
CLIENT ALERT

SEC Issues Final Rule on Facilitating Shareholder Director Nominations (“Proxy Access”)

INTRODUCTION:

On August 25, 2010, the Securities and Exchange Commission (“SEC”) adopted new rules on facilitating shareholder director nominations (“proxy access”).¹ The new Exchange Act Rule 14a-11 creates a process for eligible shareholders nominating directors to gain access to a company’s proxy statement and proxy card. To be eligible to nominate directors under 14a-11 individuals or groups of shareholders must hold at least 3% of what the Commission calls “voting and investment power” in a company’s securities that are entitled to be voted (with positions adjusted for shares sold short, while securities loaned to third parties can be counted toward the ownership threshold, but only if the nominating shareholder will recall the loaned securities upon notification that their Rule 14a-11 nominee will be included in the company’s proxy materials). Eligible shareholders must also have maintained sufficient “voting and investment power” continuously for at least 3 years prior to submitting a 14a-11 nomination (and will have to document that they have done so through disclosures on a new Schedule 14N). Each company faces a maximum number of potential 14a-11 directors and nominees amounting to 25% of the total number of directors on a company’s board (rounded down, and based on the total number of board seats, even for companies with classified/staggered boards). The proxy access provisions apply only if state or foreign laws do not prohibit shareholders from nominating directors. Shareholders taking advantage of the proxy access rules will also have to disclose on Schedule 14N forms certain information concerning both the nominating shareholders and their director nominees. In order to facilitate the SEC’s proxy access process, which will also apply to registered investment companies (RICs), the Commission is also imposing new disclosure requirements on companies via Form 8-Ks (regarding information necessary for shareholders to act in a timely manner concerning Rule 14a-11 nominations).

The Commission has also amended Rule 14a-8(i)(8) to narrow the “election exclusion” to prevent companies from excluding from their proxy materials shareholder proposals that would establish a mechanism for the inclusion of one or more shareholder director nominees in a company’s proxy

¹ Release Nos. 33-9136; 34-62764; IC-29384; File No. S7-10-09. The full text of the release is available on the SEC’s website at: <http://www.sec.gov/rules/final/2010/33-9136.pdf>.

materials (provided all of the procedural requirements of Rule 14a-8 are met [current eligibility criteria of Rule 14-8 still apply]).² However, as the adopting release explained, “a shareholder proposal seeking to limit or remove the availability of Rule 14a-11 would be subject to exclusion under Rule 14a-8.”

The SEC deferred application of Rule 14a-11 for “smaller reporting companies” (generally issuers with public floats of less than \$75 million),³ but only for three years after the rules go into effect later this year. This deferral does not cover the amendment to Rule 14a-8 (described above). The Commission noted in its adopting release that: “a delayed effective date for smaller reporting companies should allow those companies to observe how the rule operates for other companies and should allow them to better prepare for implementation of the rules. We also believe that delayed implementation for these companies will allow us to evaluate the implementation of Rule 14a-11 by larger companies and provide us with the additional opportunity to consider whether adjustments to the rule would be appropriate for smaller reporting companies before the rule becomes applicable to them.”⁴

The new rules will go into effect 60 days after they are published in the *Federal Register*, which will be in time for the 2011 annual meetings at most of the companies subject to the new rules. Eligible shareholders can submit nominees for inclusion in next year’s proxy statement no later than 120 days (and no earlier than 150 days) before the anniversary date of the mailing of the company’s proxy statement in the prior year. Thus, the new rules will have an impact on meetings in 2011 where the 120 day deadlines occur on or after the effective date of the rules. If a company did not hold an annual meeting during the prior year, or if the date of the scheduled meeting will change by more than 30 days from the prior year, Schedule 14N notices will be required in a reasonable time before the company mails its proxy materials.

Battle Over Proxy Access at the SEC

In a reflection of the polarizing and partisan nature of the long and difficult debate over proxy access, the new rules were adopted by only a narrow 3-2 (party line) vote in favor. Opposition to the new rules came from Republican Commissioners Kathleen Casey and Troy A. Paredes. SEC Chairman Mary L. Schapiro asserted that the new rules on proxy access are the result of “constructive debate,” and reflect “dozens of instances of ‘give and take.’” For example, while the Commission increased the ownership thresholds from 1% (as proposed) to 3% (as adopted) of “voting and investment power” in a company’s securities that are entitled to be voted, and extended the length of required ownership from 1 to 3 years, it also decreased the ownership thresholds from what was proposed for the smallest companies from 5% down to the 3% level (for all companies subject to the rules). Although the Chairman has tried to position

² Under Rule 14a-8 such proposals require that the shareholder putting forth the proposal have held continuously, for one year prior to submitting the proposal, at least \$2,000 in market value (or 1%, whichever is less) of the company’s securities entitled to be voted on the proposal at the meeting.

³ The SEC deferred application of the new rule to “smaller reporting companies” (as defined in §17 CFR 240.12b-2) for a period of three years. The SEC defines “smaller reporting companies” as “an issuer that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that: had a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter...or in the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than \$75 million as of a date within 30 days of the date of the filing of the registration statement...or in the case of an issuer whose public float...was zero, had annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available. See <http://www.sec.gov/rules/final/2010/33-9136.pdf>. See also the description of “smaller reporting company” [S-K 10(f)(1)] contained in The Division of Corporation Finance, *Financial Reporting Manual* (UPDATED 07/07/10). <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml>.

⁴ Page 70. <http://www.sec.gov/rules/final/2010/33-9136.pdf>.

the new rule as a reflection of significant compromise, the final result still reflects, in her words, “a marked change to the status quo.” It is, at best, a tenuous “change,” since there can be little doubt that we will see challenges through the courts, while the political winds in Washington could shift dramatically over the next few years, and companies have yet to demonstrate the numerous means at their disposal to marginalize most 14a-11 challenges. Indeed, even Chairman Schapiro acknowledged in public comments that the Commission will “monitor” implementation “not only in the context of future application to smaller companies...but also so that we can make prompt changes for all companies, if practice demonstrates the need to do so.”⁵

Commissioner Casey explained her opposition to the new rules in a statement at the open meeting. She asked: “how can the Commission justify any ownership or holding period thresholds that will deny some shareholders the right to proxy access? I do not accept that a federal proxy access mechanism is a fundamental right...restrictions on the use of proxy access are necessary to allow companies to run efficient and cost-effective director elections.” Casey also offered an interesting insight into the decision-making on the part of advocates on the Commission: “a primary, if unstated, objective of this rule is to put the issue of proxy access behind the Commission once and for all...paradoxically, the rule that the Commission adopts today virtually guarantees that the Commission will be forced to deal with this issue for years to come...the rule is so fundamentally and fatally flawed that it will have great difficulty surviving judicial scrutiny. Second, an inevitable consequence of this rule, if it survives, is that the staff will be tasked with the unenviable responsibility of brokering disputes and addressing a broad array of issues arising from the operation of this new federal right every proxy season.”⁶

Chairman Schapiro argued in her comments on the rule that “the Dodd-Frank Wall Street Reform and Consumer Protection Act...confirms the Commission's authority to act” on proxy access.⁷ The adopting release also asserts that advocates at the Commission: “continue to believe that we have the authority to adopt Rule 14a-11 under Section 14(a) as originally enacted. In any event, Congress confirmed our authority in this area and removed any doubt that we have authority to adopt a rule such as Rule 14a-11.” Even so, Professor Joseph Grundfest, who is a former commissioner, was quoted by *Bloomberg* suggesting that the new rule could be challenged on the grounds that the rule does not provide a mechanism for shareholders to reject or modify 14a-11 proxy access provisions.⁸ The new rule does allow a company's shareholders to adopt, through a Rule 14a-8 shareholder proposal, access rules that provide for greater access but, in the words of Chairman Schapiro, “they cannot limit the availability of our new proxy access rule.” The text of the adopting release also weighed in with this argument: “A rule that would permit some shareholders (even a majority) to restrict the federal securities law rights of other shareholders would be without precedent and, we believe, a fundamental misreading of basic premises of the federal securities laws...it would be no more appropriate to subject a federal proxy rule that provides the ability to include nominees in the company proxy statement to a shareholder vote than it would be to subject any other aspect of the proxy rules – including the other required disclosures – to abrogation by shareholder vote.”⁹

⁵ <http://www.sec.gov/news/speech/2010/spch082510mls.htm>

⁶ <http://www.sec.gov/news/speech/2010/spch082510klc.htm>

⁷ <http://www.sec.gov/news/speech/2010/spch082510mls.htm>

⁸ “SEC Approves Rule That May Make It Easier to Remove Directors,” *Bloomberg*, Aug. 25.

⁹ Page 19. <http://www.sec.gov/rules/final/2010/33-9136.pdf>

PROXY ACCESS PROVISIONS:

New Exchange Act Rule 14a-11 enables eligible shareholders to have their director nominees included in a company's proxy materials (quoting the adopting release) "regardless of any provision of state law or a company's governing documents that purports to waive or prohibit the use of Rule 14a-11." The adopting release noted that 14a-11: "will apply only when applicable state law or a company's governing documents do not prohibit shareholders from nominating a candidate for election as a director. In addition, as adopted, the rule will apply to a foreign issuer that is otherwise subject to our proxy rules only when applicable foreign law does not prohibit shareholders from making such nominations. Also consistent with the Proposal, companies may not 'opt out' of the rule – either in favor of a different framework for inclusion of shareholder director nominees in company proxy materials or no framework...the final rule will apply to companies that are subject to the Exchange Act proxy rules, including investment companies and controlled companies, but will not apply to 'debt-only' companies."

The Commission also explains in the adopting release that: "the rule will apply regardless of whether any specified event has occurred to trigger the rule and *will apply regardless of whether the company is subject to a concurrent proxy contest*" (*italics added*). The latter has been emphasized because one of the most notable consequences of the new rules is their possible exploitation by multiple shareholders/groups in pursuit of similar or complementary governance agendas: with one shareholder or group pursuing 14a-11 nominations and the other a 14a-12(c) contested election.

For shareholders simply using 14a-11 there is no offsetting constraint on their use of proxy solicitation campaigns – creating an advantage for the shareholder activist in terms of the total costs of waging proxy contests for director positions. Any shareholder or group with a position large enough to qualify under Rule 14a-11 would likely have more than ample resources to fund a traditional proxy contest. Now, the practical effect of the 14a-11 process is that larger shareholders can have the company footing a major part of the bill, while the shareholders exploiting 14a-11 can redirect any funds thus "saved" to engage in proxy solicitations in support of the Rule 14a-11 nominations. This advantage is particularly extreme if/when large investors are pitted in 14a-11 contests against small-cap companies.

Voting Power and Ownership Thresholds

The SEC set the threshold for eligibility to nominate directors under 14a-11 at continuous ownership (registered and/or beneficially held) for the prior three years (as of the date the nominating shareholder or group submits a Schedule 14N) of at least 3% of the "voting and investment power" of the company's securities entitled to be voted at the meeting. For registered investment companies this threshold calculation is based on the net assets of the company. Where a company has multiple classes of stock, including situations where voting rights are unequal, "voting power" will be determined based on the collective voting power of the class or classes of stock that would be voting together on the election of directors. Nominating shareholders cannot include in their ownership calculations securities that "could be acquired," such as securities underlying options that are currently exercisable but have not yet been exercised. Nominations under 14a-11 are limited to holders of securities subject to the proxy rules (thus excluding private classes of voting securities).

The final rules require that nominating shareholders/groups hold sufficient "investment power" in a company's securities. While securities loaned to a third party can be included in calculations of total ownership, securities sold short (as well as certain securities that have been borrowed) are to be deducted from the amount of securities that may be counted towards the required ownership level. This would not

apply to shares sold short in cases where the nominating shareholder or member of the nominating shareholder group had no control over such transactions (e.g., certain pooled investment vehicles).¹⁰

The adopting release indicates that this approach was taken because “we agree with commenters who suggested that selling a company’s securities short may divest that shareholder of the economic risks of ownership.” Moreover, the SEC adopted a requirement that nominating shareholders must continue to own the qualifying amount of securities through the date of the meeting at which directors are elected, while nominating shareholders have to disclose their intent concerning plans for ownership of the securities after the election of directors.

Securities out on loan can be counted toward the ownership threshold, but only if the nominating shareholder or member of a nominating shareholder group has the right to recall the loaned securities, and will recall the loaned securities upon notification that any of the shareholder’s or group’s Schedule 14N nominees will be included in the company’s proxy materials. In such cases, it is not clear how quickly (in trading days) the recall of loaned securities has to be completed once the nominating shareholders receive that notification. This provision raises the prospect of funds developing event-driven trading strategies to take advantage of potential short squeezes in the period soon after a company’s transmission of a notice to a nominating shareholder known to have a large number of shares out on loan.

Proving the ownership requirements under 14a-11 could be difficult for some potential nominating shareholders. If the nominating shareholder has been a registered holder, the adopting release noted that “the company would have the ability to independently verify the shareholder’s ownership.” Nominating shareholders can also demonstrate ownership by attaching to Schedule 14Ns previously filed Schedules 13D or 13G (in another rule change, nominating shareholder groups can use 13Gs to report their aggregate ownership if the group was formed solely for the purpose of a Rule 14a-11 nomination) or Forms 3, 4, or 5. With regard to beneficial ownership, the 14N will require written statements from banks or brokers verifying information showing that the nominating shareholder (or member of a nominating group) continuously held positions in the securities (loaned securities can be included) for at least the previous three years. If a nominating shareholder used multiple brokers over time or simultaneously, statements concerning the amount of securities held, and the time period they were held for, would be needed from all of those brokers. That statement from a registered holder, broker, or bank will have to be dated within seven calendar days prior to the date the nominating shareholder or group submits a notice to the company on Schedule 14N.

The grey area in this aspect of the procedures is that nominating shareholders have to demonstrate sufficient “voting and investment power,” and thus have to show that they did not also hold a large enough position of shares sold short in a company’s securities to fall below the “investment power” levels required by Rule 14a-11. That “evidence” will rest mainly on statements contained in Schedule 14N. There is no requirement that nominating shareholders show ALL of their ownership positions (long and short) over a three year period in order to exclude the possibility of accounting errors or omissions on the part of nominating shareholders or their banks/brokers. Failures to disclose or properly account for

¹⁰ The adopting release commented at footnote 277 (page 100): “a number of commenters suggested that we adopt a beneficial ownership definition for purposes of Rule 14a-11 that netted all hedging arrangements (derivatives, swaps, etc.). We believe, however, that it is appropriate at this time to adopt the ownership threshold for Rule 14a-11 with the provision only relating to short sales as it contributes significantly towards the goal of excluding votes from the ownership calculation securities where the voting and economic interests are separated and does not unduly complicate the rule. Further, by excluding securities that the holder merely has the right to acquire (such as securities underlying options) and securities that have been loaned and cannot be recalled, we have further narrowed the application of the rule to address concerns about separating economic interest and voting power.” <http://www.sec.gov/rules/final/2010/33-9136.pdf>

relevant short positions would be one area that companies defending against 14a-11 contests will want to investigate.

Procedures for Reviewing Nominations and Excluding Certain 14a-11 Nominees

The SEC discarded its widely criticized proposal of a “first-in” rule in the case of multiple eligible 14a-11 nominations to go with a rule that companies must include in their proxy materials eligible shareholder director nominees from the nominating shareholder or group with the highest percentage of voting and investment power. If a nominee is found by a company to have failed to meet all necessary qualifications, or withdraws, then the company will be required to include in its proxy materials any other eligible nominee submitted by that nominating shareholder or group and then, in order of priority, nominees from the nominating shareholder/group with the next highest “voting power” amount (and found to meet all eligibility requirements) “until the maximum number of nominees is included in the company’s proxy materials or the list of eligible nominees is exhausted.” As the release went on to explain: “Under Rule 14a-11, a company will not be required to include shareholder nominations for more than a maximum of one director or 25% of the existing board, whichever is greater. If one shareholder or group that is eligible to use Rule 14a-11 nominates the maximum allowable number of candidates, a company will be permitted to exclude any other shareholder’s or group’s nominees from the company’s proxy materials. Further, if the maximum allowable number of existing shareholder director nominees *is currently in place on the board*, additional shareholder director nominees are not required to be disclosed in the proxy materials pursuant to the rule” (*italics added*, e.g., in cases of classified boards or when a company nominates previously-elected 14a-11 directors after their first term in office).¹¹ In cases where a nominating shareholder/group submits a number of nominees that exceeds the Rule 14a-11 cap, the nominating shareholder/group “may specify which nominee or nominees are not to be included in the registrant’s proxy materials.”¹²

The adopting release cited a need to keep the door open to “dialogue and negotiation between company management and nominating shareholders” to explain why the SEC opted to include a provision that will count 14a-11 nominees that “a company agrees to include as company nominees after the filing of the Schedule 14N...toward the 25%” limit. Note: a nominating shareholder or group will not be eligible to use Rule 14a-11 if there is an agreement with the company regarding a particular nominee *before* the filing of the Schedule 14N.

Schedule 14N

A notice of intent to use Rule 14a-11 must be provided on a Schedule 14N to a company (and filed on EDGAR on the same date) 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 that date. New Exchange Act Rule 14a-18 also requires shareholders submitting shareholder nominations *for inclusion in a company’s proxy materials pursuant to a state law provision or a company’s governing documents* to undertake similar disclosures concerning the nominating shareholder or group and the nominee/s via a Schedule 14N. The Schedule 14N notices will include disclosures on:

¹¹ Adopting release, Page 309. See also footnote 858. <http://www.sec.gov/rules/final/2010/33-9136.pdf>

¹² Instruction 2 to paragraph (g) in the adopting release, page 429.

1. The voting power (amount and percentage) of a company's securities that are entitled to be voted by the nominating shareholder/s;
2. Length of ownership of securities used to meet the ownership requirement;
3. Bios on both the nominating shareholder/s and the shareholder nominee/s (note that Rule 14a-11 does not include any restrictions on the relationships between the nominee and the nominating shareholder or group);
4. A statement about whether the nominee/s meet a company's director qualifications, as described in a company's governing documents;
5. Certifications by the nominating shareholder/s that they, and all of their nominees, meet all of the requirements of 14a-11, as applicable, and are not acting to either effect a change of control of the company or to gain a number of seats on the board that would exceed the maximum number of nominees that a company could be required to include in their proxy materials under Rule 14a-11.
6. A statement that the nominating shareholder/s will continue to hold the qualifying amount of securities through the date of the meeting and a statement with regard to the nominating shareholder's or group member's intent regarding the ownership of the securities following the election; and
7. An *optional* statement supporting each shareholder nominee, but which cannot exceed 500 words per nominee.

Companies receiving 14Ns are burdened with determining which eligible nominees will be included in their proxy materials (based on the eligibility and prioritization requirements of Rule 14a-11). Once the company determines that a particular nominee will be included in its proxy materials (with the relevant background information and optional statements from the 14N included in such materials), a notice of that decision must be sent by the company to the nominating shareholder/group (or their authorized representative). That notification must be postmarked or transmitted electronically at least 30 days before a company files its definitive proxy statement with the Commission.

The Commission took note of how complicated the process could get if it allowed nominations to be changed after the submission of a Schedule 14N. Thus, the new rules prohibit nominating shareholders from modifying the composition of a nominating group or changing a shareholder nominee in order to correct a deficiency identified by a company in its notice to the nominating shareholder/group. Moreover, Rule 14a-9(c) makes nominating shareholders liable for any statement in a Schedule 14N or related communication that is false or misleading. The company will not be held responsible for information provided by nominating shareholders and included in a company's proxy statement.

The burden is on the company to determine whether nominating shareholders and their nominees meet the eligibility requirements of Rule 14a-11. Companies can exclude certain Rule 14a-11 nominees. Exclusions are possible if a nominee's "candidacy or, if elected, board membership would violate controlling state or federal law, or the applicable standards of a national securities exchange or national securities association, except with regard to director independence requirements that rely on a subjective determination by the board, and such violation could not be cured during the provided time period... (or) violate controlling foreign law" (quoting the adopting release). While there are no restrictions on the relationships between the nominating shareholder and the nominee, the latter have to meet objective standards for independence set by the applicable national securities exchange or national securities association. Nor can a nominating shareholder or nominee have a direct or indirect agreement with the company regarding the Rule 14a-11 nomination.

Decisions to exclude nominees pursuant to Rule 14a-11 must be explained in a notice sent to the nominating shareholder/group. In the event the company determines that a nominee is excludable, the notice from the company will have to be postmarked or transmitted electronically (in a manner that evidences “timely transmission”) no later than 14 calendar days after the close of the period for submission of nominations pursuant to Rule 14a-11. The nominating shareholder/group will then have 14 calendar days “after receipt” of the notice from the company to transmit or postmark a response correcting any eligibility or procedural deficiencies identified – except that neither the composition of the nominating shareholder group nor the shareholder nominee/s may be changed. If, after providing the required notice and time for an optional response by the nominating shareholder/group, the company reaches a final determination that it will exclude a nominee, then the company must provide a notice explaining the basis for exclusion (along with a supporting opinion of counsel when a company’s basis for excluding a nominee or nominees relies on a matter of state or foreign law) to the Commission no later than 80 calendar days before filing its definitive proxy statement and form of proxy with the Commission. A copy of that notice of exclusion to the Commission must also be sent to the nominating shareholder or each member of the nominating shareholder group, who will then have the choice of responding within 14 calendar days (after “receipt” of a copy of the notice from the company).

If the company also seeks an informal statement of the Commission staff’s views on the basis for excluding a nominee, the company will also have to deliver a notice concerning the SEC’s response to the nominating shareholder/group promptly following receipt of the Commission staff’s response. The adopting release also noted that due to the requirements of a company’s review process (among multiple 14a-11 nominees) companies may need to seek no-action requests from the staff “on all nominees that they believe they can exclude at the outset.”¹³

Solicitations

Rule 14a-2(b)(7) treats communications between shareholders for the purpose of forming a nominating shareholder group as solicitations under the proxy rules. Accordingly, the Commission exempted from the proxy rules written communications made in connection with Rule 14a-11 (subject to limits on their content and a requirement that they be filed with the Commission). Written and oral communications between shareholders seeking to form a nominating shareholder group must meet certain requirements: the shareholders involved cannot be holding the target company’s securities with the purpose, or effect, of changing control of the company or gaining a number of seats on the board of directors exceeding the maximum number of nominees that the registrant could be required to include under Rule 14a-11 (25% of the board, or one, whichever is greater); shareholders must limit the content of written communications to information specified in the rule, including disclosures of certain identifying information, and have “no solicitations in connection with the subject election of directors other than pursuant to the provisions of Rule 14a-11 and the new exemption”;¹⁴ shareholders must also file with the Commission all related soliciting materials or, in the case of oral communications, a filing under cover of Schedule 14N with the appropriate box checked (with such filings made before or at the same time as the first solicitation).

Solicitations supporting a nominee or against a company’s nominees will be exempt under Rule 14a-2(b)(8), but must be reported on Schedule 14N, and can start only after the nominating shareholder/group has received a notice from the company that a shareholder nominee is to be included in

¹³ Adopting release, page 31.

¹⁴ Quoting the description in the adopting release.

the company's proxy materials. The Commission, in its adopting release, also explained that it adopted an instruction to Rule 14a-11 intended to "make clear that, in order to rely on Rule 14a-11 to have a nominee or nominees included in a company's proxy materials, a nominating shareholder or group or any member of the nominating shareholder or group may not be a member of any other group with persons engaged in solicitations or other nominating activities in connection with the subject election of directors; may not separately conduct a solicitation in connection with the subject election of directors other than a Rule 14a-2(b)(8) exempt solicitation in relation to those nominees it has nominated pursuant to Rule 14a-11 or for or against the company's nominees; and may not act as a participant in another person's solicitation in connection with the subject election of directors."¹⁵

New Disclosure Requirements Imposed on Companies

To facilitate the Rule 14a-11 proxy access process, the Commission is also imposing new disclosure requirements on companies. These new requirements are designed to provide timely transparency regarding anticipated meeting dates and deadlines for filing proxy access notices, as well as the net assets of registered investment companies (for calculating ownership threshold criteria). As the adopting release explained: "A company will be required to file a Form 8-K, within four business days of determining the anticipated date of the meeting, disclosing the date by which a nominating shareholder or group must submit notice to include a nominee in the company's proxy materials pursuant to Rule 14a-11, which date shall be a reasonable time before the registrant mails its proxy materials for the meeting. We also have clarified that where a company is required to include shareholder director nominees in the company's proxy materials pursuant to an applicable state or foreign law provision, or a provision in the company's governing documents then the company is required to disclose the date by which a nominating shareholder or nominating shareholder group must submit the Schedule 14N required pursuant to Rule 14a-18." An investment company that is a series company must also disclose via 8-Ks "the total number of the company's shares that are outstanding and entitled to vote for the election of directors (or if votes are to be cast on a basis other than one vote per share, then the total number of votes entitled to be voted and the basis for allocating such votes) at the shareholder meeting as of the end of the most recent calendar quarter." Exchange Act Rule 14a-5 has also been amended to require companies to disclose the deadline for submitting nominees for inclusion in the company's proxy materials for the company's next annual meeting of shareholders (under Rule 14a-11, an applicable state or foreign law provision, or a company's governing documents).

Investment Companies

Despite significant opposition from the investment company industry, the SEC has extended Rule 14a-11 to cover investment companies.¹⁶ The adopting release asserted that this was done, among other reasons, because "the trend for investment company boards is to have strong governance practices."

The Commission's release addressed numerous arguments against extending Rule 14a-11 to cover registered investment companies, including the facts that: the boards of directors of investment

¹⁵ Adopting release, pages 53-54. <http://www.sec.gov/rules/final/2010/33-9136.pdf>

¹⁶ Despite recent opposition from the ICI to having investment companies included in the proposed rule, a footnote in the SEC's adopting release stated: "we note that, in response to the 2003 Proposal, ABA and ICI indicated that there were no reasons to treat investment companies differently from non-investment companies. See letter from Investment Company Institute (December 22, 2003) on File No. S7-19-03...."

companies have a different regulatory regime under the Investment Company Act and serve different functions than do the boards of non-investment companies; the rule would impose significant costs on common “unitary” and “cluster” boards within a fund complex; elections that are “contested” under NYSE rules will keep brokers from being able to vote client shares on a discretionary basis (and increase costs for investment companies to achieve a quorum). However, the adopting release marginalized such concerns in favor of an argument that: “The purpose of Rule 14a-11 is to facilitate the exercise of shareholders’ traditional state law rights to nominate and elect directors to boards of directors and thereby enable shareholders to participate more meaningfully in the nomination and election of directors at the companies in which they invest. These state law rights apply to the shareholders of investment companies, including each investment company in a fund complex, regardless of whether or not the fund complex utilizes a unitary or cluster board...the separate regulatory regime to which investment companies are subject emphasizes the importance of investment company directors in dealing with the conflicts of interest created by the external management structure of most investment companies...We believe...the benefits of the rule justify these costs...We believe that the costs imposed on investment companies will be less significant than the costs imposed on other companies...to the extent investment companies do not hold annual meetings as permitted by state law, investment company shareholders will have less opportunity to use the rule...even when investment company shareholders do have the opportunity to use the rule, the disproportionately large and generally passive retail shareholder base of investment companies will probably mean that the rule will be used less frequently than will be the case with non-investment companies.”

To facilitate the proxy access process, the Commission also created a new disclosure requirement for registered investment companies via Form 8-K. In addition to the new disclosure requirements for companies described above (related to the disclosure of dates of meetings where directors will be elected and required dates by which a nominating shareholder or group must submit a Schedule 14N notice), a registered investment company must also disclose the total number of the company’s shares that are entitled to vote for the election of directors as of the end of the most recent calendar quarter. Nominating shareholders seeking to determine the “voting power” thresholds in the case of registered investment companies can rely on either Form 8-K disclosures (for a series company) or, if that is not available, a registered investment company’s most recent annual or semi-annual report filed with the Commission on Form N-CSR.¹⁷

What the SEC Did Not Include

The adopting release includes a very lengthy discourse on why the Commission did not accept a wide variety of proposals. In some cases, the text stands as a monument to the readiness of advocates to simply marginalize some complex issues in a rush to impose a proxy access rule and sort out the “unintended” consequences later. For example, the Commission rejected any constraints on shareholder nominees being nominated repeatedly, even if those nominees and campaigns continually end up with very poor or potentially no voting support at all. Their argument in the release was that such constraints “would add undue complexity to the rule’s operation.” Of course it would, but that would merely reflect the very nature of the transformational nature of the proxy access rule imposed by the SEC. As the rule currently stands, there is significant risk of certain shareholder nominations being used repeatedly by the same shareholder/s simply to harass a board (as part of a larger campaign that has as its end game some

¹⁷ See the adopting release, page 414. <http://www.sec.gov/rules/final/2010/33-9136.pdf>

other objective besides securing access to a board seat) or even simply to gain access to corporate proxy materials to publish information that is directed not so much at the election of a director (except perhaps nominally so), but some other agenda. The SEC has mandated that companies fund the printing presses, with a potential reach in some cases of upwards of tens of millions of shareholders - if only a group with an agenda can secure 3% of the “voting and investment power” of a company’s securities. The SEC has left the door wide open to potential abuse of this process.

The Commission also decided against allowing companies to give shareholders the option of voting for or withholding votes from company nominees as a group. The adopting release was critical of the idea of grouping a company’s nominees on the grounds that: “This would result in an advantage to the management nominees and would be inconsistent with an impartial approach and the goals of Rule 14a-11. The final rule clarifies that the change would apply not only when a nominee is included pursuant to Rule 14a-11, applicable state law, or a company’s governing documents, but also where a nominee is included pursuant to a provision in foreign law.”

IMPLICATIONS:

The Altman Group’s survey on proxy access issues¹⁸ was cited in the SEC’s adopting release for the fact that “participants predicted that, on average, 15% of companies listed on U.S. exchanges could expect to face a shareholder director nomination under Rule 14a-11 in 2011.”¹⁹ The “short list” of companies at greatest risk of seeing Rule 14a-11 nominations in 2011 is a combination of large-cap companies currently facing significant challenges from activists and small-cap companies that may see hedge fund activists take advantage of the new rule to mount more effective campaigns. The *Wall Street Journal* (Aug. 23) cited several key shareholder activists (from CtW Investment Group, AFSCME, and CalSTRS) as identifying Massey Energy Company, Dell Inc., and Chesapeake Energy Corporation as potential targets for proxy access nominees in 2011.²⁰

CalSTRS and CalPERS may rank among the most active participants in campaigns involving proxy access nominations. Both institutions have been active this year building a database of qualified independent director candidates, which the Dir. of Corporate Governance at CalSTRS, Anne Sheehan, told The Altman Group is being done in order to have an: “effect on the cultural mind-set” of corporate boards – “This is not a short-term goal and we realize that this will not be accomplished in one annual meeting season.”²¹

While the number of shareholder director nominations submitted under 14a-11 could be substantial over the next few years, the total number of nominations that will be *successful* could be far less than some advocates are hoping for. A critical flaw of the proxy access concept is that some advocates appear to underestimate just how effective corporate responses typically are when forced into confrontational situations. It also remains to be seen how retail shareholders will react to having shareholder director nominees in the corporate proxy materials. While proxy access advocates may expect a higher number of votes resulting from gaining access to corporate proxy materials, it could also drive higher turnouts by retail investors against 14a-11 nominees (particularly so if such nominations are

¹⁸ <http://www.altmangroup.com/pdf/AltmanGroupSurveyProxyAccessJan19.pdf>

¹⁹ Page 270, and at Footnote 795. <http://www.sec.gov/rules/final/2010/33-9136.pdf>. The survey by The Altman Group is also referenced at footnote 872 (page 317), footnote 973 (page 350) and footnote 1048 (page 375).

²⁰ “New Rules on Proxies Puts Heat on Firms,” *WSJ Online*, Aug. 22.

²¹ *Governance & Proxy Review* (Vol. 1, #42), May 14, 2010. http://www.altmangroup.com/gpr/vol1_issue42.html

seen widely as being driven by narrow interest groups). Candidates representing narrow interest groups will find it very tough, as a general proposition, to secure a majority of the votes cast (or for that matter securing enough support to organize a group large enough to first reach the eligibility criteria for filing Schedule 14Ns, and then be certain to have a combined “voting and investment power” interest large enough to ensure that they are first in line).

We also expect to see some nominations fail simply because certain shareholders/groups nominating 14a-11 candidates neglect to support those nominations with effective solicitation campaigns. Indeed, there are significant costs associated with mounting effective proxy contests – to a point where many of the largest shareholders eligible to use 14a-11 will have to examine the tradeoffs between running less costly, but also potentially ineffective, 14a-11 campaigns (often for only 1 director given the limits imposed by Rule 14a-11) and dedicating the resources necessary to win short slate contests. Indeed, one 14a-11 director, elected after a confrontation with management, is unlikely to have much influence in such a polarized setting. It is little wonder that some advocates of proxy access are calling the SEC’s proxy access rules, as adopted, a “minimalist” approach.²²

ACTION ITEMS:

Corporate issuers and registered investment companies should immediately establish internal processes for meeting new disclosure requirements (on Form 8-Ks), as well as for reviewing and responding quickly to Schedule 14N notices. For most companies, the extended timeframes between when notices have to be submitted (to Schedule 14N filers and the SEC) and the time when proxy statements will be mailed should provide sufficient time to manage reviews of proxy statements and proxy cards on a case-by-case basis (as they are impacted, if at all, by Rule 14a-11 nominations).

Companies that are most likely to face challenges via Rule 14a-11 in the 2011 proxy season should also develop strategies for responding, which can start with proactive communications with key shareholders (in order to get ahead of the curve in terms of preventing Rule 14a-11 challenges). Governance risk assessments should include a review of your shareholder base (looking not only at your largest shareholders, but also what groups may be formed) and identifying key resources for information on activists preparing Rule 14a-11 campaigns. Issuers facing significant risk of Rule 14a-11 contests also need to conduct scenario analyses for the purpose of developing and assessing potential defense strategies.

Companies will also be actively trying to identify cases of false or inadequate disclosures by shareholders nominating directors. In contested cases companies may come to rely on shareholder identification/surveillance providers to assist them (acting as agents of those companies) in discovering information about short positions, borrowed shares, and other circumstances where a nominating shareholder may have failed to fully disclose and account for their “voting and investment power.”

²² See Andrew Shapiro, President, Lawndale Capital Management, LLC, letter/blog (arguing that the minimum should have been for 2 seats and a cap set at 33%) posted on the website *Seeking Alpha* (seekingalpha.com) on Aug. 26, 2010.

THE ALTMAN GROUP:

Prior reports and alerts on proxy access issues are available through our website at www.altmangroup.com. To find out more about our “Governance Risk Assessments” and governance consulting services please contact either:

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