

## *SEC Publishes Proposed Rules on Stockholder Proxy Access*

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

On June 10, 2009, the Securities and Exchange Commission (“SEC”) published stockholder proxy access rules 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. 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 is now increased focus on boards of directors, especially in the areas of executive compensation and risk management. Stockholder rights advocates are pointing 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) proposed rules intended to provide stockholders with greater access to corporate proxies:

- 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.
- 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, 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 we 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 May 20th open meeting. We have also provided an overview of the controversies and concerns surrounding the proposed rules and the debate over proxy access.

### **New Rule 14a-11 – Stockholder 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% 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% in a large accelerated filer, or a registered investment company with net assets of \$700M or more;
- 3% in an accelerated filer, or a registered investment company with net assets of \$75M or more and less than \$700M; or
- 5% 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% 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. In the proposed rules as published, 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 nominees 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 new 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 fourteen (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 fourteen (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 fourteen (14) days, 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 eighty (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 thirty (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 ten (10) days of the final results of the election.

When a stockholder or stockholder group nominates director candidates, the company would also 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 in the election;
- details of stock trades in the past two years;
- criminal convictions; and
- any arrangement or understanding 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 include 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.

An amendment to Rule 14a-9 has been proposed which would explicitly 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 company's proxy materials would not automatically be incorporated 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 must have continuously held company voting securities of at least \$2,000 or 1% 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 may eventually 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 directors would be nominated and elected.

### **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 represents a selection of topical criticisms:

#### **Controversy Surrounding the Premise of the Proposed Amendments**

- Several commentators have expressed disagreement with the SEC's premise that greater stockholder oversight could have prevented or mitigated the current financial crisis. These commentators often express skepticism that independent, outside directors are as aware of the risks inherent in a company's business as management representatives on a board might be.

#### **Conflict with Current State Regulation; Overbroad Approach**

- The proposed amendments have been criticized as stymying state initiatives in expanding proxy access. For example, Delaware recently amended its corporation law (March 2009) to permit companies to allow stockholder proxy access through changes in their bylaws. Other states were expected to follow suit, 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. 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 amend only Rule 14a-8(i)(8), and allow stockholders and boards to determine on a company by company basis whether to allow greater access to company proxy materials.

#### **Unintended Consequences**

- The proposed amendments may cause an unmanageable proliferation of candidates for board elections, which combined with the plurality voting system might cause situations in which the threshold amount of votes needed for election is pushed so low that a small but committed voting block could have a large influence in an election.
- The expansion of trading in derivatives has caused an increase in the number of shares voted at meetings through proxies where 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 voters having a larger interest in the failure of the corporation than in the appreciation of the shares.
- The proposed amendments, when combined with: (i) a pending rule of the New York Stock Exchange which may prohibit brokers from voting shares owned by clients, and (ii) an increasingly common requirement for majority support for directors in election votes, may lead to unfilled board seats and have a deleterious effect on the functioning of the board.
- 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 disclosed in the same proxy statement.

- Boards seeking to limit the effect of stockholder nominated directors under the proposed rule may, in some instances, choose to expand the board size to dilute, to an extent, those directors.
- Stockholders relying on proposed Rule 14a-11 may not intend to do so “for the purpose of or with the effect of changing control” of the company. It is unclear how narrowly or broadly this standard would be interpreted in practice.
- Special and disparate interests may 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 majorities and minorities may foster an adversarial and tension-filled environment. Management may provide the entire board less information due to a concern that the minority board members would misuse this information.

## **SEC Regulatory Authority**

- 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 in elections. Indeed, one of the dissenting SEC Commissioners specifically stated that the SEC's authority in adopting these rules is questionable.
- Senator Schumer has introduced a bill called the Shareholder Bill of Rights Act of 2009<sup>1</sup> 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. The passage of this bill would militate against an invalidation of SEC action by the courts.

## **Financial and Other Concerns**

- Commentators have expressed concern over the price of compliance. The SEC has attempted to estimate the cost to businesses of accommodating greater stockholder access to the proxy, and has provisionally 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 decision-making 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 Rule 14a-8.
  - All stockholders of a given company may effectively 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 federal government as a stockholder be excluded from this rule?
- Should the SEC consider making these proposed rules applicable only once a triggering event occurs (e.g., "X" number of years of lagging behind in a peer index, being delisted, being sanctioned by the SEC)?
- If stockholders are aggregating to meet ownership thresholds must they all meet the one-year minimum holding period?
- If a stockholder does not own their stock through the meeting date, what are the repercussions for the stockholder and their nominee?
- If a stockholder's intent not to seek a change of control changes over time, what are the repercussions for the stockholder and their 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 (in effect by the other stockholders)?
- 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?
- Should the stockholder nominee also be required to make the same representations that nominating stockholders are required to make pursuant to Schedule 14N?
- When calculating 25% of the board, should stockholders and companies round up or down?
- 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% or greater interest in a competitor?
- Will companies be in a position to make the determination of whether a stockholder nominee has met all the necessary criteria?
- 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?
- Could a board adopt bylaws that would exclude certain classes of stockholders from nominating directors?
- Could a board exclude a nominee under the provision "prohibited by applicable state law" if they felt including the nominee would endanger stockholder value and therefore be a breach of fiduciary duty?
- If an institution lends shares for short selling, does it lose the right to vote those shares and consequently impair its fulfillment of the one-year holding period required by 14a-11?

**Conclusion**

In its release, the SEC stated that “amending our rules to provide for the inclusion of shareholder 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. Others may claim that the proposed rules are not sufficient.

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 United States Chamber of Commerce questioning the authority of the SEC to adopt these rules and committing to challenge them, and Senator Schumer proposing a “Shareholder Bill of Rights,” the issue of stockholder access has not been settled. The comments received in the upcoming months will be important in shaping the final rules as stockholder proxy access continues to be a hot topic in the current political and economic climate.

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

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For more information, please contact the following Jenner & Block attorneys:

**Joseph P. Gromacki**  
Partner  
Tel: 312 923-2637  
Email: jgromacki@jenner.com

**Jerry J. Burgdoerfer**  
Partner  
Tel: 312 923-2820  
Email: jburgdoerfer@jenner.com

**Elaine Wolff**  
Partner  
Tel: 202 637-6389  
Email: ewolff@jenner.com