# A New World Order: What Your Board Should Know About Proxy Access

September 23, 2010

## Introduction

After considering proxy access for 30 years, the Securities and Exchange Commission (the "*SEC*") on August 25, 2010 voted 3-2 to adopt a proxy access rule (the "*proxy access rule*"). The rule was published in the Federal Register on September 16, 2010, and will become effective on **November 15, 2010**. The adoption and publication of the proxy access rule, along with the onset of mandatory, non-binding "Say on Pay" votes on executive compensation as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*"), mark the beginning of a new era in the relationship between the board of directors of a public company and its shareholders. This Legal Alert will discuss the most significant provisions of the proxy access rule and analyze its impact on public companies, before summarizing steps a board of directors should take in preparation for the new world order.

## The New Rule

The SEC previously proposed amendments to the federal proxy rules regarding proxy access in 2003, 2007 and 2009. Each successive proxy access proposal issued by the SEC met controversy, not only with respect to its content, but also the authority of the SEC to issue such rules under federal laws. More recently, the Dodd-Frank Act amended Section 14(a) of the Securities Exchange Act of 1934 (the "*Exchange Act*") to authorize, but not require, the SEC to issue rules regarding the inclusion of shareholder nominees in a company's proxy materials, thus paving the way for the SEC to issue the proxy access rule. However, a number of observers have noted that Rule 14a-11 may still face a legal challenge from corporate groups; opponents of the rule have 60 days from its August 25 approval date to file such a legal challenge, presumably under the Administrative Procedure Act.[1]

The proxy access rule, as adopted, requires all public companies to:

- Provide shareholders the ability to vote for shareholder nominees on the proxy ballot;
- Include information about director nominations from certain qualified shareholders or shareholder groups in proxy materials for their shareholder meetings; and
- Include shareholder proposals in proxy materials that seek to change or establish governing document procedures regarding the inclusion of shareholder director nominations in proxy materials.

The heart of the proxy access rule is codified as new Rule 14a-11 under the Exchange Act which, according to the adopting release, "will require companies to include information about shareholder nominees for director in company proxy statements, and the names of the nominee or nominees as choices on company proxy cards." Rule 14a-11 applies automatically to public companies; therefore,

[1] Ted Allen, *Proxy Access Likely Will Face a Court Challenge*, RickMetrics Blog *available at* http://blog.riskmetrics.com/gov/2010/09/proxy-access-likely-will-face-a-court-challenge.html (last visited September 19, 2010).

companies need not opt in to proxy access. The requirement to comply with the proxy access rule also applies to companies that are concurrently the subject of a traditional proxy contest. Further, a company may not opt out of proxy access unless governing law or its governing documents completely prohibit shareholder nomination of directors (a relatively unlikely situation). However, under new Rule 14a-8, a shareholder may propose modifications to a company's governing documents to allow less, but not more, restrictive proxy access procedures than those contemplated by Rule 14a-11 (see below for more information on Rule 14a-8).

***Eligibility***

The new Rule 14a-11 allows eligible investor groups to nominate directors to appear on management proxy statements if they own a 3% stake in the company for at least three years as of the date the shareholder's notice of intent is filed on new Schedule 14N. This ownership threshold differs substantially from the proxy access rule proposed by the SEC in June 2009, which would have instituted tiered ownership thresholds varying from 1% to 5% of voting shares depending on company size. Despite receiving many comment letters to the contrary, the SEC made clear in its adopting release that the 3% ownership threshold and the three-year holding requirement also applies to open- and closed-end investment companies, with the caveat that the ownership calculation for investment companies without a market capitalization will be based on the net assets of the fund.

In order to include share holdings in calculating a nominating shareholder's ownership, the shareholder must have both voting and investment power; nominating shareholder groups will be able to aggregate their shares to meet the 3% ownership threshold. To determine whether a shareholder or group has continuously held 3% of voting and economic ownership of the shares, loaned shares will be counted only if the shareholder has the right to call them back and will recall them upon notification that its nominees are included in the proxy. However, borrowed shares and shares sold short will not be counted for this ownership purpose. In calculating the percentage of ownership, individual nominating shareholders and nominating shareholder groups may include shares held in street name by brokers or other intermediaries acting on their behalf.

The nominating shareholder or group must not hold its securities with the purpose, or the effect, of changing control of the company or gaining a number of seats on the board of directors that exceeds the maximum permitted under new Rule 14a-11 (see below). The nominating shareholder or group must make a statement to this effect on Schedule 14N that must be filed with the SEC and will be held to Rule 14a-9 liability (the antifraud provision governing the federal proxy rules) for disclosures in the Schedule 14N.

***Specific Requirements***

A company must include a number of shareholder-nominated director nominees that represents no more than 25% of the company's board of directors, but no less than one director. For companies with a board of directors of seven or fewer, this means that there will never be more than one shareholder-nominated director on the slate for election at any given time.

Rule 14a-11 also mandates that the nominating shareholders disclose relationships between themselves and their candidates as well as relationships between the company and either candidates or their proponents, but does not require that nominees be independent from the nominating shareholders. In addition, a company may exclude director nominees who do not meet the *objective* independence standards of the relevant stock exchange (but not its *subjective* standards). A company could also exclude a nominee who would violate state or federal law or stock exchange rules (other than those with respect to independence) if the violation cannot be cured within 14 days after being notified by the company that it intends to exclude the nominee on this basis.

### *Schedule 14N*

Shareholders seeking to have their director nominations included in a company's proxy materials pursuant to Rule 14a-11 must provide notice of such intent on new Schedule 14N under the Exchange Act. Nominating shareholders will be required to file Schedule 14N with the SEC through EDGAR on the same date that notice is sent to the company. In addition to its notice provisions, Schedule 14N includes disclosure requirements that, according to the adopting release, are designed to "provide transparency and facilitate shareholders' ability to make an informed voting decision on a shareholder director nominee or nominees without being unnecessarily burdensome on nominating shareholders or groups."
Under new Schedule 14N, nominating shareholders are required to give notice of their intent to use Rule 14a-11 "no earlier than 150 days prior to the anniversary of the mailing of the prior year's proxy statement and no later than 120 days prior to this date."

Among other items, the notice on Schedule 14N will be required to disclose:

- The amount of shares held by the individual nominating shareholder or each member of a nominating shareholder group;
- The length of time the shares have been held;
- Biographical and other information about the nominating shareholder;
- Certification that the nominating shareholder meets the eligibility criteria of Rule 14a-11 and does not hold any shares "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;" and
- That neither the director nominee nor the nominating shareholder has an agreement with the company regarding the nomination of the nominee.

The nominating shareholder may also submit a short (no more than 500 words) statement in support of its nominee. The nominating shareholder or shareholder group will be liable for any false or misleading information provided in this Schedule 14N; according to the rule, the company will not bare any liability for merely reproducing such statements in its proxy materials.

If the company believes the eligibility requirements as set forth in the rule have not been met, it must provide notice to the shareholder or shareholder group and provide an opportunity for such deficiencies to be cured. If the company still believes these deficiencies remain, it may submit notice of its intent to exclude the shareholder nominee to the SEC no later than 80 days prior to the filing of its definitive proxy statement, subject to a no-action review process by the SEC.

### *New Rule 14a-8*

Rule 14a-8 previously had allowed companies to exclude shareholder proposals to amend a company's governing documents to allow for proxy access. New Rule 14a-8 under the Exchange Act, as amended, would require companies to include qualifying shareholder proposals that seek to establish procedures for the inclusion of shareholder nominees, as long as they do not limit the availability of proxy access under new Rule 14a-11.

## The New World Order

Supporters of proxy access argue that it will encourage shareholders to take an active role in monitoring the performance of management and the incumbent board and, if dissatified, use the threat of replacement to effectuate change. They argue that the current system is broken, as evidenced by the relative dearth of contested elections in publicly traded companies.[2] Critics of proxy access argue that the current system is not broken, and that shareholders are free to "vote with their feet" and sell their shares if they are dissatisfied with management performance. Critics further anticipate that institutional investors will make the most use of proxy access and not individual investors.[3] While some argue that proxy access may not affect a large swath of public companies immediately, these sweeping changes are in place for the 2011 proxy season, and companies should prepare now for this new world.

## What Boards of Directors Can Do Now

Even though the new proxy access rule has not yet taken effect, at least one investor has announced its intention to make use of the new proxy access rule to nominate two board candidates.[4] Companies wishing to get ahead of the proxy access world can take the time now to become educated and organized for the 2011 proxy season before proxy access begins in earnest. Listed below are recommendations of actions boards can take in preparation for the uncertainty that lies ahead.

- *Director Qualification Bylaws* -- The Delaware General Corporate Law ("*DGCL*") gives the board the authority to adopt bylaws specifying the qualifications required to serve on the board.[5] Boards should examine their qualification bylaws (or consider adopting such a bylaw) to make sure they are written in a way that gives the board discretion to interpret the qualifications of any director nominee. However, these qualifications should be rationally related to the qualifications needed to serve as director (e.g., policy qualifications such as education, experience, etc. as well as legally required limitations such as interlocking directorships) and should not be written in a way that limits shareholder franchise. While failure to satisfy the qualification standards will not preclude a nominee from being included in the proxy statement under Rule 14a-11, or from being voted upon, companies may, subject to state law, preclude nominees from serving as directors for failure to satisfy reasonable qualification requirements. In addition, nominating shareholders using Rule 14a-11 must disclose whether, to their knowledge, their nominees meet the company's director qualifications, which may affect both the quality of the proposed nominees and the number of votes that non-qualified nominees may receive.[6]
- *Advance Notice Bylaws* – Boards should review, and consider revising, advance notice bylaws to deal with the proxy access time frames, including the information requirements for shareholder nominees under the new rule. Companies that did not previously have state-of-the-art advance notice bylaws for notice of business and director nominations should consider adopting or revising such provisions.[7]

---

[2] J.W. Verret, "Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank," George Mason University Law and Economics Paper Series (August 2010).
[3] *Id.*
[4] Ted Allen, "Investor Plans to Use New Proxy Access Rule," RiskMetrics Corporate Governance Blog, *available at* http://blog.riskmetrics.com/gov/2010/09/investor-plans-to-use-new-access-rule.html (last visited September 19, 2010).
[5] Verret, *supra* note 2.
[6] Adam Emerrich, et al, "Shareholder Proxy Access: Time to Get Ready," Harvard Law School Forum on Corporate Governance, *available at* http://blogs.law.harvard.edu/corpgov/2010/09/16/shareholder-proxy-access-time-to-get-ready (last visited September 19, 2010).
[7] *Id.*

- *Engagement with Key Investors* – Engaging constructively and proactively with shareholders may allow companies to prevent the discord among its shareholders that could lead to a proxy access nomination. Consultation with key investors should aim to build constructive relationships between investors and directors and could involve the following steps:

    - Identify key shareholders, trade associations, proxy agents and potential media outlets that have the capacity to influence investor and public opinion on compensation matters;
    - Prepare an outreach plan well before proxy season;
    - Consult with institutional shareholders proactively so that the board can receive early notice of potential material dissent; and
    - Offer meetings with board members to key market players and compensation consultants. In so doing, however, companies should be sensitive to not run afoul of the SEC's Fair Disclosure Regulation ("*Regulation FD*") and should provide participating directors training on Regulation FD.[8] These interactions should focus not just on financial and operating performance, but also on compensation and corporate governance, particularly considering the onset of mandatory "Say on Pay" votes on executive compensation.

- *Boardroom Confidentiality* – Along with policies relating to director communications with shareholders, boards should review their policies to ensure they protect both material non-public information about the company and its performance (traditionally the subject of a company's code of conduct) and the confidentiality of board room discussions (and by extrapolation, collegiality among board members).
- *Resolve Controversies* – Boards should consider using the engagement strategies described above to identify any significant controversies and make strides to rectify them prior to a problem.
- *Director Qualifications* – Companies have been facing increasing calls from shareholders to focus more on the diversity of board membership. For example, the California Public Employees' Retirement System ("*CalPERS*") announced in August that it had assembled a database of diverse director candidates, so it and others can have nominees available to nominate via proxy access to public company boards. Further, in December 2009, the SEC issued amendments to the proxy disclosure rules that, among other new disclosure requirements, oblige companies to disclose any policy they have with respect to diversity. Given this increased attention to the diverse make-up of the board and its nominees, boards should determine now whether they sufficiently meet shareholder expectations in this regard.
- *Review Proxy Adviser Positions* – The influence of proxy advisers, such as RiskMetrics/ISS, is likely to grow with the advent of both a "Say on Pay" and proxy access. Boards should review the analysis given by key proxy advisors from their 2010 annual meetings and consider making changes, where appropriate, or devising strategies to communicate to shareholders why an adviser's policy should not govern their voting decisions.
- *Committee Charters* – Boards should consider closely examining and possibly revising their corporate governance and nominating committee charters and related bylaws to deal with vetting shareholder nominees. On a related note, boards should also consider whether their corporate governance and nominating committee members are appropriately trained and have sufficient availability to deal with this increased responsibility.

## Conclusion

[8] For example, one of the best ways to avoid running afoul of Reg FD is to focus on governance matters under the board's purview.

The ultimate impact of the new proxy access rule is still unknown. However, there has been a palpable shift in the balance of power as shareholders continue to seek greater influence in corporate governance. Boards should begin preparing for the proxy season now by engaging constructively with shareholders and conforming their corporate governance practices to the requirements of the new proxy access rule.

■ ■ ■

*If you have questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*


| | | |
|---|---|---|
| **Authors** | | |
| Cynthia M. Krus | 202.383.0218 | cynthia.krus@sutherland.com |
| Terri Ginsberg | 202.383.0976 | terri.ginsberg@sutherland.com |
| | | |
| **Related Attorneys** | | |
| Harry S. Pangas | 202.383.0805 | harry.pangas@sutherland.com |
| John J. Mahon | 202.383.0515 | john.mahon@sutherland.com |
| Lisa A. Morgan | 202.383.0523 | lisa.morgan@sutherland.com |
| Owen J. Pinkerton | 202.383.0254 | owen.pinkerton@sutherland.com |
| Anne W. Gray | 202.383.0966 | anne.gray@sutherland.com |
| Payam Siadatpour | 202.383.0278 | payam.siadatpour@sutherland.com |
| Vlad M. Bulkin | 202.383.0815 | vlad.bulkin@sutherland.com |
| Bradford J. Sayler | 202.383.0837 | brad.sayler@sutherland.com |