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## The New Proxy Regime

On August 25, 2010, a divided Securities and Exchange Commission (SEC) adopted several amendments and a new Rule 14a-11 - the "proxy access" rule - granting shareholders the right, upon meeting certain criteria, to nominate directors and to have the nominees included in the company's proxy materials. On September 29, 2010, the Business Roundtable and the U.S. Chamber of Commerce sued the SEC, challenging the final rules and requesting a stay of the effective date of the rules, pending the outcome of the lawsuit. On October 4, 2010, the SEC issued a self-imposed stay of the effective date of Rule 14a-11 and its related amendments, pending the outcome of the challenge.

Even though Rule 14a-11 will not be effective for the upcoming proxy season, reporting companies would be well advised to familiarize themselves with the new requirements. The recently enacted Dodd-Frank Act gives the SEC the explicit authority to issue proxy access rules, thus resolving a long-standing point of controversy. As a result, several commentators believe the Dodd-Frank Act significantly lowers the risk that court challenges to the constitutionality of the rules will be successful. A smart company, therefore, should take advantage of the delayed effective date to review how it communicates with large shareholders, to assess potential governance risks, and to reassess the criteria for board membership.

### **WITH FEW EXCEPTIONS, NEW RULE 14A-11 APPLIES TO ALL PUBLIC COMPANIES**

These new proxy access rules will basically affect all Securities Exchange Act reporting companies, including investment companies, but not companies whose only public securities are debt securities. There are no opt-out options; however, smaller reporting companies, as defined under SEC rules, have a three-year deferral period. Foreign companies falling within the definition of "foreign private issuer" are exempt from the new rules, as they were under the old regime; however, foreign companies that do not meet the foreign private issuer definition are subject to the rules unless applicable foreign laws prohibit shareholders from making nominations for directorship.

### **REQUIREMENTS FOR SHAREHOLDER NOMINATIONS**

Under the new rules, a shareholder who meets the following criteria can avail itself of the company proxy statement and materials to nominate directors:

- The shareholder must own at least 3 percent of the total voting power of the

- company's securities entitled to vote on the election of directors at the annual meeting.
- The shareholder must have held the securities for at least three years, and continue to own at least the required amount of securities through the date of the meeting to elect directors.
- Shareholders may nominate the greater of one director or 25 percent of the total board; the nominees must satisfy the applicable stock exchange's objective independence standards.
- The shareholder must submit nominees no earlier than 150 days and no later than 120 days before the anniversary date of the mailing of the company's proxy statement in the prior year.

Individual or groups of shareholders may aggregate their shares to meet the 3 percent threshold; however, shareholders may not borrow stock to achieve the threshold. Likewise, they may not use the new rules if they hold their stock for the purpose of changing control of the company or gaining more seats on the board than is permitted by Rule 14a-11. Notably, securities loaned to a third-party are counted toward the 3 percent threshold if the securities can and will be recalled upon notification to the shareholder that its nominees are included in the proxy statement. Where there are multiple eligible nominating shareholders, and the number of shareholder nominees exceeds the limit, the shareholder or group with the highest percentage of voting power will have its nominees included in the company's proxy materials.

Nominating shareholders must file a new Schedule 14N with the SEC, which will be made public on EDGAR. Schedule 14N requires several disclosures, including the amount and percentage of the voting power of the company owned by the shareholder or shareholder group, the length of ownership, a statement that the shareholder or group intends to hold the securities through the meeting date, and biographical information and a description of the nature of the relationship between the nominating shareholder, the company, and any nominee. Shareholders are not prohibited from nominating themselves as candidates for director.

### **SHAREHOLDER NOMINEES THAT MAY BE EXCLUDED FROM THE COMPANY PROXY MATERIALS**

A company is not required to include shareholder nominees in its proxy materials if the nominees' candidacy or election violates the rules of the applicable securities exchange or any controlling state, federal, or foreign laws. Companies may also exclude nominees who fail to meet objective independence standards of the relevant stock exchange. Nominees, however, may not be excluded for failing to meet the subjective independence standards of the stock exchange's or the company's own director qualifications. The company can and should include a disclosure of any conflicts between its qualification requirements for board members and the nominees' qualifications in the proxy materials.

### **OPT-OUT PROVISIONS ARE NONEXISTENT**

Under Rule 14a-11, companies and shareholders may not opt out of the proxy access provisions by prohibiting the inclusion of shareholder nominees in the company's proxy materials. The SEC did, however, provide a single mechanism for opting out - amending the company's governing documents to prohibit shareholders from nominating any directors. This provision is impractical for most companies, as the rights of shareholders under state laws include the right to nominate a contesting slate of directors.

### **THE NEW PROXY REGIME IS UPON US - NOW WHAT? PRACTICAL CONCERNS AND CONSIDERATIONS**

As a practical matter, large companies with a single class of stock may be less likely to have shareholder nominees because the 3 percent continuous ownership requirement imposes a substantial financial commitment. However, in smaller reporting companies, there is a very tangible likelihood that shareholders will have the voting power to nominate board members and, as a result, a greater possibility that those nominees may be elected.

#### Make Large Shareholders Feel Included

One practical alternative to staving off Rule 14a-11 nominations may be a company-initiated revision to its nomination procedures, with allowance for shareholders' input. Under the prior version of Rule 14a-8, companies could exclude shareholder proposals relating to the nomination and election of members of the board of directors or other analogous governing bodies. The amended rule now permits shareholder proposals to amend a company's governing documents relating to proxy access, provided such proposals expand on, or provide an alternative to, the access afforded by Rule 14a-11. If a company takes the step of amending the provisions in a manner reasonable to its shareholders, it reduces the likelihood that shareholders will find it necessary to use Rule 14a-8 to propose more onerous provisions.

#### Revise Governing Documents to Force Disclosure of Nominees' Qualification Shortcomings

The new rules require nominating shareholders to disclose whether, to the best of their knowledge, a nominee meets the director qualification requirements as set forth in the company's governing documents. Therefore, companies may want to consider moving key qualification requirements for directorship that are not contained in the company's certificate of incorporation or bylaws to the bylaws. This forces nominating shareholders to disclose any failure by their nominee to meet such requirements.

#### Enact Critical Board Resolutions Before the Rules Go into Effect

Before the rules become effective, boards may wish to consider whether certain proposals should be acted on now rather than tabled until after an election at which shareholder nominees are included, as the election of shareholder nominees may create less board cohesion.

#### Communicate with Large Shareholders to Avoid Detrimental Conflicts

Companies with large shareholders may want to consider how they communicate with those shareholders. Companies may need to more actively engage these shareholders and identify issues of concern to them. Shareholders who feel included and informed are less inclined to submit their own slate of nominees.

#### Composition of Board and Proxy Disclosures

Companies may also consider reviewing the current composition of their boards to discern whether any areas of expertise are needed. Companies should also consider expanding the disclosed experience of board members so shareholders are more fully aware of the breadth and scope of a director's experience and areas of expertise. A shareholder may be less likely to nominate a candidate or to vote for another nominee if the shareholder believes the company has a board which represents diverse constituencies and has areas of expertise likely to contribute to the success of the company.

## **CONCLUSION**

Proponents of the new regime tout the end of the current system, where shareholders looking to oust board members must foot the massive cost of a proxy fight with separate ballots and mailings. Proponents also see the new rules as providing incentive to companies to be responsive to shareholders' concerns or face contested board elections.

Conversely, critics claim this regime will harm companies by giving activist investors who do not share the company's vision the power to disrupt business by distracting management and forcing board members to become ultraconservative and focused on short-term goals rather than on the overall long-term goals of the company.

Although it is still unknown whether the new rules will survive the legal challenge, companies should be proactive and anticipate that come 2012 this may be more than a matter of interest. It may be the priority. At the very least, companies should be aware of the SEC's current proposals, and should discern whether, under those proposals, they have any shareholders who meet the eligibility requirements. The final rules and accompanying press release may be found at [www.sec.gov/rules/final/2010/33-9136.pdf](http://www.sec.gov/rules/final/2010/33-9136.pdf) and [www.sec.gov/news/press/2010/2010-155.htm](http://www.sec.gov/news/press/2010/2010-155.htm).

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If you have any questions about these new rules and how they may affect your company, please contact [Ed Samorajczyk](#) in our Hartford office at 860-275-8207. [Keisha Palmer](#) was instrumental in assisting in the preparation of this alert.

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