

# Meridian Client Update

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## SEC Adopts Proxy Access Rules

**The Securities and Exchange Commission (SEC) has made it considerably easier for eligible shareholders to nominate their own corporate directors.** The SEC has facilitated shareholders' ability to nominate directors by the adoption of new Rule 14a-11 (proxy access) and amendments to Rule 14a-8 (permitting shareholder proposals on procedures for inclusion of shareholder nominees on corporate proxy materials).

The adoption of these two rules marks an end to nearly 10 years of debate during which time the SEC has attempted to adopt some form of proxy access rules without success. In fact, the SEC first considered the issue of proxy access as early as 1942. The SEC's most recent proposal on proxy access was languishing, in part, because some believed the SEC lacked the legal authority to adopt proxy access rules. That all changed by virtue of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act that expressly authorizes the SEC to promulgate proxy access rules. Wasting little time since the enactment of Dodd-Frank, the SEC on August 25, 2010 voted 3 to 2 to adopt its 2009 proposed proxy access rules subject to certain modifications. The two Republican commissioners voted against adoption.

As noted in introductory remarks to the final proxy access rules, the SEC's proposed and final proxy access rules were driven by concerns of many shareholders about the accountability and responsiveness of some companies and boards of directors to shareholder interests. These concerns included whether boards were exercising appropriate oversight of management, whether boards were appropriately focused on shareholder interests and whether boards need to be more accountable for their decisions regarding issues such as compensation structures and risk management. The SEC concludes in the preamble to the final rules that the "principal way that shareholders can hold boards accountable and influence matters of corporate policy is through the nomination and election of directors." This rationale forms the principal basis under which the SEC adopted the final proxy access rules.

## New Rule 14a-11: Proxy Access

Under the SEC's newly adopted proxy access rule (Rule 14a-11), certain shareholders or shareholder groups will be able to include their director nominees in a company's proxy materials. This rule 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. The SEC notes in the final rules that it is not aware of any law in any state or in the District of Columbia that prohibits shareholders from nominating directors. If a company's governing documents prohibit shareholder nominations, shareholders could seek to amend the governing document by submitting a shareholder proposal under amended Rule 14a-8 (see discussion below).

## Eligible Shareholders Who May Submit Director Nominees

A shareholder or a group of shareholders acting in concert are eligible to have included in a company's proxy materials their director nominees; provided that the shareholder (or shareholder group):

- **Owns at least 3% of Outstanding Voting Shares.** The shareholder (or shareholder group) must hold at least **3%** of the total voting power of the company's securities. Such securities must be entitled to vote on the election of directors at annual shareholder meetings. ***Under the proposed rule***, the ownership threshold was 1% for large companies. Borrowed shares of stock are not counted against the 3% ownership threshold. However, shares of stock that a nominating shareholder owns, but has lent to a third-party, would be counted against the 3% ownership threshold, so long as the nominating shareholder has the right to recall the stock and would do so if the company includes the shareholder's nominee in its proxy under the new rules.
- **Held shares for at least 3 years.** The shareholder (or shareholder group) must have held the shares meeting the ownership requirement for **at least 3 years** and must continue to hold such shares through the date of the applicable shareholder meeting at which directors are elected. ***Under the proposed rule***, the holding requirement was 1 year.
- **Nominates no more than the maximum permitted number of nominees.** The shareholder (or shareholder group) may include on the corporate proxy ballot up to one nominee, or the number of nominees that represents up to 25% of the company's board of directors, whichever is greater. In the case of a staggered board, the 25% limit is calculated based on the total number of board seats, **not the number of seats up for election**. A company's shareholders may opt, through either a management proposal or shareholder proposal, to increase proxy access by permitting shareholders to nominate a greater number of directors – but such proposals cannot limit the availability of proxy access (such a shareholder proposal would be made pursuant to amended Rule 14a-8; see discussion below).
- **Certifies intent not to seek a change in control or more than the maximum number of shareholder nominees allowed.** The shareholder (or shareholder group) must certify that it is not holding shares for the purpose, or with the effect, of changing control of the company or to gain board seats in excess of the maximum number of shareholder nominees permitted under Rule 14a-11.
- **Holds the greatest percentage of voting shares in cases of 2 or more submitting shareholders.** In situations where more than one eligible shareholder or shareholder group seeks to have their nominees included in the company's proxy materials, the shareholder or shareholder group who holds the **highest percentage** of voting shares will have its nominees included in the company's proxy materials. Nominees by other shareholders or shareholder groups will **not** be included in the corporate proxy ballot. ***Under the proposed rule***, the first shareholder or shareholder group from which a company received timely notice of intent to nominate a director would have had its nominees included in the company's proxy materials.

## Impact of Director Qualification Standards, Federal and State Law and Exchange Requirements on Shareholder Nominees and Elected Nominees

Except for certain narrowly prescribed circumstances, companies may neither exclude a shareholder nominee from the corporate proxy nor refuse to seat an elected shareholder nominee on the board.

The proxy access rules specifically provide that a corporation **may not exclude** a shareholder nominee from the corporate proxy ballot on the grounds the nominee does not satisfy the corporation's director qualifications rules. However, the corporation may disclose to shareholders that a shareholder nominee does not meet its director qualification standards. Additionally, a nominating shareholder or shareholder group must disclose whether, to the best of their knowledge, the nominating shareholder's or group's nominee meets the corporation's director qualifications, if any, as set forth in the corporation's governing documents.

The proxy access rules **do permit** a corporation to exclude a shareholder nominee from the corporate proxy ballot, or if elected, board membership, if the nominee's candidacy, or if elected, board membership would violate federal law, state law or applicable exchange requirements. However, such exclusions are **not permitted** solely due to the shareholder nominee or elected shareholder nominee failure to meet the independence standards of the applicable securities exchange (and such failure could not be cured during the permitted time period).

### Companies Subject to the Rule 14a-11 Proxy Access

Generally, the new proxy access rules apply to all companies subject to the proxy rules, other than companies whose only public securities are debt securities.

"Smaller reporting companies" are subject to the rule, but the application of the rule is delayed until the third anniversary of the rule's effective date. A company with a public float of less than \$75 million is considered a smaller reporting company, unless the company is an investment company, an asset-backed issuer or a majority-owned subsidiary of a parent that is not a smaller reporting company.

A foreign company that meets the definition of "foreign private issuer" would not be subject to the proxy access rules. Foreign issuers that do not qualify as foreign private issuers and are otherwise subject to the proxy rules would be subject to the proxy access rules only when applicable foreign law does not prohibit shareholders from nominating a candidate for election as a director.

### Effective Date

The proxy access rules will become effective 60 days after their publication in the Federal Register.

### Submission Date for Shareholder Director Nominees

An eligible shareholder must submit director nominee(s) **no later than 120 days before the 1-year anniversary date** of the mailing of the company's proxy statement in the prior year.

For example, assume an eligible shareholder wishes to include its director nominee in a company's proxy to be mailed to shareholders during April 2013. The company's prior year proxy was mailed on April 1, 2012. In this case, the eligible shareholder must submit its director nominee no later than 120 days before April 1, 2013 (the 1-year anniversary of the prior year mailing) or December 2, 2012.

**For the upcoming 2011 proxy season, proxy access will be in effect for many companies.** However, shareholders will be able to submit nominees for inclusion in corporate proxies filed during 2011 only if the applicable submission deadline falls on or after the effective date of the proxy access rules. Once the proxy access rules are published in the Federal Register, it will be possible to determine when shareholders must submit director nominees. *For example, if the final rules become effective on November 1, 2010, Rule 14a-11 generally would apply to companies that mailed their proxy statement for their last annual meeting no earlier than March 1, 2010. For those companies that mailed their proxy statement on March 1, 2010, shareholder submission of director nominees would be due no later than November 1, 2010.*

### Amended Rule 14a-8: Shareholder Proposals on Procedures for Permitting Proxy Access

Proxy access under Rule 14a-11 does not apply to corporations whose governing documents prohibit shareholders from nominating directors. To facilitate shareholders' rights to nominate directors in such a circumstance, the SEC adopted amendments to Rule 14a-8. The amended rule requires a company to include in their proxy materials shareholder proposals seeking to amend the company's governing documents to permit the inclusion of one or more shareholder director nominees in the company's proxy ballot. In addition, the shareholder proposal may call for greater proxy access than allowed under Rule 14a-11 (i.e., permit an eligible shareholder to nominate more than the number of permitted candidates under Rule 14a-11). However, the proposal cannot be used as a specific means to nominate a board candidate. That must be done through Rule 14a-11.

A shareholder may submit a proposal under amended Rule 14a-8 if it meets the following requirements:

- Owns shares with a market value of at least \$2,000 or owns 1% of securities entitled to vote on the proposal at a shareholder meeting; and
- Held such shares for at least one year by the date the shareholder submits the proposal.

Shareholder proposals under amended Rule 14a-8 are subject to the same submission deadlines applicable to shareholder nominee submissions under amended Rule 14a-11.

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*The SEC's adoption of the proxy access rules has brought mixed responses. Many activist shareholders, corporate governance advisors, unions and others welcome the proxy access rules as a necessary counterbalance to what is perceived to be entrenched management and unresponsive boards. In contrast, some business interests and Republican lawmakers see proxy access as an unwarranted intrusion in the operation of corporate boards that will do little if anything to enhance corporate governance and may hurt the collegial nature of boards, with members focused on special interest issues.*

*The fundamental question around proxy access is whether it will herald in a new and more robust era of shareholder activism. Clearly companies that are underperforming or are perceived to be engaging in egregious executive pay practices will likely be targets for shareholder nominated directors. However, a broad range of reasons may motivate shareholders to nominate directors, including a company's environmental practices, political alliances and contributions, outsourcing practices and community relations, among others. Whether the specter of shareholder nominees encourage corporations and boards to more proactively engage shareholders on a broad range of issues remains to be seen.*

*To further add to the mix, proxy access will likely further enhance the influence of shareholder advisory firms such as Institutional Shareholder Services and Glass Lewis. These firms will undoubtedly evaluate the merits of shareholder nominated directors versus board nominated directors. In contested director elections where obtaining a plurality of the votes cast is sufficient to be elected, a proxy advisory firm's recommendation may be enough to tilt the vote outcome in favor of the recommended nominee.*

*One final point boards and management need to bear in mind regarding proxy access – it will be far easier for shareholders to place their nominees on the corporate proxy than to get their nominees elected to the board.*

The **Client Update** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or [dkalfen@meridiancp.com](mailto:dkalfen@meridiancp.com).

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