

Corporate Governance Commentary

Proxy Access Bulletin No. 3

June 15, 2009

We welcome you to the first of a series of *Proxy Access Bulletins and Analyses* jointly published by [Latham & Watkins LLP](#) and [Georgeson Inc.](#) These publications follow on from prior 2009 publications by each firm dealing with earlier stages in the proxy access debate. By combining thoughtful legal analysis from Latham & Watkins with Georgeson's expertise on trends related to corporate governance, the shareholder voting process and other shareholder matters, we hope to provide you with timely, useful and practical guidance as you navigate the issues created by proxy access.

The Latham & Watkins-Georgeson Proxy Access Bulletins and Analyses are designed to:

- Facilitate your understanding of the various proposals being made on multiple fronts to enable shareholder proxy access
- Support your efforts to shape the outcome of these proposals on the legislative and regulatory fronts
- Assist you in taking concrete action in response to the final rules as a matter of both procedure and best practices as they emerge

Our *Proxy Access Bulletins* will be brief updates on “breaking” events related to proxy access, to be delivered quickly following material new developments. They will be short, fact-specific alerts intended to keep our clients and friends up-to-date on a real time basis.

Our *Proxy Access Analyses* will focus on in-depth analysis of the relevant legal and practical issues of proxy access as they develop and will suggest concrete actions we think companies should consider in response to proxy access developments.

For additional resources regarding this topic, please [click here](#) and [here](#).

Proxy Access Proposed Rules Published by SEC

On June 10, 2009, the SEC published a proxy access rule proposal for public comment. The Commission's release, entitled “Facilitating Shareholder Director Nominations,” gives concrete form to the broad objectives the Commission outlined at its May 20, 2009 open meeting (at which it approved publication of the rule by three votes to two).

As expected, the SEC is proposing to:

- *create a new Rule 14a-11* that would require companies to include shareholder nominees for directors in company proxy materials under prescribed circumstances, and
- *revise existing Rule 14a-8(i)(8)* to allow shareholder proposals to amend a company's governing documents regarding nominating procedures or disclosure related to shareholder nominations, thus reversing the SEC's 2007 prohibition on using Rule 14a-8 for shareholder proxy access proposals.

Proposed Rule 14a-11

The key features of the proposed rule are as follows:

- *Companies Subject to Proxy Access:* The proposed rule would apply to all Exchange Act reporting companies subject to the proxy rules, regardless of their size, including investment companies and companies that have voluntarily registered their stock (under Section 12(g)) but excluding debt-only issuers and foreign private issuers.
- *Minimum Ownership:* The proposed rule would set a tiered minimum-ownership requirement for shareholders seeking to nominate directors:
 - 1 percent of the shares of a large accelerated filer (net assets of \$700 million or more),
 - 3 percent of the shares of an accelerated filer (net assets of \$75 million or more, but less than \$700 million), and
 - 5 percent of the shares of a non-accelerated filer (net assets less than \$75 million).
- *Minimum Holding Period:* Each nominating shareholder would be required continuously to have held the requisite number of shares for at least one year prior to the date it notifies the company of its intent to nominate a director, and must intend to hold the shares at least through the date of the annual or special meeting.
- *Aggregation:* Unaffiliated shareholders would be permitted to aggregate their holdings to meet the minimum share ownership threshold. There is no limit on the size of a nominating group. Communications for the purpose of forming a nominating group would be exempt from the proxy rules, provided they are limited in scope, do not request or solicit actual proxies and are filed with the Commission.
- *Beneficial Ownership Reporting:* The formation of a nominating group holding in excess of 5 percent of an issuer's equity securities would still be required to be reported under Regulation 13D. However, the formation of a nominating group would not affect any group member's otherwise existing eligibility to file on Schedule 13G rather than 13D. Moreover, an amendment to Rule 13d-1 would specifically allow groups formed solely to nominate a director pursuant to Rule 14a-11 to file on Schedule 13G.
- *Timing of Nomination:* Nominations would need to be submitted to the company on the same time schedule as Rule 14a-8 proposals (*i.e.*, no later than 120 days prior to the date of publication of the prior year's proxy material), unless a company's advance notice bylaws provided for a shorter period.
- *Mandated Disclosure and Filing:* Each nominating shareholder (including each shareholder within a nominating group) would be required to represent as to a number of items, including that:
 - the shareholder intends to hold its shares through the date of the annual meeting, as well as its intent with respect to continued ownership following the meeting (although the proposed rule is silent as to whether and how the shareholder's lending of its shares during this period would affect either of these statements),
 - the shareholder's nominees are in compliance with applicable objective stock exchange independence requirements,
 - neither the nominee nor the nominating shareholder has an agreement with the company regarding the nomination,
 - the shareholder is not attempting to effect a change of control (or to gain more than a minority of directors),

- the candidate's nomination to or initial service on the board, if elected, would not violate controlling state or federal law or applicable listing standards, and
- the shareholder or shareholder nominating group is eligible to use Rule 14a-11 in terms of the minimum share ownership requirements.

The nominating shareholder would be required to file with the SEC and submit to the company a new schedule, Schedule 14N, which would cover all the information required under the new rule. Under proposed Rule 14a-19, this information would be required whether the shareholder nomination is made pursuant to Rule 14a-11 or pursuant to state law or a company's governing documents.

- *Minimum of One, no More than 25 percent of Directors:* Shareholders utilizing the direct access process could nominate the greater of one director (for a board of seven or less) or up to 25 percent of the board (rounded down to the closest whole number below 25 percent). Additional shareholder-nominated directors could be elected through a concurrent conventional proxy contest.
- *Staggered Boards:* Where a company has at least one director currently elected to its board pursuant to Rule 14a-11 and the term of the director extends past the date of the meeting at which directors will be elected, a company may exclude Rule 14a-11 nominees from its proxy to the extent that the election of the nominee would result in the total number of Rule 14a-11 nominated directors being more than 25 percent of the board.
- *More Directors than Slots:* If there are more nominations for proxy access directors than slots, priority would be determined by the date of submission, not the amount of shares held by the nominating shareholders. Moreover, a nominating shareholder or group is not limited in the number of its nominations, and the earliest nominating shareholder could nominate the full complement of available access slots.
- *Independence:* Proxy access nominees at listed companies would have to meet the applicable independence standards of the relevant exchange, except for any subjective determination required to be made by the company's board. There would not be any mandated independence standard for non-listed companies. Nominees would not, however, need to be independent from nominating shareholders.
- *Prohibition on Slate Voting:* When a shareholder nominee is included on a company's proxy, proposed Rule 14a-11 would not permit a company to provide shareholders with the option of voting only for (or withholding authority to vote for) all the company's nominees as a slate. Each nominee must be voted separately.
- *Investment Companies:* A series of specially tailored provisions would adapt the shareholder access process to registered investment companies.
- *Dispute Resolution:* There will be a dispute-resolution process (involving no-action requests submitted to the Staff) analogous to that used in connection with shareholder proposals under Rule 14a-8.

Proposed Amendments to Rule 14a-8(i)(8)

As noted, in addition to proposing a direct right to proxy access, the SEC is also proposing to amend Rule 14a-8(i)(8) explicitly to permit shareholder proposals relating to proxy access in the form of bylaw amendments and requests for bylaw amendments. This amendment to Rule 14a-8(i)(8) would reverse the SEC's 2007 codification of its interpretation of the so-called "election exclusion." A shareholder proposal would be excludable to the extent the proposal conflicts with proposed Rule 14a-11.

The thresholds for direct access proposals under proposed amended Rule 14a-8(i)(8) would remain unchanged from those for other Rule 14a-8 proposals—shareholders would be required only to hold a minimum of \$2,000 in market value or 1 percent of the

outstanding shares (whichever is less) for a one-year period prior to the date they submit a proposed amendment.

Many Questions and Few Answers

The Commission's proxy access proposals raise a multitude of questions, many of which are explicitly identified in the release and many of which are not. These questions, in general, fall into four distinct categories:

- *The Need for Change and Its Consequences.* The Commission fundamentally justifies its proposals by pointing to the current economic crisis. In particular, it cites serious concerns whether a weakness in corporate governance is directly linked to loss of investor confidence. Is there empirical evidence to support that link and the broader assertion that proxy access would address these ills? Put another way, what analysis supports the assumptions that proxy access will improve corporate governance and that, as a necessary corollary, the business community and society overall will benefit? Indeed, the release itself acknowledges that, in some cases, the proposals could lead to "lower quality boards." That comment rings true with our experience that the introduction into the boardroom of inexperienced directors who lack industry or community relationships with a sitting group of experienced and qualified directors can produce dysfunction and paralysis rather than improved decision-making.
- *Unidentified Policy and Practical Implementation Issues.* Taken on its own terms, the SEC proposal fails to address a myriad of challenging issues that are bound to arise in practice. A quick sample of those issues includes:
 - What is the appropriate nature of "ownership" for the required holding period? The proposed rules sometimes merely talk about "holding" the shares and sometimes about "beneficial ownership." Neither term is defined and each has a variety of meanings depending on the context and intent of its usage.
 - Should a proxy access director shed that status if re-nominated by the board for an additional term? If so, access "creep" could be a real issue for companies, leading to an inherent bias against re-nominations.
 - If the nominating shareholder changes its non-control intent, should this affect an elected access director? Does it matter if the company has annual elections for the full board or a staggered board?
 - Is it appropriate and feasible to permit a traditional election contest to take place simultaneously with a "proxy access" election contest? Will the company have the right to solicit against the non-access nominees using proxy cards that list only management's slate? Can the shareholders nominating the proxy access director support the other shareholder nominees and distribute a combined proxy card? Will the profusion of proxy cards and the application of state law providing that the latest proxy supersedes all earlier proxies create too much confusion and potential for unintended consequences?
 - How should proposed Rule 14a-11 interact with corporations whose governing documents already allow for proxy access? Proposed Rule 14a-11 suggests that the two regimes would exist side-by-side, provided that the corporate regime is more open to shareholder nominees—some would say "more shareholder friendly"—than Rule 14a-11. It is also noteworthy that the Commission has requested comments on whether Rule 14a-11 should control when the shareholders of a corporation have approved a shareholder access regime that is either more or less restrictive than a Rule 14a-11 regime.
 - What will be the effect of the proposed liability regime under Rule 14a-11? The rule provides that a company will not be responsible for information provided by a nominating shareholder and then repeated by the company in its proxy statement, except where the company "knows or has reason to know" that the information is false or misleading. How will companies in practice assure themselves of the accuracy of statements by nominating shareholders? Does

this open the door to claims that a company had a due diligence obligation it failed to meet?

- *Statutory Authority.* Whether the SEC has the statutory authority to adopt the proposed proxy access rules (or indeed any proxy access rule) is a question that has been debated in the context of the SEC's 2003 and 2007 proxy access initiatives. It will continue to be debated in the context of the 2009 SEC initiative and, assuming the SEC does adopt proxy access rules, almost certainly will be the subject of litigation. The wild card here, of course, is whether Congress will adopt new legislation containing a grant of authority to resolve this controversy.
- *Federalism.* There is little doubt that, assuming it has statutory authority, the SEC has the constitutional power to pre-empt state corporate law. The question, then, is whether it is appropriate policy for the SEC to act in an area that many think has historically been and should continue to be the exclusive province of state administration of corporate law. This debate is brought home by the challenging federalism issues raised by the proposed SEC proxy access regime.
 - A major question is how the proposed rules would and should interact with existing state laws and the existing provisions of a company's governing documents relating to director nominations and elections. The Commission's proposal addresses the federalism issue by providing that a company can exclude otherwise qualifying access nominees under the federal regime if, but only if, specifically prohibited by applicable state law or the governing documents of the company.
 - As the Commission's release notes, no state has enacted such a law. The result if a state were to do so seems clear. However, it is less clear whether a state could enact a statute that bars proxy access under the federal regime but nonetheless permits access under a state law regime.
 - As for corporate charters and bylaws barring access, while we are not aware that any currently exist, the proposed rules seems to contemplate adoption of charter or bylaw amendments that would bar access. This raises the possibility of shareholders "opting out" of access by charter or bylaw amendment, as well as a board's opting out of access by board adopted bylaws in states like Delaware where board adoption of proxy access bylaws will be permissible as of August 1, 2009.

Next Steps

The comment period will be open for 60 days from the date the release is published in the Federal Register. It is obvious that the Commission will receive a large number of comments. The Commission received 690 comments in response to the 2003 proxy access proposal and 8,800 comment letters in response to the 2007 proposal (though 8,400 of those were form letters). Moreover, there are 171 specific "request for comments" from the Staff in the release, many of which themselves contain multiple questions. This alone will certainly result in a number of long and complicated comment letters and a highly complex review process prior to implementation of a proxy access regime.

One possibility might be for the Commission to amend Rule 14a-8 to permit access proposals for the 2010 proxy season while it continues to work on its substantive access proposal. But this solution to the timing issues would be controversial and potentially further complicating in that it would permit a rash of Rule 14a-8 shareholder access proposals which, if adopted, might be at odds with the Commission's final rules.

Other timing and process uncertainties include:

- The possibility of legislative action by Congress, either in the form of an enabling statute that would confirm SEC rulemaking authority, or in the form of a more prescriptive mandated access regime (such as Sen. Schumer's recently proposed "Shareholder Bill of Rights").

- State legislation relating to proxy access, including enabling statutes such as Delaware's, statutes barring access entirely or statutes prescribing access regimes either supplementing the SEC rule proposals or, perhaps, purporting to supersede SEC access rules.
- Actual or threatened litigation challenging the Commission's statutory authority to enact an access regime.
- Adoption of access bylaws by companies seeking to demonstrate the lack of need or the inappropriateness of an SEC "one size fits all" rule or to pre-empt shareholder proposals under an amended Rule 14a-8.
- Publication of "model" access bylaws to inform the debate about the provisions needed or appropriate for an access regime.
- The possibility of final or additional rulemaking on such items as New York Stock Exchange Rule 452 (as it applies to director elections) and the SEC's e-proxy rules, which could make the final SEC proxy access regime part of a wider reconsideration of the current proxy system.

Conclusion

Given the likely extensive and vociferous debate that the SEC comment process has invited, the controversial nature of the proposed rules and the other uncertainties outlined in this alert, some have predicted the Commission will be challenged to enact its full proxy access proposal in time for the 2010 proxy season. In our view, it is too early to tell. As a consequence, general counsel and corporate secretaries would be well advised to schedule sessions at their early fall board meetings to educate their boards on the issues presented by the proposed rules, possible bylaw amendments and other appropriate preparation for the 2010 proxy season. In upcoming *Commentaries* our firms will provide our clients information to support such discussions and planning.

If you have any questions regarding this *Commentary*, please contact the Georgeson Inc. representatives or Latham & Watkins LLP representatives listed below or the Latham attorney with whom you normally consult.

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