating shareholders with notice of whether it will include or exclude the nominating shareholders' nominee no later than 30 days before it files its definitive proxy statement with the SEC.

#### **Rule 14a-18/Schedule 14N**

Rule 14a-18 lists the disclosure requirements of Schedule 14N. As proposed, notice on Schedule 14N shall be sent to the company by the date specified in the company's advance notice bylaw, or, if no such provision exists, at least 120 days before the date the company mailed its proxy materials for the prior year's annual meeting (unless otherwise noted on Form 8-K, as discussed below). Schedule 14N notice must include the following:

- Representations that
  - To the knowledge of the nominating shareholders, the nominee's candidacy or board membership would not violate applicable laws or rules (other than subjective rules of applicable securities exchanges or associations regarding director independence, as discussed below);
  - The nominating shareholders satisfy the conditions of Rule 14a-11 regarding shares beneficially owned;
  - The nominee meets the objective definition of independence under rules of applicable securities exchanges or associations (as opposed to any subjective criteria, such as a determination by the board of directors or a committee of the board of directors regarding independence of a director); and
  - Neither the nominee nor the any of the nominating shareholders has any direct or indirect agreement with the company regarding the nomination;
- A statement from the nominee that the nominee consents to being named in the proxy statement and to serve on the board if elected;

- A statement that the nominating shareholders intend to continue to own the requisite shares through the date of the meeting at which the nominee will be nominated (as well as a statement regarding the nominating shareholders' intent with respect to continued ownership after the election);
- A statement in support of the nominee not to exceed 500 words, provided the nominating shareholders desire to make such a statement; and
- Various other disclosures similar to those currently required in a contested election, including information about the amount and percentage of securities beneficially owned and information regarding the nominee similar to that provided for company nominees in the proxy statement.

The actual text of Schedule 14N includes a certification by the nominating shareholders that the securities described are not held for the purpose or for the effect of changing control of the company or to gain more than the permitted number of seats on the board.

### Rule 14a-2

The SEC has also proposed rule amendments aimed at allowing shareholders to communicate among themselves more freely for the limited purposes of forming a shareholder nominating group or soliciting support for a nominee under Rule 14a-11. As amended, Rule 14a-2 allows such solicitations without much of the disclosure and limitations typically applicable to such communications, subject to the following conditions:

- For solicitations to form a nominating group, each written communication shall include no more than the following:
  - A statement of each soliciting shareholder's intent to form a nominating group;
  - Identification of, and a brief statement regarding, the potential nominees (or characteristics of potential nominees if no such individual has yet been identified);
  - The percentage of securities beneficially owned by each soliciting shareholder or by the group; and
  - The means by which shareholders may contact the soliciting party;
- For solicitations in support of a nominee placed on the company's proxy statement in accordance with Rule 14a-11, each written communication shall include the following:
  - The identity of each nominating shareholder and a description of all direct and indirect ownership and other interests of such nominating shareholder; and
  - A prominent legend advising shareholders to read the company's proxy statement;
- Shareholders soliciting support for a nominee may not seek the power to act as proxy for a shareholder; and
- Under either type of solicitation, any soliciting material published, sent or given to shareholders must be filed by the soliciting shareholders with the SEC no later than the date it is first made available to shareholders.

### Rule 14a-8(i)(8)

At present, Rule 14a-8(i)(8) allows a company to exclude proposals from the company's proxy materials if they relate to an election to the board of directors. The rule amendment proposed by the SEC will narrow the scope of this exclusion. Notably, proposals that request an amendment to the company's governing documents regarding director nomination or nomination disclosure will not be excludable, provided such an amendment does not conflict with Rule 14a-11 or applicable state law.<sup>4</sup>

The current requirements to include a proposal in a proxy statement will continue to apply to Rule 14a-8(i)(8) – a shareholder proponent must have continuously held for at least one year the lesser of (a) \$2,000 in market value or (b) one percent of the securities entitled to vote on the proposal. Additionally, such a shareholder must continue to hold the securities through the date of the meeting where a vote on the proposal is taken.

Rule 14a-8(i)(8) will continue to allow the board to exclude proposals which (a) would remove a director before his or her term expired, (b) question the competence, business judgment, or character of one or more director nominees, (c) nominate an individual for election to the board of directors other than pursuant to Rule 14a-11 (or similar provisions in state law or the company's governing documents), or (d) otherwise could affect the outcome of the upcoming election of directors.

### Other Rule Changes

In connection with the changes described above, the SEC has proposed the following amendments:

*Rule 13d-1:* Any group of shareholders formed solely for activities in connection with a nomination under Rule 14a-11 whose aggregate beneficial ownership exceeds five percent of the company's securities shall be permitted to file on Schedule 13G as opposed to on Schedule 13D, provided the group otherwise meets the requirements to file on Schedule 13G. This exception is not available after the election of a director so nominated. The SEC has also proposed that nominating shareholders will not be deemed "affiliates" solely by reason of their making a nomination under Rule 14a-11 or for soliciting for the election of such a nominee. If the nominee is elected, the nominating shareholders will not be considered affiliates solely on account of making the nomination or having an agreement or relationship with the director regarding the nomination.

*Rule 14a-4:* Consistent with the goal of the proposed amendments, the SEC has also proposed that proxy cards including at least one shareholder nominee in accordance with Rule 14a-11 (or a similar provision under applicable state law or the company's governing documents) may not contain the option to vote for, or withhold authority as to, any nominees as a group. Each nominee must be voted on individually, thus making it easier to vote for a combination of nominees recommended by the company and nominees recommended by shareholders.

*Form 8-K:* The SEC has proposed amending Form 8-K to provide that, where the company did not hold an annual meeting the previous year or has changed the date of the annual meeting by more than 30 days from the previous year's meeting date, the company is required to disclose the date by which a nominating shareholder must submit a Schedule 14N. The date must be a reasonable time before the company mails its proxy materials.

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<sup>4</sup> As discussed above, the proposed amendment seeks to allow proposals under Rule 14a-8 of nomination procedures that are different from Rule 14a-11, provided that such procedures are in addition to those under Rule 14a-11 and do not preclude any shareholder from using Rule 14a-11 to make a nomination.

*Rule 14a-19:* In connection with including a nominee in the company's proxy materials pursuant to a procedure set forth under applicable state law or the company's governing documents rather than Rule 14a-11, the SEC has proposed a number of disclosure requirements. These requirements are largely the same as those required for a nomination under Rule 14a-11.

*Schedule 14A:* The proposed amendments include a requirement that if a shareholder nominee is included in the company's proxy materials, the materials must include certain information disclosed by the nominating shareholders with regard to the nominee and the nominating shareholders.

However, the SEC has not proposed any amendments related to Exchange Act Section 16. Any group of shareholders whose aggregate beneficial ownership of any class of equity securities registered under Exchange Act Section 12 exceeds 10 percent, regardless of whether the group is formed solely for purposes of making a nomination under Rule 14a-11, shall be considered an "insider" and subject to the applicable Section 16 requirements.

### Outstanding Issues

In addition to the ongoing debate between balancing a less costly method of increasing director vigilance in oversight and decision making on the one hand, and resistance to constraining directors to the point that their ability to increase shareholder value is diminished on the other, the proposed amendments present several issues.<sup>5</sup>

First, corporate governance is an issue of state law. Under the internal affairs doctrine, matters such as the election of directors are left to states and not decided under federal law (i.e., the Exchange Act).<sup>6</sup> Delaware has recently passed amendments allowing companies to provide in their bylaws for shareholder proxy access or for reimbursement of shareholder proxy expenses.<sup>7</sup> The scope of these SEC proposed amendments in an area traditionally left to state law is a complex issue.

Secondly, in regulating issues of corporate governance, states have often taken an enabling approach, rather than a mandatory approach. For instance, the Delaware amendments regarding proxy access allow each company to choose, within a set range, the extent of access provided for in the company's bylaws. In contrast, the SEC proposed amendments require that each company allow proxy access to the same extent. Some have questioned the wisdom in requiring even well-governed companies to adopt this level of proxy access. While it may be difficult to determine which companies are well managed or for shareholders to otherwise adopt changes to the bylaws, the fact that the proposed amendments will, in at least one sense, increase corporate costs<sup>8</sup> may support an enabling approach to proxy access.

<sup>5</sup> The remarks of SEC Commissioner Troy A. Paredes in opposition to the proposed amendments provide insight into many of the unresolved issues regarding the proposed amendments. A transcript of his statement is available at <http://www.sec.gov/news/speech/2009/spch052009tap.htm>.

<sup>6</sup> On May 19, 2009, the Shareholder Bill of Rights Act of 2009 was introduced in the U.S. Senate. If approved in its current form, the act will give the SEC express authority to adopt rules on shareholder access to a company's proxy materials similar to the SEC's proposed amendments (provided that such rules must require shareholder nominees to beneficially own a minimum of one percent of the voting securities of the company for at least two years before making a nomination). This would have a significant impact on the argument that the proposed amendments encroach too far into an area of state law.

<sup>7</sup> The Delaware legislature recently amended the Delaware General Corporations Law to add Section 112 and 113. In addition, North Dakota recently adopted the Publicly Traded Corporations Act which, among other things, expands shareholder access to proxy materials.

<sup>8</sup> The SEC release includes an estimated total burden on reporting companies of \$7,630,420 annually.

In light of these first two issues, a number of commentators have indicated that litigation challenging the authority of the SEC to promulgate these amendments is likely if the proposed amendments are enacted as presently written. The principal arguments would likely be that the proposed amendments create a substantive right and that they conflict with corporate rights under state law. Both the character of the actions taken by the SEC and its authority to do such appear to be unsettled questions. Proponents of the proposed amendments argue that the amendments fall within the SEC's authority to create rules and regulations pertaining to the solicitation of proxies and that the amendments "merely [put] shareholders in the same place that they would be if they had attended the meeting"<sup>9</sup> – not create a new shareholder right. While the SEC may be able to decrease the risk of litigation by making application of the proposed amendments voluntary or by only adopting amendments to Rule 14a-8 (as opposed to Rule 14a-11), given the strong polarization between those supporting and those opposing the proposed amendments, it is likely that litigation will result if these amendments are adopted as presently written.

Finally, the amendments proposed by the SEC raise a number of practical concerns. While the amendments seem to speak of shareholders as one unanimous whole, shareholders are not in fact uniform. As a result, these amendments may pave the way for "special interest" directors – those who cater only to a small minority of shareholders. Further, while some shareholders may welcome increased proxy access, for others the amendments may at best, only change one unsympathetic board member for another, and at worst, replace desirable directors with self-interested directors. Some shareholders may benefit at the expense of others.

As Professor Stephen Bainbridge has observed, experience with the effects of cumulative voting has shown that once these directors are elected to the board pursuant to the proposed amendments, the result may be a rift in the board leading to "pre-meeting caucuses" by the majority, adversarial relations between board members, and decreased flow of information between directors.<sup>10</sup> David Hirschmann, president of the U.S. Chamber of Commerce Center for Capital Markets Competitiveness, has noted that, "politicizing the board room would hurt millions of individuals."<sup>11</sup> While increased oversight and accountability may be a desirable goal, any benefit of these proposed amendments may come at the cost of a non-unified board.

Taken one step further, if a director elected pursuant to the proposed amendments is going to be effectively shut-out of the board, why would anyone want to serve in such a position? At the same time, given the increased duties and potential for liability as a director under Sarbanes-Oxley, the risk of being singled-out and replaced by a shareholder nominee may make it difficult to find people willing to serve as independent directors. The result may be having to fill independent directorships with less qualified individuals – harming rather than benefiting shareholders.

In any event, the issue of shareholder proxy access is far from settled and will likely continue to enlist many advocates on both sides. The SEC has provided that public comments to be considered in preparing the final rules must be received by August 17, 2009. We expect a large number of comments will be made on the proposed rules.

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<sup>9</sup> *Industry Expected to Sue if SEC Adopts Proxy Access; Lawsuit Risk can be Reduced*, by Yin Wilczek, available at <http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-7SXTTA?OpenDocument>.

<sup>10</sup> For a more detailed analysis of this issue, please see *A Comment on the SEC Shareholder Access Proposal*, by Stephen M. Bainbridge, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=470121](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=470121).

<sup>11</sup> *SEC Weighs 1 Percent Threshold for Board Nominations*, by Jesse Westbrook, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTsdYGHJu59M>.

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