

SEC Adopts New Rules Mandating Shareholder Access to Proxy Statements

On August 25, 2010, the Securities and Exchange Commission (SEC) adopted, by a vote of 3-2, new rules that give shareholders unprecedented access to an issuer's proxy statement. New Rule 14a-11 will require an issuer, in certain circumstances, to include in its proxy materials nominees for election to the board of directors submitted by a shareholder or a group of shareholders ("nominating shareholder"). To be eligible, a nominating shareholder must hold at least three percent of the issuer's shares eligible to vote for directors and have held those shares for at least three years. In addition, changes to Rule 14a-8(i)(8) require, in certain circumstances, shareholder proposals relating to the election of directors to be included in an issuer's proxy materials. The new proxy access regime of Rule 14a-11 will be effective for most companies beginning with the fast-approaching 2011 proxy season.

Background

In June 2009, the SEC released for public comment a proposal requiring companies to provide proxy access to certain shareholders. The June 2009 proposal was the third time in a decade that the SEC has attempted to address the issue of proxy access, and resulted in this rulemaking.

As in the previous proxy access efforts by the SEC, the proposal generated significant public commentary, with the SEC receiving over 600 comments. Several commenters argued that the SEC did not have the authority under the Securities and Exchange Act of 1934, as amended ("Exchange Act"), to issue rules requiring shareholder access to proxies. However, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law last month, amended the Exchange Act to explicitly provide the SEC with the authority to adopt proxy access rules.

Which Companies Are Subject to the Adopted Rules?

Rule 14a-11 generally applies to all companies with equity securities registered under Section 12 of the Exchange Act, except for foreign private issuers who are exempted from the proxy rules, and investment companies registered under Section 8 of the Investment Company Act of 1940. Smaller reporting companies will be subject to the rule three years following Rule 14a-11's effective date.

The adopting release makes clear that if applicable state law, applicable foreign law in the case of a foreign-domiciled corporation or the issuer's governing documents prohibits any shareholder from nominating candidates for the board of directors, Rule 14a-11 will not apply. However, in a departure from the rules proposed in June 2009, the rule will apply to companies regardless of whether state law, foreign law or the issuer's governing documents, simply limits shareholders' ability to include shareholder director nominees in the issuer's proxy materials.

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This change from the June 2009 proposal is particularly meaningful, since many companies may have been able to fashion limitations in their governing documents that would have allowed the issuer some degree of control in the area of shareholder proxy access. However, since Rule 14a-11 as adopted will apply unless any and all shareholder nominations are prohibited by an issuer's governing documents, we believe that few, if any, companies will be able to "opt out" of proxy access by amending their governing documents.

The adopting release also makes it clear that in cases where applicable provisions of state or foreign law or the issuer's governing documents are more permissive, such as if the ownership threshold for a nominating shareholder is lower than three percent, Rule 14a-11 will not be available. In cases where such provisions are more permissive in some areas and more restrictive in others, Rule 14a-11 will remain available to a nominating shareholder.

Which Shareholders Are Eligible to Submit a Nominee for Inclusion in an Issuer's Proxy Materials?

Rule 14a-11 establishes shareholder eligibility requirements based on duration and level of ownership. However, rather than the tiered approach detailed in the proposed rule, where the ownership threshold to nominate a director varied upon the size of the issuer, the adopted rule includes a single test that will be applied to all companies subject to shareholder nominations under the rule. Specifically, to be eligible to include their nominees in an issuer's proxy materials, a shareholder under Rule 14a-11 must hold at least three percent of the issuer's shares eligible to vote for directors, and must have held them continuously for at least three years. The date for determining shareholder eligibility will be the date on which the nominating shareholder provides notice to an issuer on Schedule 14N of their intent to nominate directors.

Ownership

In determining the number of shares held and included in the calculation, the nominating shareholder must hold both the power to dispose of and to vote the securities, including those that are held "either directly or through any person acting on their behalf." The release states that this last language covers relationships, such as parent and subsidiary, when for organization or tax reasons, among others, investment and voting power is held by an entity that is controlled by another entity. The SEC is careful to point out, however, that this provision does not include securities that are held in a pooled investment vehicle in which the nominating shareholder does not have voting and investment power over the securities held in the pooled investment vehicle.

The rule differs from the concept of beneficial ownership under Rule 13d-3, which requires either voting or investment power as opposed to the requirement for the nominating shareholder to have both under 14a-11.

The release makes clear, however, that shares loaned to a third party by a nominating shareholder may be counted toward a nominating shareholder's ownership only if the nominating shareholder has the right to recall the loaned shares and will recall the loaned shares upon being notified that any of its nominees will be included in the issuer's proxy materials. Also, the rule states that because the rule is intended to be used by shareholders with a significant long-term commitment to the issuer, borrowed shares may not be used to satisfy the ownership threshold.

In response to comments concerned about shareholders divesting economic risk associated with their shares, the rule requires that the holdings of a nominating shareholder be reduced by the voting power of any of the issuer's securities in which the nominating holder has an open short position.

Holding Period

Shareholders seeking to use Rule 14a-11 must have held the minimum amount of shares used to satisfy the three percent ownership threshold continuously for at least three years. In the case of a group of shareholders formed to satisfy this threshold, each member of the group must have held the amount of their shares being used to satisfy the threshold for the full three years. In effect, this means that the maximum amount of securities held by a group member that can be used to satisfy the ownership threshold is limited to that member's "low water mark" stock holdings during the three-year period.

In addition, each member of a nominating shareholder group will be required to provide verification of their ownership during the holding period. The verification requirement may be satisfied either through appropriate Schedules 13D or 13G, Section 16 filings, or a written statement from the record holder of the shares certifying that the shareholder continuously held the amount of securities being used to satisfy the ownership threshold for a period of at least three years.

Only those shareholders who are holding the securities of the issuer without the purpose, and without the effect, of changing control of the issuer or gaining a number of seats on the board exceeding the maximum number of nominees permitted to be nominated under Rule 14a-11, may be nominating shareholders. The nominating shareholder is required to provide a certification to this effect in its notice to the issuer on Schedule 14N.

Are There Restrictions on Whom a Nominating Shareholder May Nominate?

A shareholder nominee is not required to be included in an issuer's proxy materials if the nominee's candidacy or, if elected, board membership, would violate controlling state law, federal law or rules of a national securities exchange or association (other than rules regarding independence of directors), and such violation cannot be cured.

With respect to director independence standards, the SEC slightly altered the consideration given to the independence of shareholder nominees. As proposed, the rule would have required the nominating shareholder to certify that the shareholder nominee was independent within the meaning of generally applicable objective independence requirements of any applicable national securities exchange. As adopted, however, the rule affirmatively requires that nominees be independent under the objective independence standards of the applicable exchange, in addition to providing the related certification.

In response to comments, the SEC also adopted a requirement that nominating shareholders disclose under Schedule 14N, whether, to the best of their knowledge, the nominating shareholder's nominee meets the issuer's director qualifications set forth in the issuer's governing documents. As is currently the case in contested elections, issuers will also be able to provide disclosure in their proxy statement about whether they believe a nominee submitted under Rule 14a-11 satisfies the issuer's director qualifications.

As adopted, Rule 14a-11 requires an issuer to include only a limited number of shareholder nominees. Therefore, absent an explicit prohibition, the rule could have offered an opportunity for the issuer to use a nominating shareholder as a surrogate to block the inclusion of a bona fide shareholder nominee. Thus, to be eligible under the rule, neither the nominee nor the nominating shareholder may have an agreement with the issuer regarding nominations.¹

¹ The instructions to Rule 14a-11 make clear that unsuccessful negotiations with an issuer's nominating committee for the inclusion of a nominee as a management nominee or regarding whether the issuer is required to include the shareholder nominee under Rule 14a-11 are not considered to be a direct or indirect agreement with the issuer for this purpose.

How Many Shareholder Nominees Is an Issuer Required to Include in Its Proxy Materials?

Under the rule, both as proposed and as adopted, the issuer must include in its proxy statement no more than one shareholder nominee or the number of nominees that represents 25 percent of the issuer's board of directors, whichever is greater.² The SEC makes clear in the adopting release that the number of directors that may be nominated pursuant to Rule 14a-11 is calculated based on the size of the whole board, and includes those seats to which an issuer may have granted contractual rights.

In addition, in response to comments concerned about the possible breakdown in communications between shareholders and issuers, the SEC adopted a provision designed to facilitate negotiations between issuers and nominating shareholders. In cases where an issuer negotiates with an eligible nominating shareholder that has filed a Schedule 14N before beginning any discussion with the issuer about the nomination, the rule will allow an issuer to count nominating shareholder nominees who are later included in the issuer's proxy materials as shareholder nominees for the purposes of the one director or 25 percent threshold.

Finally, where multiple nominating shareholders have submitted nominees for inclusion in the issuer's proxy materials, an issuer will only be required to include in its proxy materials the nominees of the nominating shareholder representing the highest qualifying voting power percentage. The SEC had proposed a "first come, first served" concept where, in the event that an issuer received more shareholder nominees for directors than are required by the rule to be included, the issuer would have only been required to include those nominees put forward by the first nominating shareholder to notify the issuer. This method was almost uniformly opposed by commenters.

What Notices and Filings Are Required of Nominating Shareholders?

The notice requirements of the proposed rule were adopted substantially as proposed. Under the adopted rule, however, several of the disclosures under Rule 14a-11 as proposed have been included in the new Schedule 14N as adopted. In addition, the SEC adopted a uniform deadline for submission of notice to an issuer, rather than allowing advance notice bylaw provisions to set the deadline.

Schedule 14N requires information regarding:

- the nominating shareholder (including information relating to its relationship with the issuer and any interests they may have with competitors—as they are currently required to do in contested elections);
- the eligibility of the nominating shareholder to submit a nominee;
- the nominee's eligibility (including independence), and whether, to the best of the nominating shareholder's knowledge, the nominee meets the director qualifications set by the issuer;
- the nominee, including relationships between the nominee and the nominating shareholder (similar to that required to be disclosed for director nominees in proxy statements);
- the relationship between the nominee and the issuer, including the existence of any agreements;

² In the instance that 25 percent of the board does not result in a whole number, the maximum number is rounded down. Additionally, where a director was elected as a shareholder nominee pursuant to Rule 14a-11, and his or her term extends past the date of the shareholder meeting for which the issuer is soliciting proxies (for example, in the case of a classified board, typically involving three-year terms), then this director is included in the calculation for the 25 percent threshold.

- the amount and ownership percentage of the issuer’s securities, including disclosure of securities loaned or sold in a short sale that has not been closed out;
- the nature of the nominating shareholder’s ownership of such securities, including a statement regarding their intent to continue to own the requisite shares through the meeting and disclosure of their intent with respect to continued ownership after the election;³
- the absence on the part of the nominating shareholder of a change in control intent or an intent to gain more than the maximum number of board seats provided for under the rule; and
- the methods by which the nominating shareholder may solicit shareholders, including any website address on which the nominating shareholder may publish soliciting materials.

Additionally, if desired to be included in the issuer’s proxy statement, the Schedule 14N must include any statement in support of the shareholder nominee, which may not exceed 500 words per nominee.

The Schedule 14N is required to be amended promptly for any material change, such as the eligibility of the nominating shareholder. The nominating shareholder is also required to file a final amendment to the Schedule 14N, disclosing within 10 days of the final results of the election being announced by the issuer the nominating shareholder’s intention with regard to continued ownership of its shares.

When Are Those Filings Due?

Under Schedule 14N as adopted, a nominating shareholder is required to provide notice during a window period of no earlier than 150 calendar days, and no later than 120 calendar days, before the date that the issuer mailed its proxy materials for the prior year’s annual meeting (“Window Period”).⁴

What Are the Obligations of the Issuer After It Receives a Nomination Notice?

Determination Regarding Inclusion

Companies may reject shareholder nominations under Rule 14a-11 if:

- the rules are not applicable to the issuer;
- the nominee does not meet the eligibility requirements of the rules; and
- the issuer has received more nominees than it is required to include.

As proposed, Rule 14a-11 would have permitted the exclusion of a shareholder nominee if the Schedule 14N included false or misleading statements. As adopted, an issuer may not exclude a nominating shareholder’s nominee on this basis.

³ Additionally, if the nominating shareholder has not filed a Schedule 13G or 13D, or Form 3, 4 or 5, they will need to provide a written statement from the “record” holder of the shares (usually a broker or bank), dated no more than seven calendar days prior to the submission of the notice, verifying ownership of the securities for at least three years.

⁴ Similar to Rule 14(a)-5(f), if the issuer 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, then the issuer must announce the nomination deadline in a Form 8-K within four business days after the issuer determines the anticipated meeting date.

Instead, the adopting release states that disputes concerning whether information is false or misleading should be handled through disclosure and private litigation, if necessary.

In any such case, the issuer would be required to notify the nominating shareholder and the SEC of its determination to exclude the nominee promptly after that determination and not later than 14 calendar days after the close of the Window Period. The issuer may then also avail itself of a no-action letter process similar to that for current Rule 14a-8. As with Rule 14a-8, the documents filed with the SEC are made available to the public.

Procedures Regarding Inclusion

If the issuer does not determine to exclude a nominee, the issuer is required to inform the nominating shareholder that the nominee will be included in the issuer's proxy materials no later than 30 calendar days before the issuer files its definitive proxy statement. The issuer must then include disclosure regarding the nominee in the issuer's proxy statement, although the issuer may identify any shareholder nominees as such and recommend how shareholders should vote on such nominees.⁵ The issuer must also provide the opportunity to the nominating shareholder to include in the issuer's proxy materials a statement of support for each candidate not exceeding 500 words, which is required to have been included in the Schedule 14N filed by the nominating shareholder. A preliminary proxy statement need not be filed with the SEC.

Additionally, like the issuer, a nominating shareholder can solicit support for its nominee outside of the proxy statement, provided that such solicitations are conducted within the applicable proxy rules and any solicitation materials are filed with the SEC on the date of first use.

How Will a Nominating Shareholder's Solicitations Be Treated Under the Proxy Rules?

The new rules exempt solicitations associated with the formation of a nominating group from the proxy rules, so long as the shareholder is not holding the issuer's securities with the purpose or effect of changing control of the issuer or to gain a number of seats on the board of directors that exceeds the maximum number of nominees that the registrant could be required to include under the rule.

However, such written communication is limited to:

- a statement of intent to form a group;
- the identity and a brief statement regarding the nominee or characteristics of future nominees the group intends to nominate;
- the percentage voting power of the issuer's securities that are entitled to be voted on the election of directors that each soliciting shareholder holds or the aggregate percentage held by any group to which the shareholder belongs; and
- the soliciting party's contact information.

Such written soliciting material must be filed with the SEC no later than the date the material is first published, sent or given to shareholders. Unlike the proposed rule, under the adopted rule the soliciting material is required to be filed under the cover of Schedule 14N. Also, unlike the proposed rule, the exemption has been extended to oral communications. However, a shareholder seeking to form a nominating shareholder group will be required to file a Schedule 14N notice upon commencement of the oral solicitation.

⁵ The issuer is not permitted to allow shareholders to vote for the issuer nominees as a group, but instead each nominee must be voted on separately.

The adopted rules also exempt solicitations by nominating shareholders from the proxy rules, provided that:

- the soliciting party does not seek to act as a proxy or act on behalf of a person who furnishes or requests a form of revocation, abstention, consent or authorization;
- the writing contains the identity of the nominating shareholder or group and a description of his or her direct or indirect interests, by security holdings or otherwise, and a prominent legend in clear, plain language advising of the shareholder nominee and that important soliciting materials can be found at the issuer's website; and,
- the soliciting material is filed with the SEC on Schedule 14N no later than it is first published, sent or given to shareholders, and sent to each securities exchange where the issuer has securities registered and listed.

A nominating shareholder or group may rely on these exemptions after receiving notice from the issuer that it will include the nominating shareholder's nominee or nominees.

A shareholder or group would lose their exemption if they subsequently engaged in a non-Rule 14a-11 nomination or solicitation in connection with the subject election of directors, or if they become a member of a group with persons engaged in soliciting or other nominating activities in connection with the election of directors outside of Rule 14a-11. These exemptions do not apply when attempting to make a nomination pursuant to the issuer's governing documents or state law.

What Changes Were Made to Existing Shareholder Proposal Rules Due to the Proxy Access Rules?

Changes to the Election Exclusion

Companies, including investment companies, will no longer be able to rely on Rule 14a-8(i)(8) to exclude shareholder proposals relating to shareholder nomination bylaw amendments under the election exclusion as long as such proposals are not more restrictive than the provisions of the new Rule 14a-11.

The SEC also codified certain prior interpretations of Rule 14a-8(i)(8) that permit certain types of proposals to continue to be excluded from an issuer's proxy material. Under the amendment to the election exclusion, companies would be able to continue to exclude proposals that would:

- seek to disqualify a nominee standing for election;
- remove a director from office before the expiration of his/her term;
- question the competence, business judgment or character of a nominee or director; and
- nominate a specific individual for election to the board of directors, other than through the Rule 14a-11 process, applicable state law provision, or an issuer's governing documents; or
- otherwise affect the outcome of the upcoming election of directors.

What Changes Would Be Made to Existing Beneficial Ownership Reporting Rules?

Schedule 13G

Shareholders currently permitted to report their beneficial ownership on Schedule 13G will be able to continue to do so throughout the shareholder nomination process for activities undertaken solely in connection with a nomination under Rule 14a-11. Absent the proposed amendments to Schedule 13G, a nominating shareholder would have found it difficult to certify passive intent with regard to the issuer, and therefore may have been ineligible to report their beneficial ownership on the short-form Schedule 13G. However, under the rules as adopted, any actions beyond a Rule 14a-11 shareholder nomination will result in a shareholder being ineligible for this exclusion and the use of Schedule 13G. However, if a nominating shareholder is successful in electing one of its nominees, it will need to closely evaluate its Schedule 13G eligibility going forward.

Section 16

In its shareholder access proposal in 2003, the SEC proposed an exemption from Section 16 for groups formed solely for the purpose of nominating a director pursuant to the proxy access rules. The SEC declined to include such an exemption in this proposal and no exemption was adopted in the final rule. Instead, the SEC will continue to apply the current analysis for the determination of whether a ten percent owner group has been formed for the purposes of Section 16.

What Other Changes to Existing Securities Laws Were Made to Facilitate Proxy Access?

Dates and Voting

New Item 5.08 of Form 8-K requires that an issuer that did not hold an annual meeting during the previous year or changed the date of this year's annual meeting by more than 30 days must file a Form 8-K within four business days of determining the date of the meeting and disclose the date by which a nominating shareholder or group must submit notice to include a nominee in the issuer's proxy materials pursuant to Rule 14a-11. Where an issuer is required to include shareholder nominees pursuant to state law, foreign law or the issuer's governing documents, then the issuer must disclose the date by which a nominating shareholder must submit a Schedule 14N pursuant to Rule 14a-18.

The SEC also amended Rule 14a-5 to require disclosure of the deadline for submitting nominees for inclusion in the issuer's proxy materials for the next annual meeting.

Issuer Affiliates

The SEC declined to adopt a safe harbor for nominating shareholders, and determination of "affiliate status" for nominating shareholders will continue to be on a facts-and-circumstances basis.

What Would Be the Potential Liability for Statements Made by the Issuer and by the Nominating Shareholders Under the Federal Securities Laws?

Exchange Act Liability for False or Misleading Statements

The rules as adopted provide that the nominating shareholder, and not the issuer, is responsible for any false or misleading statements included in the notice provided by the nominating shareholder to the issuer that is then included in the issuer's proxy statement. As proposed, an issuer would have been liable if it had known or had reason to know such statements were false and misleading. This provision was not included in the final rule. Instead, the final rule makes clear that an issuer will not be responsible for information that is provided by the nominating shareholder that is later reproduced by the issuer in its proxy statements.⁶

In addition, the SEC revised the proposed rule to make clear that the nominating shareholder will bear responsibility for false and misleading statements made in the Schedule 14N and related communications as well.

Securities Act and Exchange Act Liability Resulting from Incorporation by Reference

Any information that is provided to the issuer by the nominating shareholder, and then included in the issuer's proxy materials, is not incorporated by reference into any filing under the Securities Act, the Exchange Act or Investment Company Act unless the issuer determines to incorporate that information by reference specifically into that filing. To the extent that the issuer does incorporate that information by reference in any future filing, then the information is treated as being the issuer's own disclosure for purposes of the antifraud and civil liability provisions of the Securities Act, the Exchange Act or the Investment Company Act.

How Would the Rules Apply to Investment Companies?

The rules as adopted apply the same three percent share ownership and three-year holding requirement to registered investment companies.

Additionally, if an investment company did not hold an annual meeting during the prior year or the date of the meeting has changed by more than 30 days, it will be required to file a Form 8-K disclosing the date by which the shareholder notice must be provided to the investment company. Also, in the case of a series company, the issuer is required to disclose the total number of shares of the company outstanding and entitled to be voted in the election of directors at the meeting as of the end of the most recent calendar quarter.

With respect to registered investment companies or business development companies, any nominating shareholder or group of shareholders must not be an "interested person" of the company, as defined in Section 2(a)(19) of the Investment Company Act.

⁶ The rules regarding the responsibility for false or misleading statements based upon information received from nominating shareholders are modeled after Exchange Act Rule 14a-8(l)(2). Exchange Act Rule 14a-8(l)(2) applies with respect to proposals and supporting statements that are submitted by shareholders and then required to be repeated in the issuer's proxy materials by Exchange Act Rule 14a-8. In this regard, Exchange Act Rule 14a-8 states that "the company is not responsible for the contents of [the shareholder proponent's] proposal or supporting statement."

When Will Companies have to Comply with Proxy Access?

The new rules become effective 60 days following their publication in the Federal Register. For the 2011 proxy season, shareholders may use new Rule 14a-11 if its effective date falls before or during the issuer's Window Period.

However, smaller reporting companies will not have to comply until three years from the effective date.⁷

What Should Companies be Doing Now?

In anticipation of the 2011 proxy season, companies should work with their advisors to develop a comprehensive contingency plan in the event that a Rule 14a-11 nominee is submitted. Specifically, companies consider the following actions.

- Attempt to identify any three percent shareholders and assess the likelihood of a Rule 14a-11 nomination.⁸
- Identify those issues, such as financial performance, executive compensation and corporate governance, that may serve as the impetus for shareholder use of Rule 14a-11.
- Revise advance notice bylaws to ensure a workable framework for shareholders' submission of director nominees and inclusion in issuer's proxy materials under Rule 14a-11.
- Consider whether director qualification requirements that have typically been memorialized in a corporate policy should be formalized as bylaws.
- Amend corporate governance and nominating committee charters and related bylaws to address the vetting and consideration of shareholder nominees.
- Assess the need for revisions to board policies relating to topics such as confidentiality, Regulation FD and conflicts of interest, if a Rule 14a-11 nominee is elected.

⁷ Under Rule 12b-2, generally, a smaller reporting company is a company that has a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter. Whether or not an issuer is a smaller reporting company is determined on an annual basis.

⁸ Because Schedule 13D/13G filings will not identify all potential Rule 14a-11 proponents, as well as the difficulty of identifying the ultimate beneficial owner of shares held in "street name," companies may need the assistance of a proxy solicitation firm with this process.

For more information, contact your Alston & Bird LLP attorney or one of the attorneys in the firm's [Securities Group](#).

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