

SEC Grants Shareholders Unprecedented Access to Company Proxy Statements

ROBERT A. FRIEDEL | FRIEDEL@PEPPERLAW.COM

SHIRLEY R. KUHLMANN | KUHLMANN@PEPPERLAW.COM

On November 15, 2010, after nearly ten years and two unsuccessful proxy access campaigns, new Securities and Exchange Commission (SEC) rules will become effective, granting shareholders unprecedented and significant access to public company proxy statements.

The new rules, which have been revised since they were released as proposed rules in June 2009, enable shareholders, subject to certain eligibility requirements, to include director nominations representing up to 25 percent of the board of directors in a company's proxy statement.

SHAREHOLDER NOMINATIONS

Historically, shareholders of public companies have had only limited access to company proxy statements, and that access was restricted to certain business-related proposals – shareholders had no ability to require companies to include any director election-related proposals in company proxy statements. With the adoption of these new rules, shareholders will be able to mount a proxy contest against incumbent directors without the expense of preparing and filing a separate proxy statement as has been required previously.

The new rules may be used by shareholders to nominate director candidates in the 2011 proxy season with respect to any company that mailed its most recent annual meeting proxy statement on or after March 15, 2010. "Smaller reporting companies," which are companies with less than \$75 million of public float, will not be subject to the new rules until November 2013.

Under the proxy access rules, the eligibility of shareholders to include director nominees in a company's proxy statement is subject to the following conditions:

SHAREHOLDERS CAN NOW PROPOSE – AND REQUIRE COMPANIES TO FUND – EFFORTS TO REVISE DIRECTOR ELECTION PROCEDURES, AND DIRECTLY NOMINATE DIRECTORS THROUGH THE COMPANY'S PROXY STATEMENT.

- **Shareholder Eligibility.** A shareholder, or a group of shareholders acting in concert, wishing to submit director nominations, is required to own shares representing at least 3 percent of the subject company's voting power in the election of directors, and the shareholder or group is required to have held such shares for at least three consecutive years.

Nominating shareholders will also need to certify that they do not hold their stock for the purpose of effecting a change of control of the company, or to gain more than minority representation on the board of directors. A company may object to inclusion of a shareholder nominee if evidence exists that one or more of the nominating shareholders intends to effect a change of control of the company. In addition, the SEC may bring an enforcement action against any

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shareholder that falsely disavows an intent to effect a change of control in connection with the nomination of a director candidate.

- **Anatomy of Schedule 14N.** Eligible shareholders will submit their nominations on a new Schedule 14N, which is required to be filed with the SEC and delivered to the company 120 to 150 days before the anniversary of the mailing date for the prior year's proxy statement. Shareholders may nominate directors representing up to 25 percent of the full board of directors, and must include biographical information for each such nominee in Schedule 14N. Schedule 14N will also set forth information regarding the eligibility of the nominating shareholders, including their respective ownership amounts and holding periods.

A director who is initially nominated pursuant to a Schedule 14N proposal, but who is subsequently nominated by the company's nominating committee to serve as a director, will be included as a director nominated by shareholders for the purposes of calculating the aggregate number of directors that may be nominated by shareholders in a given election cycle.

Pepper Point: If approached by a shareholder seeking to have the company nominate a shareholder-recommended nominee, consider requiring the shareholder to file a Schedule 14N before commencing discussion of the nominee. In this manner, if the nominee is ultimately put forward by the company's nominating committee, she will nonetheless count towards the 25 percent maximum contained in the new proxy access rules.

Companies will be under no obligation to include in their proxy statements candidates for director whose election would violate any applicable state or federal law, regulation or listing standards of the securities exchange applicable to the company, other than "subjective" stock exchange-based independence requirements (i.e. where the board of directors is required to determine, in its discretion, whether a director nominee has a relationship which would interfere with his or her exercise of independent judgment as a director). Nominees will be required to satisfy "objective" stock exchange-based independence requirements (i.e. dealing with whether a nominee has been employed by the company or has received more than a specified amount of compensation from the company, and similar objective determinations).

Furthermore, while the failure of a shareholder nominee to satisfy any specific director qualification standards imposed by a company in its governing documents will not serve as a basis for a company to refuse to include the nominee in the company's proxy statement, nominating shareholders will be required to disclose in their Schedule 14N whether their nominees satisfy all applicable director qualification standards.

Pepper Point: Companies may wish to consider adopting director qualification standards in their governing documents, recognizing that these standards will apply to all directors, not just those nominated by shareholders. While the failure to satisfy qualification standards will not preclude a shareholder nominee from being included in the company's proxy statement, this failure may be highlighted by the company as a reason for shareholders not to vote in favor of that nominee.

- **Rejection of Shareholder Nominations.** The company may exclude a shareholder nominee if any of the applicable requirements of the new rules are not met. However, a nominating shareholder or group may cure any error within the time periods specified in the new rules, provided that the composition of the nominating shareholder or group and the identity of the proposed nominee(s) may not be changed in order to cure and error. If the nomination is not cured within the time periods specified in the rule, the company may exclude the nomination from its proxy statement.

If the company receives director nominations from multiple shareholders, the company will be required to include the proposal submitted by the shareholder or group with the largest share holdings; candidates nominated by smaller shareholders will be included to the extent that the largest shareholder did not fully exercise its right to nominate directors representing its full 25 percent allotment. Any available remaining slots will be afforded to the next largest shareholder, and any available remaining slots after that shareholder makes its nominations will be afforded to the next largest shareholder, and so forth.

Pepper Point: Companies should review their advance notice provisions and other requirements dealing with director nominations in their governing documents to consider their enforceability in light of the SEC's new proxy access rules. State corporate laws generally permit a company to impose reason-

able procedural rules on the right of shareholders to nominate candidates for election as directors. On the other hand, the SEC has stated that it does not believe that a company may require a shareholder nominee to complete the company's standard director questionnaire as a condition to including the nomination in the company's proxy statement and the SEC would be expected to have a similar view with respect to other similar procedural requirements for shareholder nominees set forth in a company's governing documents.

- **Solicitations Permitted Outside the Proxy Statement.** Communications between shareholders to form a group for purposes of including one or more director nominees in a company's proxy statement will not be deemed to be proxy solicitations – and will not trigger a requirement for the shareholders to file their own proxy statement – if they comply with certain conditions, including that shareholders file such communications with the SEC and that no such communications be made with an intent to effect a change in control of the company.

In addition, once a nominating shareholder has announced its nominee(s) on Schedule 14N, communications by such shareholder in support of its nominee(s) will be exempt from the proxy solicitation rules so long as these communications bear a legend directing other shareholders to review the shareholder nomination described in the company's proxy statement and neither provide a form of revocation or consent nor seek the power to act as proxy for shareholders. A nominating shareholder would be permitted to send shareholders an unmarked proxy card matching the company's card, requesting shareholders to complete, sign and date the card and return it to the company.

OTHER SHAREHOLDER PROPOSALS

In addition to creating an explicit mechanism for shareholders to include director nominees in company proxy statements, the new rules expand the category of director election-related proposals that a shareholder may submit for inclusion in a company's proxy statement. Historically, companies were permitted to exclude such proposals from their proxy statements. Under the new rules, companies will only be able to exclude an election-related proposal if it:

- would disqualify a nominee who is standing for election
- would remove a director from office prior to the expiration of his term
- questions the competence, business judgment or character of one or more nominees or directors
- seeks to include a specific individual in the company's proxy statement, or
- otherwise could affect the outcome of the *upcoming* election of directors.

Pepper Point: *This new right of shareholders to include director election-related proposals in company proxy statements will likely give rise to shareholder proposals of amendments to governing documents to relax the requirements for inclusion of shareholder nominees in a company's proxy statement. For example, shareholders may propose an amendment to a company's bylaws to require the company to include shareholder nominees in the company's proxy statement as long as the shareholders own a small number of voting shares, or for only a short holding period. Companies should review the amendment provisions in their governing documents with this in mind.*

This revised framework for addressing election-related shareholder proposals, and the director nomination provisions, translate into a substantial increase in shareholder influence over the director nomination and election process: shareholders will now have the power to propose – and require companies to fund – efforts to revise director election procedures, as well as to directly nominate directors through the company's proxy statement. Companies would be well served to respond to this new paradigm by continuing to improve corporate governance processes and by listening to and integrating shareholder concerns into their governance approach to forestall the nomination and other election-related battles that the new rules facilitate.