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September 2010

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## SEC Adopts Proxy Access Rule for Shareholder Director Nominations

On August 25, 2010, the Securities and Exchange Commission (SEC) voted 3 to 2 to adopt amendments (Amendments) to the federal proxy rules that will implement a new system of "proxy access," which has come to mean a procedure by which shareholders of a public company can participate in the director nomination process. Under the Amendments, a shareholder or group of shareholders meeting eligibility requirements can require a public company to include a limited number of director nominees proposed by the shareholder in management's proxy materials.

In her introductory remarks opening the SEC's August 25 open meeting, SEC Chairman Mary L. Schapiro noted that proxy access has been debated for more than 30 years. She noted, too, that some past debate concerned whether the SEC has the authority to adopt proxy access rules. That issue was resolved in July 2010 with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which gave the SEC explicit authority to make rules addressing shareholder access to company proxy materials. The proxy access rules, which are primarily contained in new Rule 14a-11 promulgated under the Securities Exchange Act of 1934 (Exchange Act), permit a single shareholder or group of shareholders owning at least 3 percent of the voting power of shares entitled to vote for directors to nominate a number of directors up to 25 percent of the total number of directors that comprise the board and to have such nominees included in the company's proxy statement. The rules are intended to be effective for the

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### Contacts:

[Abby E. Brown](#)

+1.202.626.6792

[Frank M. Placenti](#)

+1.602.528.4004

[Joseph P. Richardson](#)

+1.602.528.4801

[Fred A. Summer](#)

+1.614.365.2743

[David A. Zagore](#)

+1.216.479.8610

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2011 proxy season, going into effect 60 days after they are published in the *Federal Register*.

The adopting release, which includes the text of the Amendments and new Schedule 14N that must be filed by a nominating shareholder or shareholder group during the nomination window period, is available at the [SEC website](#).

The most significant provisions of the Amendments are discussed below.

### **Affected Companies**

New Rule 14a-11 will apply to companies that are subject to Exchange Act proxy rules, including registered investment companies. There is no exception for controlled companies, and the rule will also apply to companies that elect to voluntarily register a class of equity securities under Section 12(g). Smaller reporting companies (public companies with less than US\$75 million in common equity public float) will be subject to Rule 14a-11, but on a delayed basis beginning on the third anniversary of the effective date of the rule.

Rule 14a-11 will not apply to companies that are subject to the SEC's proxy rules solely because the company has a class of debt registered under Section 12 of the Exchange Act. Foreign private issuers, which are exempt from the SEC's proxy rules with respect to solicitations of their shareholders, will be exempt from Rule 14a-11.

Rule 14a-11 is mandatory for all subject companies, and there is no "opt-in" or "opt-out" provision in the new rules. Even with the approval of its shareholders, a company may not increase the ownership threshold for proxy access. A company may adopt proxy access rules that are more permissive of proxy access than Rule 14a-11, but may not adopt rules that restrict the operation of Rule 14a-11.

### **Shareholder Eligibility**

Rule 14a-11 will require companies to include in their proxy materials director nominees proposed by any owner of at least 3 percent of the total voting power of the company's securities entitled to be voted in the election of directors who has held the securities continuously for at least three years. The three year holding period is measured from the date the nominating shareholder or group files its Schedule 14N with the SEC announcing its submission of a director nominee or nominees. A nominating shareholder will be

tools to continually improve staffing and pricing models, training and resource optimization, knowledge management and more.

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required to continue to own at least the required amount of securities at least through the date of the meeting at which directors are elected. Shareholders may aggregate holdings to establish sufficient ownership. The nominating shareholder or group must hold both voting and investment power, either directly or through any person acting on their behalf, in order to satisfy the 3 percent ownership and three continuous year holding thresholds. Shareholders may include shares loaned out (as long as loaned shares may be recalled and will be recalled upon notification that any of the nominees will be included in the company's proxy materials). A shareholder may not include shares sold short, shares that are borrowed or shares where only the right to acquire exists (e.g., shares subject to an exercisable option are not includable in any calculation to determine whether the 3 percent threshold has been met).

Nominating shareholders or groups will be required to file a new form, Schedule 14N, to provide information relating to eligibility and nominees. The new rules require a nominating shareholder or members of a group of nominating shareholders to demonstrate ownership of shares in any of several ways. If the nominating shareholder or group member is the registered holder of the shares, the holder should so state; if he or she is not the registered owner, he or she must demonstrate ownership by attaching to Schedule 14N a written statement from the "record" holder of the nominating shareholder's shares verifying that, within seven days before filing the Schedule 14N, the nominating shareholder or member of the nominating shareholder group continuously held the securities being used to satisfy the applicable ownership threshold of at least three years. In the alternative, if the nominating shareholder or member of the group has filed a Schedule 13D, Schedule 13G, Form 3, Form 4 or Form 5, or amendments to these documents, that shareholder or group member may so state and attach a copy or incorporate the filing or amendment into the Schedule 14N.

Shareholders will not be eligible to use Rule 14a-11 if they are holding the securities for the purpose of changing control of the company, or to gain a number of seats on the board of directors that exceeds the number of nominees a company could be required to include under Rule 14a-11. If a shareholder has previously filed a Schedule 13D that indicated intent to effectuate a change of control, that shareholder would presumably be ineligible to submit a nomination under Rule 14a-11.

If multiple shareholders or groups submit nominations

and the number of nominees surpasses the maximum number required to be included by Rule 14a-11, the nominating shareholder or group of nominating shareholders with the highest percentage of the company's voting power will have its nominee or nominees included in the company's proxy materials.

### **How Many Shareholder Nominees Must Be Included?**

A qualifying shareholder or group may nominate the greater of one nominee and a number of nominees equal to no more than 25 percent of the board's total membership. This is the case regardless of whether the board is classified. Thus, if a shareholder were entitled to nominate three directors and only three members of a classified board were being elected that year, the shareholder would be entitled to nominate persons to fill the entire class. 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. For a board of eight members, shareholders will be permitted to nominate up to two directors. For a board of 13, 14 or 15 members, shareholders will be permitted to nominate up to three directors.

Shareholder nominees that a company would otherwise have to include in its proxy materials will count toward the 25 percent maximum threshold if the company agrees to include them as company nominees after the filing of a Schedule 14N. Further, any director elected under Rule 14a-11 procedures serving a three year term on a classified board will count against the 25 percent cap for the following two annual meetings. However, if a director elected under Rule 14a-11 procedures is subsequently renominated by the company, that director will not count toward the 25 percent maximum threshold.

### **Nominee Qualifications**

Any person may be nominated under the proxy access rule if that person's candidacy or, if elected, board membership would not violate controlling state, federal or foreign law, or the applicable standards of a national securities exchange or national securities association, other than rules relating to director independence that rely on a subjective determination by the board. The nominee must, however, satisfy objective independence standards of the applicable national securities exchange or national securities association. Neither the nominating shareholder nor the nominee may have a direct or indirect agreement with the company

regarding the nomination prior to the filing of notice of the nomination on Schedule 14N. Any failed negotiations between the nominating shareholder and the company regarding a nominee will not be considered an "agreement" for this purpose. There are no restrictions on the relationship between the nominating shareholder and the nominee.

Companies may not exclude nominees who do not meet director qualification requirements set forth in the company's organizational documents, regardless that such requirements are applicable to all other nominees for election as a director. If a nominee does not meet such requirements, the company may include that fact or belief in its proxy statement. If a nominee who does not meet qualification requirements is elected, then state law would determine whether that nominee would take a board seat. Because the nominee failed to be qualified under state law, he or she would presumably not be seated, and state law would govern what happens with respect to that seat. Although governing document qualifications cannot disqualify a nominee from being included in the company's proxy statement, such qualifications may remain a useful tool for companies to ensure that directors meet minimum standards important to the company.

### **Schedule 14N – Filing Requirements Applicable to Nominating Shareholders**

Nominating shareholders will be required to file with the SEC and submit to the company a notice on new Schedule 14N. Schedule 14N was modeled after Schedule 13G, with some added disclosure requirements. The notice to the company and the filing with the SEC must be made on the same day, no earlier than 150 calendar days, and no later than 120 calendar days, prior to the anniversary of the prior year's proxy materials' mail date. If the company did not hold an annual meeting during the prior year, or if the date of the annual meeting is changed by more than 30 calendar days from the prior year's meeting date, the company must within four business days of determining the anticipated meeting date file a Form 8-K to disclose under new Item 5.08 the date by which a nominating shareholder must submit a notice of nomination. Such disclosure must be "a reasonable time" before the company will mail its proxy materials.

Schedule 14N will require disclosure of the amount and percentage of the voting power of the securities owned by the nominating shareholder or group, the length of ownership and a statement of intent to continue to hold the securities through the date of the meeting. The

nominating shareholder or group must also disclose its intent respecting continued ownership of the shares following the election (which intent may be conditioned upon the results of the election). Schedule 14N will require certain disclosure concerning the nominee, including biographical and other information similar to that now required in an election contest, and whether the nominee satisfies the company's director qualifications, if any, as provided in the company's governing documents. Disclosure is also required as to the nature and extent of the relationships between the nominating shareholder or group, the nominee or nominees, and the company or any affiliate of the company. The Schedule 14N must also disclose any website address where the nominating shareholder or group may publish soliciting materials. The Schedule 14N will require certification that the nominating shareholder is not seeking to change control of the company or gain more than minority representation on the board and that the nominating shareholder and the nominee(s) satisfy the applicable requirements of Rule 14a-11. The nominating shareholder and each member of a nominating shareholder group must certify that the information provided is true, complete and correct to such person's knowledge and belief, after reasonable inquiry. The nominating shareholder is also permitted to include in the Schedule 14N a statement of support, not to exceed 500 words, for each of its nominees. The company must include in its proxy statement any statement so provided, and the company will have no liability under the securities laws of any incorrect information included in a supporting statement from a nominating shareholder or group.

### **Eligibility Determinations**

If a company, having received and reviewed a Schedule 14N, accepts a shareholder nominee, it must notify the nominating shareholder or group in writing no later than 30 calendar days before filing its definitive proxy materials. If the company believes that the nominee may be excluded, then it must provide the nominating shareholder or group with notice of its intent to exclude the nominee no later than 14 calendar days after the close of the window period for submission of nominees pursuant to Rule 14a-11. The notice must state the basis for the exclusion. The nominating shareholder or group will be permitted a further 14 calendar day period to cure any eligibility or other deficiencies, but may not include a substitute nominee or nominating shareholder as a means to correct a deficiency identified in the company's notice of intention to exclude. If the company continues to believe that the nomination is invalid, it must provide notice to the SEC and the nominating shareholder or group no later than 80

calendar days before the company files its definitive proxy statement. After a 14 day period in which the nominating shareholder or group may respond, the SEC staff will, in its discretion, issue a no-action response stating its view whether the exclusion would be proper. Promptly following the staff's response, the company must provide notice to the nominating shareholder or group stating whether it will include or exclude the nominee. This procedure is closely akin to the procedure currently in place with respect to shareholder proposals under Rule 14a-8.

### **Proxy Card**

When a shareholder nominee is included on the company's form of proxy pursuant to Rule 14a-11, the option of voting for or withholding authority to vote for the company's nominees as a group, which is otherwise permitted with respect to director elections, will be prohibited. The company must instead require that shareholders vote on each nominee separately. The company may identify on the form of proxy any shareholder nominees as such and may recommend whether shareholders vote for or against or withhold votes on those nominees and management's nominees.

### **Proxy Materials**

If a shareholder nominee satisfies the Rule 14a-11 eligibility criteria, then the company's proxy statement must include certain information on the nominee as provided on the Schedule 14N notice filed by the nominating shareholder, including the nominee's business experience and, if provided by the nominating shareholder, a statement in support of the nominee, not in excess of 500 words.

In the adopting release, the SEC staff noted that the inclusion of disclosure regarding a shareholder nominee for director does not trigger the filing of a preliminary proxy statement. The staff also noted in the release that it does not believe a shareholder nominee should be required to complete a company's director questionnaire, which several commenters had suggested would be appropriate so that similar information would be available concerning all nominees up for election. Instead, the SEC adopted a requirement that a nominating shareholder or group disclose under Item 5 of Schedule 14N whether, to the best of their knowledge, the nominating shareholder's or group's nominee meets the company's director qualifications, if any, as set forth in the company's governing documents. As noted above, the company may choose to provide disclosure in its proxy statement about

whether it believes a nominee satisfies the company's director qualifications, as is currently done in a traditional proxy contest.

### **Rule Changes Regarding Solicitations by the Nominating Shareholder or Group**

The proxy access rules also resulted in rule amendments to exempt limited communications from certain disclosure, filing and other requirements of the proxy rules under two circumstances. Solicitations, including written and oral communications, made in connection with the formation of a nominating shareholder group will be exempt under new Rule 14a-2(b)(7). Written communications may include no more than a statement of the shareholder's intent to form a nominating shareholder group; identification of and brief statement regarding the potential nominee(s) – or, if no nominees have been identified, the characteristics of the nominee(s) that the shareholder intends to nominate, if any; the percentage of voting securities that each soliciting shareholder holds or the aggregate percentage held by any group to which the shareholder belongs; and contact information. The written information must be filed with the SEC under cover of Schedule 14N on the day first used. The exception will also cover oral communications, which are not limited in content. To rely upon the exception for oral solicitations, the shareholder must file a notice of commencement of oral solicitations on Schedule 14N.

Rule 14a-2(b)(8) will exempt solicitations in support of a shareholder nominee from generally applicable disclosure, filing and other requirements, provided that the soliciting shareholder does not seek to obtain or act as proxy for other shareholders, each written communication includes certain information including a specified legend and any soliciting material is filed with the SEC on Schedule 14N no later than the day first used. Nominating shareholders may rely on Rule 14a-2(b)(8) after receiving notice from the company that the company will include the nominating shareholder's nominee(s) in the company's proxy materials.

Neither Rule 14a-2(b)(7) nor (8) provides an exemption for communications in connection with non-Rule 14a-11 proxy contests, such as may occur under the director nomination provisions of a company's governance documents. Both of these new rules provide that 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 exemption is intended to prevent exempt Rule 14a-11 solicitations

from being used as a first step in a more aggressive proxy contest.

### **Application of Liability Provisions in the Federal Securities Laws to Nominating Shareholders**

The SEC amended Rule 14a-9 to forbid any misleading misstatements or omissions by nominating shareholders. Thus, a nominating shareholder or group will be liable for any false or misleading statements it makes about the nomination or the nominee, regardless of whether the statements are ultimately included in the company's proxy materials. A company will not be responsible for information provided by the shareholder and then reproduced in the company's proxy materials. Generally, information provided by the shareholders will not be incorporated by reference into company filings unless the company chooses to do so.

### **Continued Use of Schedule 13G and Effect of Section 16 on Shareholder Groups**

The SEC cautions that nominating shareholder groups need to consider whether they have formed a group under Rule 13d-5 that would be required to file a collective beneficial ownership report. However, the Amendments do change the beneficial ownership reporting rules so that shareholders relying on Rule 14a-11 may still be eligible to file a Schedule 13G in lieu of filing a Schedule 13D despite activities in connection with the inclusion of a nominee under Rule 14a-11.

The Amendments will not exclude a nominating shareholder group from aggregation under Section 16, so Rule 14a-11 groups should be analyzed in the same way as any other group for purposes of determining whether the group members are 10 percent owners subject to Section 16.

### **No Limitation on Repeated Nominations**

The new proxy access rules include no limitations on the ability of shareholders to nominate previously unsuccessful candidates. A 3 percent or greater shareholder is free to nominate the same candidate(s) every year regardless of the number of votes received by an unsuccessful candidate in any prior election, provided that the conditions of Rule 14a-11 are met.

### **Shareholder Proposals**

The Amendments also change Rule 14a-8(i)(8) governing shareholder proposals to allow resolutions

calling for amendments to a company's governing documents to alter nomination procedures. As amended, proposals by qualifying shareholders that seek to establish a procedure in the company's governing documents for the inclusion of shareholder director nominees in company proxy materials would no longer be excludable under Rule 14a-8(i)(8). The amendment also codifies certain SEC staff interpretations to prevent use of the amended rule to allow shareholder proposals related to specific elections. For example, the rule explicitly disallows shareholder proposals disqualifying nominees or removing sitting directors, questioning the qualifications or character of a particular director or nominee, nominating a specific candidate otherwise than as authorized by law, or otherwise affecting the upcoming election of directors.

### **Effective Date**

The changes to the proxy rules will be effective 60 days after publication in the *Federal Register*. Smaller reporting companies will not be subject to Rule 14a-11 until after the third anniversary of the effective date of the Amendments to the proxy rules discussed above. Whether the new rules will be applicable for a company's upcoming proxy statement will depend in part on the date that the Amendments are published in the *Federal Register* and in part on the date on which the company mailed its proxy statement for the prior year's annual meeting. The new rules require that a shareholder wishing to nominate a director pursuant to the new rules must do so within a window period that occurs between 150 and 120 calendar days prior to the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting. The SEC has made it clear that eligible shareholders will be able to submit director nominees for inclusion in management's proxy materials so long as the window period is open following the effective date of the new rules. If the window period opens before, but closes after, the effective date of the rule changes, shareholders would be able to submit nominees between the effective date of the Amendments and the close of the window period.

For Rule 14a-8, shareholders still must submit their proposals no later than 120 days before the anniversary date of the mailing of the company's proxy materials in the prior year. Shareholders will be able to submit nominees for inclusion in next year's proxy statement if the 120 day deadline falls on or after the effective date of the Amendments to the proxy rules.

For example, if the Amendments are published in the

*Federal Register* on September 7, 2010, they will become effective on November 6, 2010, the 60th day following publication, and new Rule 14a-11 and amended Rule 14a-8 would be available as to companies that mailed their proxy statements for their last annual meeting on or after March 6, 2010. However, for companies that mailed on March 6, 2010, the new rules would be available for only one day, November 6, 2010, the 120th day preceding the anniversary of the prior year's proxy mailing date.

### **Ramifications of Proxy Access and Related Rule Amendments**

It is unclear to what extent institutional investors that have not previously pursued proxy contests will avail themselves of the provisions of Rule 14a-11. Certainly, the Amendments make it easier and less costly for institutional investors to nominate directors if they so choose. Similarly, it is unclear whether other investors will be able to organize groups large enough to meet the 3 percent ownership threshold and, if they do, whether larger shareholders will step in and propose nominees that "trump" the nominees of smaller investors for the limited number of shareholder directors that may be included in the company's proxy statement.

Most majority voting provisions in company governing documents do not apply in contested elections for directors. 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.

When Rule 14a-11 shareholder nominees are elected to the board, it will be interesting to discern whether the traditional processes that afford continuing directors and newly elected directors an opportunity to become better acquainted and lay the basis upon which they can work harmoniously together remain in place. Many commenters have observed that there is a good likelihood that some boards, particularly where the proxy contest was vigorously contested, may be characterized by distrust and perhaps dislike among directors. It remains an open question whether the presence on boards of directors of those who may be hostile to management or unwelcome by other directors will improve corporate governance, accountability and performance, as the SEC hopes.

In tandem, it will also be interesting to monitor the interplay of future public company acquisitions in relation to the Amendments. Shareholders cannot avail themselves of the new proxy access rule if they own

company securities "for the purpose of changing control of the company." Directors, particularly those representing dissident shareholders, may be eager to consider acquisition/change in control opportunities that are perceived as increasing shareholder value. If such considerations are conducted shortly after nomination of a director via proxy access, some commenters have speculated that litigation may ensue.

### **Preparing for the Next Annual Meeting**

Companies subject to the new proxy access rule and the other proxy rule amendments should determine the following:

- Identify your 3 percent and greater shareholders and evaluate whether any of them might be interested in nominating a director;
- Identify those of your shareholders under the 3 percent threshold that might be interested in soliciting for formation of a Rule 14a-11 group to nominate directors;
- Determine whether your advance notice bylaws are compatible with Rule 14a-11, including its notice provisions and information requirements;
- Review the company's director qualification requirements as they are set forth in the charter and bylaws, and determine whether the requirements are sufficient to prevent persons unsuitable to serve from being seated on the board (and consider rolling any separate director qualification or share ownership policy requirements into the company's governing documentation, as the nominating shareholder's certification for compliance with director qualifications is tied to "governing documents" in Schedule 14N);
- Determine whether under the company's governing documents majority voting provisions would or would not operate in a Rule 14a-11 contested election of directors, and if majority voting provisions would operate, determine whether they are workable in a contested election; and
- Consider whether you should modify the size of the board.

For more information about the new proxy access rules and their implications, please contact your principal Squire Sanders lawyer or any of the lawyers listed in this Alert.

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