

SEC Proposes New Proxy Access Rules To Facilitate Shareholder Director Nominations

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On June 10, 2009, the Securities and Exchange Commission (the “Commission”) issued proposed rules and related amendments under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), that would facilitate greater shareholder access to a company’s proxy materials for the nomination of candidates for the board of directors. The proposed rules are consistent with the Commission’s May 20, 2009 announcement regarding its decision to issue proposed rules relating to shareholder access. This is the third time that the Commission has visited the issue of shareholder access. Proposed rules were issued in 2003 and 2007 on the subject, but were not adopted. However, given the recent market volatility and the impact of the recession, the current political environment is more receptive to such measures than in the past. A complete copy of SEC Release No. 33-9046 (the “Release”) can be accessed at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

General

As noted by the Commission in the Release, two of the fundamental rights of all shareholders are the rights to nominate and vote on candidates for the board of directors. However, while state law provisions generally provide for the exercise of such rights in person at a shareholder meeting, the proxy process has become the principal means by which most public company shareholders exercise these rights. Consequently, for public company shareholders to effectively nominate and vote for directors who are not proposed by management, shareholders must adhere to the proxy rules.

The Commission believes that the current proxy regulatory framework imposes significant barriers which ultimately have the effect of impeding shareholders’ fundamental nominating and voting rights. The Commission notes that if shareholders are dissatisfied with the performance of a public company’s board of directors, the existing proxy regulations provide shareholders with five options to address current board members. Specifically, shareholders can:

- Institute a proxy contest in accordance with the Commission’s proxy rules and nominate their own slate of directors;
- Attempt to present a shareholder proposal pursuant to Rule 14a-8 and have shareholders vote on proposal topics addressing their dissatisfaction;
- Conduct a “withhold” or “vote no” campaign against members of the board of directors;
- Sell their shares in the company; or
- Seek to use the company’s established shareholder nomination process.

The Commission believes that these options are not effective. In particular, the Commission notes that the traditional proxy solicitation process is highly cost prohibitive and that most shareholders do not have the financial means to conduct a proxy contest. Moreover, the Commission acknowledges that shareholder proposals relating to board nominations are currently excludable by management under Rule 14a-8(i)(8). Finally, the Release highlights that, unless a company has adopted majority voting for directors, the effectiveness of shareholders instituting

a “withhold” or “vote no” campaign is minimal.

The proposed rules are a direct response to these perceived impediments and seek to establish a process by which shareholders may more easily exercise their nomination and voting rights.

Proposed Rule 14a-11 – Director Nominations

The primary amendments set forth by the Commission are proposed Rule 14a-11 and the related Schedule 14N. Under proposed Rule 14a-11, a qualifying shareholder or group would be permitted to include a limited number of director nominees in a company’s proxy materials by sending the company, and filing with the Commission, a notice on new Schedule 14N. Rule 14a-11 would apply to all Exchange Act reporting companies (including certain registered investment companies), except for companies that only have a class of debt registered under the Exchange Act. As proposed, Rule 14a-11 is universally applicable to all Exchange Act registrants and is not scaled for smaller reporting companies.

Shareholder Eligibility Requirements

To balance enhanced shareholder access with the potential disruption to companies, the Commission has proposed the following eligibility requirements on a shareholder or group seeking to propose a nominee under Rule 14a-11:

- **Ownership Threshold** – The shareholder or group must beneficially own, as of the date of the Schedule 14N notice, either individually or in the aggregate:
 - At least 1% of the outstanding voting securities of large accelerated filers;
 - At least 3% of the outstanding voting securities of accelerated filers; and
 - At least 5% of the outstanding voting securities of non-accelerated filers.

- **Holding Period** – The shareholder or group must establish that it has beneficially owned the subject securities continuously for a period of at least one year prior to the date of its Schedule 14N. This one-year holding requirement is consistent with the current eligibility requirement for shareholder proposals under Rule 14a-8.
- **Statement of Intent** – The shareholder or group must certify its intent to continue to own the subject securities through the date of the relevant meeting.
- **Limited Purpose** – The shareholder or group must certify that it is not seeking to change the control of the company or to gain more than a limited number of seats on the board of directors.

Shareholder Nominees

In addition to the shareholder eligibility requirements, Rule 14a-11 provides that a company would not be required to include a shareholder nominee in its proxy materials unless the following requirements are met:

- **Independence** – A person may not be nominated if the nominee’s candidacy or subsequent election would violate applicable state law, federal law or applicable stock exchange rules, other than rules regarding director independence. The nominating shareholder or group is required to represent and certify that each proposed nominee meets the director independence requirements of the applicable exchange. A proposed nominee is not, however, required to meet any heightened independence requirements applicable to members of certain board committees (i.e., audit committee independence requirements).
- **No Relationships** – To prevent collusive practices between a company and a nominating shareholder or group, Rule 14a-11 would require that each nominating

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shareholder or group represent that no relationship exists between the company or its management and the shareholder nominee, or between the nominating shareholder or group and the company or its management (subject to certain limited exceptions). Proposed Rule 14a-11 would not impose any limitations on the relationship between a nominating shareholder or group and the nominee.

The instructions to proposed Rule 14a-11 provide that a nominating shareholder or group will not be deemed an "affiliate" of the company under the Securities Act of 1933, as amended (the "Securities Act"), or the Exchange Act solely as a result of nominating a director candidate or soliciting for the election of such nominee or against a company nominee pursuant to Rule 14a-11.

Maximum Number of Permitted Shareholder Nominees

Rule 14a-11 is not intended to provide a method for shareholders to seek a change in control of the company. Consequently, the maximum number of shareholder nominees permitted under proposed Rule 14a-11 is limited. A qualifying shareholder or group may nominate the greater of one shareholder nominee or the number of nominees that represents no more than 25% of the company's board of directors. For example, if a board of directors has 12 director positions, shareholders would be permitted to nominate up to three candidates. In the event of a classified board with an incumbent director (or directors) elected pursuant to Rule 14a-11 whose term extends beyond the date of the annual meeting, the company may reduce the number of permitted shareholder nominees by the number of such continuing director(s).

If a company has more than one qualifying shareholder or group, proposed Rule 14a-11 uses a "first-in-time" prioritization. The company will be required to include in its proxy materials the nominee(s) of the

first qualifying shareholder or group from which it receives notice on Schedule 14N, up to the total number of permissible nominees allowed. If the first shareholder or group does not nominate the maximum number of permissible nominees, the next nominating shareholder or group would be permitted to include its nominee(s), up to the maximum number. The Commission believes that "first-in-time" prioritization will create a streamlined director nomination process and allow a company to begin its proxy preparation as soon as it receives an eligible shareholder nomination on Schedule 14N.

Schedule 14N – Notice and Disclosure Requirements

For a shareholder or group to nominate a director candidate, the shareholder or group will be required to provide notice to the company on proposed Schedule 14N and file a copy of the schedule with the Commission. The disclosure required in Schedule 14N is similar to that required in contested proxy solicitations, much of which will be included in the company's definitive proxy statement. Schedule 14N would require the following disclosures:

- The name and address of the nominating shareholder or group;
- The amount and percentage of securities beneficially owned and entitled to vote at a meeting by the nominating shareholder or group;
- A statement confirming the satisfaction by the nominating shareholder or group of the one-year holding requirement;
- A statement confirming the nominating shareholder's or group's intent to hold the subject securities through the date of the relevant shareholder meeting;
- A certification that, to the best of the nominating shareholder's or group's knowledge, the securities are not being held for the purpose of effecting a change in control of the company;

- A representation that the nominating shareholder or group is eligible to submit the Rule 14a-11 nomination;
- A representation that, to the best of the nominating shareholder's or group's knowledge, a candidate's nomination or subsequent election would not violate controlling state law, federal law, or applicable stock exchange rules;
- A representation that, to the best of the nominating shareholder's or group's knowledge, the nominee meets applicable stock exchange independence standards;
- A representation that neither the nominee nor the nominating shareholder or group has an agreement with the company regarding the nomination of the shareholder nominee;
- A statement that, if elected, the nominee consents to serve as a member of the board;
- Information regarding the nominee consistent with that currently required under the proxy rules for board nominees, including certain biographical information, disclosure of certain relationships and disclosure of certain legal proceedings;
- Disclosure of any website address on which the nominating shareholder or group may publish soliciting materials; and
- If desired, a supporting statement not exceeding 500 words to be included in the company's proxy materials.

Schedule 14N must be provided to the company and filed with the Commission by (i) the date determined by the company's advance notification provision or (ii) if the company does not have an advanced notice provision, no later than 120 calendar days before the date of the one year anniversary of the mailing of the prior year's proxy materials. If the company did not hold an annual meeting in the prior year, or if the date of the meeting has changed by more than 30 calendar days, the nominating shareholder will

only be required to provide "reasonable" notice to the company, and the company would be required to disclose in a Form 8-K under new Item 5.07 the date by which shareholders must submit the Schedule 14N.

Rule 14a-11 Eligibility Determinations

Upon receipt of a Schedule 14N notification, a company must determine whether the notice is proper under Rule 14a-11 and whether any provisions allow the company to exclude the shareholder nomination. If a company accepts the nomination, the company must notify the nominating shareholder or group of its acceptance, in writing, no later than 30 calendar days prior to filing of its definitive proxy statement. The company must include disclosure regarding each shareholder nominee and the nominating shareholder or group in its definitive proxy statement and include the name of the nominee on the form of proxy. The proxy statement disclosure would include the information provided by the nominating shareholder or group in its Schedule 14N. When a shareholder nominee is included in the form of proxy, the proposed rules would prohibit the company from providing shareholders the option of voting for management's director nominees as a group, and would instead require that each director nominee be voted on individually. A company would, however, be permitted to identify in its definitive proxy statement and form of proxy each shareholder nominee and present management's recommendation in regards to such nominee.

If a company determines that it is not required to include a nominee in its proxy materials under Rule 14a-11, the company must provide written notice of its decision to the nominating shareholder or group no later than 14 calendar days after it receives the Schedule 14N, and include in the response the procedural basis for its exclusion. The nominating shareholder or group would then have 14 calendar days to respond to the company's notice and correct any eligibility or procedural

deficiencies identified; however, the nominating shareholder or group may not cure a deficiency by proposing a new nominee or substituting a new nominating shareholder. If, after receiving a revised Schedule 14N, the company determines that it still may properly exclude the shareholder nominee (after providing the required notice and expiration of the cure period), the company must provide notice of the basis of its determination to both the Commission and the nominating shareholder or group no later than 80 calendar days prior to filing its definitive proxy materials. After permitting the nominating shareholder or group to respond to the company's notice, the Commission may, at its discretion, issue a no-action response to the company and the nominating shareholder or group regarding its determination on the exclusion.

Liability for Statements Made by a Nominating Shareholder or Group

The Schedule 14N, as filed with the Commission, as well as any amendments thereto, would be subject to the liability provisions of Rule 14a-9 of the Exchange Act and would impose liability upon any nominee or nominating shareholder or group for having false or misleading statements included in a company's proxy materials. In addition, proposed Rule 14a-11 provides that a company will not be responsible for information that is provided by a nominating shareholder or group under Rule 14a-11 and later disseminated in the company's proxy materials, except where the company knows or reasonably should know that the information provided is false or misleading. As proposed, any information that is included in a company's proxy materials by virtue of Rule 14a-11 would not be incorporated by reference into any filings under the Securities Act or the Exchange Act, unless the company specifically incorporates such information in its filings.

Nominating Shareholder Solicitations

The Release proposes two limited exemptions for the dissemination of soliciting material by a nominating shareholder or group without filing

and disseminating a proxy statement. Specifically, proposed Rules 14a-2(b)(7) and (8) would provide exemptions from the proxy solicitation rules for written statements made and filed with the Commission attempting to (i) gain support of fellow shareholders to form a group sufficient to meet the nomination requirements of Rule 14a-11 and/or (ii) seek support for their Rule 14a-11 nominee. The form and content of such statements would be subject to certain restrictions set forth by the Commission and required to be filed with the Commission and the company's stock exchange no later than the date that such material is first published and sent or given to shareholders.

Groups and Beneficial Ownership Reporting and Section 16 of the Exchange Act

Under Section 13(d) of the Exchange Act, any person or group who is directly or indirectly the beneficial owner of more than 5% of a class of equity securities registered under the Exchange Act must report such ownership by filing a Schedule 13D or Schedule 13G with the Commission. Thus, nominating shareholders will need to consider whether they have formed a group under Section 13 of the Exchange Act. While the ownership thresholds of proposed Rule 14a-11 do not mirror the requirements for Section 13 reporting, nominating shareholders would need to analyze the nature of their group and file a Schedule 13D/13G as appropriate. The proposed rules provide that a nominating shareholder or group will generally not lose eligibility to file as passive investors on Schedule 13G solely due to the nomination or election of its shareholder nominee.

Nominating shareholders that choose to aggregate their holdings for purposes of making a Rule 14a-11 nomination will also need to consider the application of Section 16 of the Exchange Act. Under Section 16 of the Exchange Act, any shareholder or group that beneficially owns more than 10% of any class of equity security registered under the Exchange

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Act is generally required to file beneficial ownership reports on Forms 3, 4, and 5. Section 16 uses the same “group” definition as Section 13 of the Exchange Act, and the proposed rules would not exclude a nominating shareholder group formed for the purpose of making a Rule 14a-11 nomination.

Amendments to Rule 14a-8(i)(8) – Shareholder Proposals

The proposed rules would also amend Rule 14a-8(i)(8), which governs shareholder proposals relating to board elections. Rule 14a-8(i)(8) currently allows companies to exclude from their proxy materials shareholder proposals relating to director elections. As proposed, amended Rule 14a-8(i)(8) would generally eliminate this restriction and permit inclusion of shareholder proposals to amend a company’s governing documents and other proposals relating to director nominations, subject to certain limited exceptions. Amended Rule 14a-8(i)(8) would continue to require shareholders to meet the procedural requirements of Rule 14a-8, and proposals could not conflict with the provisions of the Rule 14a-11. In addition, amended Rule 14a-8(i)(8) would allow companies to continue to exclude proposals related to particular elections or nominations. Amended Rule 14a-8(i)(8) would permit a company to exclude a proposal if it:

- Would disqualify a nominee or remove a director before his or her term has expired;
- Questions the character or competence of one or more nominees or directors;
- Attempts to nominate an individual for election to the board of directors outside of the parameters of Rule 14a-11, applicable state law or the company’s governing documents; or
- Otherwise could affect the upcoming election of directors.

Application to Registered Investment Companies

As detailed in the Release, the proposed rules would also apply to investment companies registered under Section 8 of the Investment Company Act of 1940, as amended (the “Investment Company Act”). The Release describes the particular modifications and mechanics for applying the proposed nomination provisions to investment companies, including:

- Alternative shareholder eligibility thresholds based upon total net assets;
- Rules for application to series investment companies; and
- Alternative certifications for a nominating shareholder or group based upon the definition of an “interested person” under the Investment Company Act.

Conclusion

As presented, the Commission’s proposed shareholder proxy access rules and related amendments represent a significant departure from current proxy rules and present the potential for a major shift in the corporate governance and proxy solicitation process of U.S. public companies. The Release requests more than 150 comments on various aspects of the proposed rules, as well as possible functional alternatives. Based upon the significant amount of questions, it appears that the Commission will thoroughly review public reaction to the Release and examine potential alternatives and/or modifications to the proposed rules. All public comments on the proposed rules are due by August 17, 2009.

This client alert is for general information purposes and should not be regarded as legal advice.