THE RECORDER

134RD YEAR NO. 201 www.therecorder.com MONDAY, SEPTEMBER 13, 2010

The nuts and bolts of proxy access

A guide to the new SEC regulations on board member nominations

John Tishler
Louis Lehot
Camille Formosa

Corporate Governance and Compliance

This is the first of a two-part series that will address the nuts and bolts of the SEC's new proxy access regime. Next week's installment will look at the implications of the new rules on management and boards of directors.

On August 25, 2010, the Securities and Exchange Commission voted 3-2, along party lines, to adopt a controversial proxy access regime. The regime permits a single shareholder or group of shareholders owning at least 3 percent of a public company's shares entitled to vote to nominate a number of directors and have shareholder nominees included in the company's proxy statement. While legal challenges are expected, the rules are intended to be effective for the 2011 proxy season.

The SEC has been exploring means of facilitating shareholder nominees of directors for decades. In the aftermath of the corporate scandals of the early 2000s, the SEC proposed in October 2003 a right for shareholders to force companies to include shareholder nominees in the company's proxy statement if certain "triggers" occurred, such as a director candidate receiving a set percentage of withhold votes in an election. That proposal was never adopted.

Today's governance environment is substantially different from when proxy access was first seriously proposed in 2003. Most larger public companies have now adopted a majority voting requirement for the election of directors, which provides shareholders an opportunity to show opposition to the board's candidates. Under most majority voting regimes, a candidate who fails to receive a majority of the votes cast must tender his/her resignation and the board or a committee will decide whether or not to accept the resignation. In 2009, the New York Stock Exchange amended its Rule 452 to prohibit brokers who trade on the New York Stock Exchange from exercising discretionary authority to vote shares held in street name in favor of director candidates in uncontested elections. The amendment to Rule 452 eliminated a reliable "head start" companies had toward achieving the majority voting requirement.

The Dodd-Frank Wall Street Reform and Consumer Protection Act prohibits broker discretionary voting on the election of directors. The Act also mandates say-on-pay and say-on-golden parachutes shareholder votes. Most commentators believe that these votes will provide a significant opportunity for shareholders to express their views on the performance of company management and force boards to give greater consideration in advance of the likely reaction of shareholders to compensation-related decisions. These decisions are often at the heart of shareholder concerns over management.

Despite all of these changes favoring the shareholder franchise, a slim majority of the commissioners determined that direct access to a company's proxy statement for shareholder nominees was necessary.

While new SEC rules do not change any state or foreign corporate law rules governing the nomination and election of directors, they do provide for the inclusion of nominees properly nominated in accordance with state law in the company's proxy statement. In so doing, they substantially reduce the costs for shareholders to have nominees considered for election.

Together with other recent rulemaking, institutional shareholders and special interests will be newly empowered in the 2011 proxy season to directly influence issuers through director elections. At the same time, incumbent directors and management will likely be forced to redirect significant time and resources to the process.

New Rule 14a-11 will apply to companies reporting under the Exchange Act, including companies subject to the Investment Company Act of 1940. However, as with other proxy rules, Rule 14a-11 will not apply to foreign private issuers. Large accelerated filers and accelerated filers will be required to comply in time for the 2011 proxy season. The rule will eventually apply to smaller reporting companies, but not until three years after the effective date.

Subject to the phase-in rule for smaller reporting companies, Rule 14a-11 is mandatory for all subject companies. A company may not opt out of or increase the thresholds for proxy access, even with the approval of its shareholders. As discussed further below, companies may adopt proxy access rules that are more permissive of proxy access than Rule 14a-11.

Rule 14a-11 requires a company to include in its proxy statement director candidates nominated by a shareholder or a group of shareholders holding in the aggregate the requisite percent of shares for the required time period.

John Tishler (858-720-8943, jtishler@sheppardmullin.com) is a partner in Sheppard Mullin, Richter & Hampton's corporate practice group in the San Diego/Del Mar office.

Louis Lehot (650-815-2640, llehot@sheppardmullin.com) is a partner in Sheppard, Mullin's corporate practice group in the Menlo Park office and Camille Formosa (650-815-2631, cformosa@sheppardmullin) is an associate in that office.

The following rules apply:

1. In calculating the 3 percent ownership requirement of the rule, ownership is reduced by any shares that a nominating shareholder has sold in a short sale. Shares borrowed by a nominating shareholder are excluded from the calculation, but shares lent to others count towards the total, provided that the lender has the right to recall such shares and will do so upon being notified that its shareholder nominee(s) will be included in the company's proxy statement.
2. The three-year holding period is measured from the date the shareholder files notification of the intent to use the proxy access rules on Schedule 14N with the SEC. The shareholder must continue to own the shares through the date of the meeting at which directors are elected, and must state its intent to continue to hold such shares after the election. If a shareholder group files, the rules are applicable to each member of the group.
3. If 25 percent of the number of authorized directors is not a whole number, the number of nominees that must be included is rounded down to the nearest whole number.
4. The number of directors shareholders may nominate is not reduced for a classified board election of a subset of directors. However, where any continuing directors who are not up for election in a given year were elected as a shareholder nominee pursuant to Rule 14a-11, these continuing directors will count toward the 25 percent maximum.

If multiple shareholders or groups propose candidates, the nominees of the nominating shareholder or group with the highest qualifying voting power percentage will be included. If that number of nominees is less than the maximum number that must be included, the nominee(s) of the next largest shareholder or group must be included, and so on until the maximum number of nominees is included. If prior to the printing of proxy materials, a director candidate is disqualified or becomes unavailable, the same order of priority must be used to put a replacement candidate in the proxy. Once a company has begun printing its proxy materials, it does not need to include replacement nominees.

A nominating shareholder or member of a group may not use Rule 14a-11 if it holds any of the company's securities (1) with the purpose or the effect of changing control of the company, or (2) to gain a number of seats on the board that exceeds the maximum number of nominees permitted under Rule 14a-11. Each nominating shareholder or group member must certify to the absence of such intent in the Schedule 14N. The SEC clarified in the final rule that the absence of an intent to change control of the company is a condition for use of Rule 14a-11. Accordingly, a company which believes that a nominating shareholder or group member has an intent to change control or to pursue further nominees has the opportunity to exclude the nominees using the SEC's informal process or litigation.

Together with other recent rulemaking, institutional shareholders and special interests will be newly empowered in the 2011 proxy season to directly influence issuers through director elections.

In addition, a nominating shareholder or member of a group may not have an agreement with the company regarding director nominations prior to filing a Schedule 14N. This rule is designed to prevent collusion among the company and friendly shareholders to nominate candidates that the board approves. This rule does not prohibit negotiations among the nominee, the nominating shareholder or group, and the nominating committee or board of directors of the company regarding the nominee's inclusion in the company's proxy statement as a company-supported nominee, where those negotiations are unsuccessful. Nor does it prohibit negotiations that are limited to whether the company is required to include the shareholder nominee in the company's proxy statement in accordance with Rule 14a-11.

Companies whose securities trade on a national securities exchange, or a trading system subject to national securities association rules, need only include a shareholder nominee in the proxy statement if the nominee meets the exchange's objective criteria for independence. Nominees do not need to meet an exchange's subjective independence requirements or the stricter requirements for audit committee membership. A company may also exclude a nominee if it believes the nominee's inclusion on the board of directors would violate federal, state or foreign law, or the rules of the applicable national securities exchange, other than rules related to independence.

Companies may not exclude nominees that do not meet director qualification requirements set forth in the company's organizational documents. If a nominee does not meet such requirements, the company can include that fact or belief in the proxy statement, which presumably would influence the vote on that nominee. If a nominee who does not meet qualification requirements is nonetheless elected, then under state law, the nominee would not in fact take a board seat, and applicable state law would govern what happens with respect to that seat. Although qualifications in governing documents cannot disqualify a nominee from being named in the company's proxy statement, such qualifications may still be a powerful tool for companies to ensure that directors meet minimum standards important to the company.

The SEC will have an informal procedure for companies to use when they believe a purported Rule 14a-11 nominee may be excluded. No later than 14 calendar days after the close of the nomination window period, an issuer must notify the nominating shareholder(s) of a determination not to include one or more nominees. The nominating shareholder(s) will have 14 days after receipt of such notice to respond, and where applicable, cure any defects in the nomination. No later than 80 calendar days before filing its definitive proxy statement with the SEC, the company must notify the SEC of its intent to exclude a Rule 14a-11 nominee and the basis for its determination. The company may (but is not required to) seek a no-action letter from the SEC staff to support its determination. Nominating shareholder(s) will have 14 days after receipt of the company's notice to the SEC to submit a response to the SEC staff. If requested by the company, the SEC staff may at its discretion and as soon as practicable provide an informal statement of its views to the company and the nominating shareholder(s). Promptly following receipt of the SEC staff's views (if provided), the company must provide notice to the nominating shareholder(s) whether it will include or exclude the nominee.

The rules adopted by the SEC tried to strike a balance between the competing interests in the proxy access debate, but many, including two of the five SEC commissioners, feel that the inclusion criteria are arbitrary and flawed. Next week's installment will discuss the implications of proxy access for management and board dynamics, steps companies should take to prepare for proxy access, and coordinating changes to SEC rules on shareholder proposals and shareholder communications.

THE**RECORDER**

134RD YEAR NO. 201 www.therecorder.com MONDAY, SEPTEMBER 20, 2010

Proxy access' effect on management

What corporate board members need to know before the new SEC regulations take effect

John Tishler
Louis Lehot
Camille Formosa

Corporate Governance and Compliance

On August 25, 2010 the Securities and Exchange Commission adopted a controversial proxy access regime that permits a single shareholder or group of shareholders owning at least 3 percent of a public company's voting shares to nominate a number of directors and have shareholder nominees included in the company's proxy statement. The following is the second of a two-part series that addresses the nuts and bolts of the new proxy access regime. Part one appeared September 13, 2010.

Under the SEC's new proxy access rules, nominating shareholders and groups will be required to provide a notice on Schedule 14N to the company of an intent to exercise these new nomination rights. Schedule 14N must be delivered to the company and to applicable securities exchanges and concurrently filed with the SEC.

John Tishler (858-720-8943, jtishler@sheppardmullin.com) is a partner in Sheppard, Mullin Richter & Hampton's corporate practice group in the San Diego/Del Mar office.

Louis Lehot (650-815-2640, llehot@sheppardmullin.com) is a partner in Sheppard, Mullin's corporate practice group in the Menlo Park office and Camille Formosa (650-815-2631, cformosa@sheppardmullin) is an associate in that office.

Disclosure required by Schedule 14N includes: (1) information evidencing that the nominating shareholder(s) and the nominee(s) satisfy the eligibility requirements of Rule 14a-11; (2) the extent and nature of relationships between the nominating shareholder(s) and the nominee(s); and (3) the beliefs of the nominating shareholder(s) as to whether the nominee(s) satisfy any board qualification requirements in the company's governing documents. There are no restrictions on relationships between the shareholder(s) and the nominee(s). However, we would expect that shareholders who wish to avoid restrictions on trading in the company's securities would avoid proposing a nominee who would make them subject to the company's insider trading policy or to reporting and short-swing liability under §16 of the Exchange Act.

Schedule 14N may include a supporting statement, not longer than 500 words per nominee, which the company must include in its proxy statement. A company will not be subject to any liability under the securities laws for incorrect information contained in the supporting shareholder statement.

Schedule 14N must be filed with the SEC no earlier than 150 calendar days, and no later than 120 calendar days, before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting. If the company did not hold an annual meeting during the prior year, or if the date of the meeting has changed by more than 30 calendar days from the prior year, the company will be required to disclose the filing date within four business days after the company determines the anticipated meeting date. The date must be reasonable, and if required to be disclosed, must be reported in a Form 8-K filed with the SEC pursuant to new Item 5.08.

Prior to the adoption of these new rules, the so called "election exclusion" provided by Rule 14a-8 permitted companies to exclude shareholder proposals to amend the company's organizational documents to establish procedures for the inclusion of shareholder director nominees in the company proxy materials proposals. Rule 14a-8 will be amended to remove that basis for exclusion. Accordingly, a shareholder may propose amendments to charter documents providing for more liberal rules of proxy access, such as reduced ownership thresholds, reduced holding periods, and the like. If the proposed amendments are to the bylaws, under Delaware and other state laws, the action may be direct rather than advisory.

The SEC also amended Rule 14a-2 to permit shareholders to solicit other shareholders to form a nominating group for Rule 14a-11 purposes and to campaign for shareholder nominees without running afoul of the proxy rules. Rule 14a-2(b)(7) provides an exception from proxy-solicitation prohibitions for oral and written communications by or on behalf of any shareholder in connection with the formation of a nominating shareholder group.

To be eligible to use this exemption, a shareholder cannot be holding the company's securities with the purpose, or with the effect, of changing control of the company or to gain a number of seats on the board of directors that exceeds the maximum number of nominees that the company could be required to include under Rule 14a-11. Written communications may include no more than (1) a statement of the shareholder's intent to form a nominating shareholder group, (2) 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), (3) the percentage of voting securities that each soliciting shareholder holds or the aggregate percentage held by any group to which the shareholder belongs, and (4) contact information. Written information must be filed with the SEC under cover of Schedule 14N on the day first used. The exception also covers oral solicitations, which are not limited in content. In order to rely on the exception for oral solicitations, the shareholder must file a notice of commencement of oral solicitations on Schedule 14N.

Rule 14a-2(b)(8) provides another 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 (1) the identity of the nominating shareholder or group, (2) a description of his/her/its direct or indirect interests, by security holdings or otherwise, and (3) a specified legend. These written communications must be filed with the SEC under cover of Schedule 14N on the day first used. There is no filing requirement for oral communications in support of nominees. A shareholder may begin these communications immediately upon being notified that such shareholder's nominee(s) will be included in the company's proxy statement.

Neither rule discussed above provides an exemption for communications in connection with non-Rule 14a-11 proxy contests, such as those that occur under the director nomination provisions of a company's governance documents. Moreover, both rules provide the exemption will be lost retroactively if the shareholder or group subsequently engages in a non-Rule 14a-11 nomination or solicitation in connection with the subject election of directors. The retroactive loss of the exemptions is designed to prevent exempt Rule 14a-11 solicitations from being used as a first stage in a more aggressive proxy contest.

In addition to the shareholder proposal and advance-notice bylaw deadlines already required to be disclosed under Rule 14a-5, companies must disclose the deadline for submitting nominees for inclusion in the company's proxy materials for the company's next annual meeting.

A 5 percent or greater shareholder, who is eligible to report beneficial ownership on the shorter-form Schedule 13G, may continue to do so even if such shareholder engages in a Rule 14a-11 process to nominate a director for inclusion in the company's proxy statement. This is an exception from the requirement for shareholders who hold shares with an intent to influence control of a company to report on the longer-form Schedule 13D.

The new rules contain no limitations on the ability of shareholders to nominate previously unsuccessful candidates. A 3 percent or greater shareholder is free to nominate the same candidates every year despite unsuccessful prior elections, provided the conditions of Rule 14a-11 are satisfied each year.

The new rules contain no limitations on the ability of shareholders to nominate previously unsuccessful candidates.

It is unclear whether institutional investors that have not previously pursued proxy contests will avail themselves of Rule 14a-11. It is also unclear whether individual investors will be able to organize groups large enough to meet the 3 percent ownership threshold, and if they do, whether larger investors will step in and propose nominees that "trump" the nominees of smaller investors for the limited Rule 14a-11 space on the proxy statement. Most majority voting provisions provide that they do not apply in contested elections for directors. Accordingly, one effect of Rule 14a-11 will be to restore plurality voting for directors in most elections where shareholders avail themselves of Rule 14a-11.

It is clear that proxy access presents a significant change to the prevailing order of the board nomination process. Where a Rule 14a-11 candidate is elected, board communications will likely be affected, at least at the outset. The traditional board nomination process affords management and the continuing directors significant opportunity to get to know a new board member. That process usually involves the existing directors and the new director getting comfortable that they will operate harmoniously together. Rule 14a-11 directors that were opposed by the current board will lack the trust built through the traditional nomination process, and depending on the nature of the campaign, may be affirmatively distrusted and even disliked by the other directors.

Of course, this sort of disruption is not new — boards that have seen successful activist shareholder campaigns have been through it. Rule 14a-11 has the potential to increase the number of boards that experience such a shift, particularly at companies that in the past were not at a significant risk of activist shareholder attack.

The risk of shareholder nominees could affect future management decisions. That is, management at some companies might find incentive to make decisions to satisfy the concerns of small constituencies of shareholders who might otherwise disrupt the proxy process by nominating dissident directors. It remains to be seen whether directors hostile to management or otherwise unwelcome by other board members will improve corporate governance, accountability and performance, as the SEC hopes. In any case, incumbent boards and company management will likely be required to spend significant additional time and resources on the director nomination and election process. Some, including dissenting Commissioner Kathleen Casey, argue that this new proxy access regime may reduce the competitiveness of U.S. corporations.

The new rules will become effective 60 days after publication in the Federal Register. The publication date is uncertain, but the new rules should be in effect in November 2010. Smaller reporting companies will be exempt from the rule until three years after the effective date. Companies that mailed proxy materials for their 2010 annual meetings in March 2010 or later will generally be subject to the new rules for their 2011 annual meeting.

In the meantime, we recommend that affected companies:

- examine their shareholder base and constructively interact with shareholders to gain a better understanding of their views and concerns now, and closely and continuously monitor their shareholder base going forward.
- review their existing bylaws and consider revisions to the advance notice and director qualification provisions in light of the new proxy access rules.
- review corporate governance policies and committee charters to determine if changes are required to operate harmoniously with Rule 14a-11 procedures.
- review risk factors for shareholder dissatisfaction, such as unpopular governance and executive compensation policies and directors who received negative voting recommendations in past years from proxy advisory firms like Institutional Shareholder Services (ISS) or Glass, Lewis & Co.
- consider whether the current size of the board and each committee continues to be appropriate.
- develop a game plan to address shareholder nominees if the shareholder composition suggests a reasonable chance of one or more shareholders using the new proxy access rules. The game plan should address all aspects of the new process, including determining whether nominating shareholders and nominees are eligible, a communications strategy, a negotiation strategy and, where appropriate, a litigation strategy.