KIRKLAND & ELLIS LLP

KIRKLAND **GOVERNANCE WATCH**

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SEC Adopts Final Rules Facilitating Shareholder Proxy Access

The SEC recently adopted new "proxy access" rules, which facilitate the rights of shareholders to nominate candidates for election to a public company's board of directors and represent a significant change to the corporate governance landscape.

As was widely expected, on August 25, 2010, the SEC, by a 3-2 vote, adopted new "proxy access" rules to facilitate the rights of shareholders to nominate candidates for election to a public company's board of directors.[1] Subject to various limitations, the new rules require public companies to include nominees of certain significant and long-term shareholders in their proxy materials, thus providing these shareholders with an alternative to the more expensive and complex process of preparing and distributing their own proxy materials. The new rules also modify the provision that historically has allowed companies to exclude shareholder proposals relating to the nomination and election of directors, the so-called "election exclusion," to enable shareholders to submit proposals concerning these matters, which could further expand shareholder proxy access. Taken as a whole, the new proxy access rules represent a significant change to the corporate governance landscape.

The first part of this *Kirkland Governance Watch* outlines the new proxy access rules. The second part of this *Kirkland Governance Watch* outlines practical considerations for companies to consider.

The key points of the new proxy access rules include the following:

- **Effectiveness of New Rules.** The new proxy access regime, which is principally set forth in a new Exchange Act Rule 14a-11, will be effective 60 days after the new rules are published in the Federal Register. Under the new rules, shareholders seeking to include one or more shareholder nominees in a company's proxy materials will be required to file a Schedule 14N (discussed below) no earlier than 150 calendar days, and no later than 120 calendar days, before the anniversary date that the company mailed its proxy materials for the prior year's meeting. The 120-day deadline is the same as that for proposals submitted by shareholders under Rule 14a-8. Depending on the effective date of the new rules, for the 2011 proxy season shareholders desiring to submit shareholder nominees may have less than the full 30-day window to submit their nominees and, if the effective date is within the requisite 120 calendar days, the window for the 2011 proxy season will have closed for that company and shareholders of that company will not have the opportunity to submit nominees until the 2012 proxy season.
- **Companies Subject to New Rules.** The new rules will apply to all companies, including registered investment companies, controlled companies and voluntary filers, that have a class of equity securities registered under Exchange Act Section 12(g). However, the rules will not apply to "debt-only" companies and foreign private issuers that are not otherwise subject to the federal proxy rules. Additionally, smaller reporting companies will be given a three-year grace period before they will be required to comply with the new proxy access rules. During this time, the SEC will determine if any rule modifications are appropriate for smaller reporting companies.
- **Companies are Not Allowed to Opt-Out.** Rule 14a-11 applies automatically. There is no opt-in requirement. Additionally, companies are not allowed to opt-out of Rule 14a-11, e.g., companies will not be able to avoid the rule's application by providing for a different framework for inclusion of shareholder nominations in a company's proxy materials or providing no framework at all or expressly prohibiting such inclusion. The only exception will be if applicable state or foreign law or a company's governing documents prohibit shareholders from nominating candidates for election as directors. Rule 14a-11 applies even if a company is engaged in a separate proxy contest, provided that any shareholders submitting a nominee pursuant to Rule 14a-11 cannot be involved in the proxy contest. Provisions under state law may provide an additional option for

shareholders to submit nominees for inclusion in a company's proxy materials. Accordingly, if a company implements procedures in light of state law proxy access provisions, such as were adopted in Delaware, that company must still comply with Rule 14a-11.

- **Three Percent Ownership Threshold.** To use Rule 14a-11, a nominating shareholder individually, or a nominating shareholder group in the aggregate, must hold at least 3% of the total voting power of the company's securities entitled to be voted at a meeting for the election of directors (annual or special) as of the date of filing its Schedule 14N (which, as we discuss below, provides notice to the SEC and a company of a shareholder's intent to nominate a director via Rule 14a-11). If a company has more than one class of securities entitled to vote on the election of directors and those classes do not vote together in the election of all directors, then the voting power calculation will be determined only on the basis of the voting power of the class or classes of securities that would be voting together in the election of directors. In order to include shares in the total voting power calculation, a nominating shareholder or group must hold both investment and voting power over the securities. Securities loaned to third parties may be included in the total voting power calculation if the nominating shareholder or group, as the case may be, has the right to recall the loaned securities and will do so upon being notified that its nominee or nominees will be included in a company's proxy materials. Securities sold short or that are borrowed and are not otherwise excludable must be deducted from the amount of securities that may be counted toward the 3% ownership requirement. As a practical matter, the 3% ownership requirement, coupled with the three-year holding period discussed below, creates the potential for shareholders to be impacted by a company's capital market initiatives (either from dilution of new stock offerings during this period or accretion as a result of stock buybacks).
- **Three-Year Holding Period.** To use Rule 14a-11, a nominating shareholder or group must have held the qualifying threshold "amount" continuously for at least three years as of the date of filing its Schedule 14N and must continue to hold such amount through the date of the shareholder meeting. For illustration, a nominating shareholder or group that held shares representing 2% of a company's total voting power three years ago, but that represent 3% on the date of the Schedule 14N as a result of an intervening stock buyback would be eligible to use Rule 14a-11. The new rules provide detailed instructions on calculating the amount of shares owned during the three-year period, but do not appear to address all possible changes in the form of ownership within that three-year period, such as a company emerging from bankruptcy, a look-back to ownership prior to a company's initial public offering and whether "tacking" and the body of learning that has developed under Rule 144 would apply.
- **Proof of Ownership.** The new rules require that the nominating shareholder or group provide a company with proof of ownership of the securities that are used for purposes of satisfying the ownership and holding period requirements. Shareholders who are not registered holders will be required to provide the SEC and a company with "one or more written statements from the registered holder of the nominating shareholder's securities (or the brokers or banks through which those securities are held) verifying that, as of a date within seven calendar days prior to filing the notice on Schedule 14N … the nominating shareholder or each member of the nominating shareholder group, continuously held the amount of securities being used to satisfy the ownership threshold for a period of at least three years." In addition, the new rules exempt from the proof of ownership requirements shareholders who have filed with the SEC a Schedule 13D, 13G or Section 16 report "as of or before the date on which the three-year eligibility period begins."
- **Maximum Number of Shareholder Nominees.** A company will be required to include in its proxy materials the greater of (i) one shareholder nominee or (ii) the number of shareholder nominees that represents 25% of the company's board of directors (rounded down to the closest whole number of directors). Companies with classified boards and existing directors who were nominated pursuant to Rule 14a-11 and whose service continues past a current election cycle count against the above maximum thresholds. Finally, where a company has multiple classes of securities and each class is entitled to elect a specified number of directors, a company will be required to include the lesser of (i) the number of nominees that the nominating

shareholder's or group's class is entitled to elect or (ii) 25% of the company's board of directors (but in no case less than one nominee).

- **No Change in Control Intent.** The new rules are not available for use as a takeover device. A nominating shareholder or group must not hold its securities with the purpose, or with the effect, of seeking to effect a change in control of a company or to gain a number of seats on the board of directors of a company that exceeds the maximum number of shareholder nominees permitted by Rule 14a-11.
- **No Agreements with Company.** No nominating shareholder or member of a nominating shareholder group may have any agreement with a company regarding the nomination of a shareholder nominee. Unsuccessful negotiations between a company and a nominee, a nominating shareholder, or a member of a nominating shareholder group to have a nominee included in a company's proxy materials as a company nominee, and negotiations that are limited to whether a company is required to include the shareholder nominee in a company's proxy materials, will not represent a direct or indirect agreement under Rule 14a-11. After a nominating shareholder or group files its Schedule 14N, a company and the nominating shareholder or group can enter into discussions regarding the shareholder nominees and whether or not those shareholder nominees should be included in a company's proxy materials as company nominees. Any such shareholder nominee that becomes a company nominee will be counted against the 25% limit discussed above.
- **Excluding Certain Shareholder Nominees.** A company may exclude a shareholder nominee if the nominee does not meet the objective criteria for "independence" of the national securities exchange or national securities association applicable to the company. However, a shareholder nominee would not need to satisfy heightened independence requirements applicable to audit committee members, any subjective standards applicable to all board members (as exist in the NYSE and NASDAQ governance requirements) or any independence standards adopted by a company itself. Additionally, a company may exclude a shareholder nominee if the nominee's candidacy or, if elected, board membership, would violate controlling federal law, state law, foreign law or the rules of the national securities exchange or national securities association applicable to a company (other than rules regarding director independence), unless such violation can be cured within 14 days of being notified by a company of the violation. (For example, a company that holds a broadcast television license and is subject to limits on the number of directors who are not U.S. citizens under federal law and the rules of the Federal Communications Commission might invoke this standard if a candidate's election would result in a violation of such limits and the potential loss of the broadcast license.)
- **Priority of Shareholder Nominees.** Where there are multiple eligible nominating shareholders or groups, the nominating shareholder or group with the highest qualifying voting power percentage will get to have its nominees included in a company's proxy materials first, up to and including the total number of shareholder nominees required to be included under Rule 14a-11. If additional shareholder nominees can be included in a company's proxy materials without exceeding the 25% limit, a company will then be required to include the nominees from the nominating shareholder or group with the next highest qualifying voting power percentage. Where fewer than all of a shareholder's or group's nominees can be included in a company's proxy materials, the shareholder or group will be permitted to decide which nominees will be included. Under the new rules, a company does not need to notify any nominating shareholder or group as to whether it plans to include a nominee in its proxy materials until the window to nominate directors has closed, in order to give a company time to evaluate and respond to all nominations at one time.
- **New Schedule 14N.** A nominating shareholder or group must provide notice to a company of its intent to require the company to include its nominees in the company's proxy materials by submitting a new Schedule 14N. The Schedule 14N must be transmitted to the company and filed with the SEC (via EDGAR) no earlier than 150 calendar days, and no later than 120 calendar days, before the anniversary of the date on which the company mailed its proxy materials for the prior year's annual meeting.

  Schedule 14N requires a nominating shareholder or group to provide detailed information as to itself

and its nominees, including (i) certifications that the shareholder or group and its nominees satisfy the eligibility requirements of Rule 14a-11 and that the shareholder or group does not have a change in control intent, (ii) disclosure whether the shareholder or group intends to hold the shares both through the meeting date and beyond, (iii) disclosure about the nature and extent of relationships between the shareholder or group, any nominee and the company, (iv) disclosure that, to the best of the shareholder's or group's knowledge, the nominee satisfies the objective criteria for independence of the relevant exchange and meets the director criteria set forth in a company's governing documents, and (v) if desired, a statement in support of the nominee, not to exceed 500 words per nominee.

- **Formation of Shareholder Group; Promotion of Nominee.** If a nominating shareholder or a group desires to solicit other shareholders to reach the required 3% threshold, the new proxy access rules provide a limited exception from Exchange Act Rule 14a-2 to allow solicitations solely in connection with the formation of a nominating shareholder group to take advantage of Rule 14a-11, provided that a Schedule 14N (including the soliciting material, if written, or a notice of commencement of oral solicitation) is filed upon the commencement of the shareholder solicitation. In addition, if, following notice from a company that a shareholder's or group's nominee will be included in a company's proxy materials, a nominating shareholder or group desires to reach out to other shareholders to garner support for its nominees (but not to request a proxy to vote), then the nominating shareholder or group would file additional Schedule 14Ns with the soliciting materials.
- **New 8-K Requirement.** If a company did not hold an annual meeting the prior year, or if the date of this year's annual meeting changes by more than 30 calendar days from the date of the previous year's annual meeting, a company will be required to file a Current Report on Form 8-K in response to a new requirement to disclose the date by which a nominating shareholder or group must submit its notice on Schedule 14N. Such date must be a reasonable time before a company mails its proxy materials.
- **Dispute Resolution and No-Action Relief.** The new proxy access rules include detailed provisions for dispute resolution between a company and a shareholder nominee or group regarding inclusion or exclusion of a nominee. Under the new rules, a company must notify the nominating shareholder or group of its intent to exclude a nominee and provide the nominating shareholder or group an opportunity to respond. If after this exchange a company still intends to exclude a shareholder nominee, a company will be required to provide notice of its intent to exclude a shareholder nominee, together with the basis therefor, no later than 80 days before the company files its definitive proxy. A company may seek a no-action letter from the SEC with regard to this determination. It is important to note that until the date of printing the definitive proxy, a company will be required to substitute in other eligible shareholder nominees if a nominating shareholder or group with higher priority withdraws or is disqualified. As a result, if a company plans to seek a no-action letter from the SEC with respect to its decision to exclude any shareholder nominee, it should also seek no action relief with regard to all shareholder nominees that it wishes to exclude. Otherwise, a company may be successful in excluding the nominees of one nominating shareholder or group and then lack sufficient time to address exclusion of the nominees from the next highest nominating shareholder or group.
- **Proxy Access Proposals Under Amended Rule 14a-8.** In conjunction with the adoption of Rule 14a-11, the SEC also amended Rule 14a-8(i)(8). Prior to the amendment, Rule 14a-8(i)(8) permitted a company to exclude from its proxy materials a shareholder proposal that related to a "nomination or an election for membership on the company's board of directors… or a procedure for such nomination or election." This was known as the "election exclusion" and permitted a company to exclude a proposal that would have resulted in an immediate election contest or which would have set up a process for shareholders to conduct an election contest in the future by requiring a company to include shareholder nominees in a company's proxy materials for subsequent meetings. The SEC amended this provision to enable shareholders to require companies to include in their proxy materials shareholder proposals that would amend, or that would request an amendment to, a company's governing documents regarding nomination procedures, provided that the proposal does not

conflict with Rule 14a-11. The amendments could result in shareholders proposing amendments to a company's governing documents that would establish procedures for the inclusion of one or more shareholder nominees in a company's proxy materials. Such procedures could include ownership thresholds, holding periods or other qualifications different from those in Rule 14a-11. Any such adopted procedures would be additive to Rule 14a-11 and would provide an additional avenue for shareholders to gain proxy access for their nominees.

- **Schedule 13D/13G Considerations.** The SEC also adopted an exemption from Schedule 13D filing requirements for a shareholder or group that is reporting ownership on Schedule 13G and seeks to take advantage of Rule 14a-11. The amendment provides that a shareholder's activities solely in connection with a nomination pursuant to Rule 14a-11 is not disqualified from continuing to report on Schedule 13G. Thus, the use of Rule 14a-11 would not require shareholders who report on Schedule 13G to comply with the more stringent requirements of a Schedule 13D filing as a "cost" of using Rule 14a-11. However, a group or shareholder would need to re-evaluate its eligibility to continue to report on Schedule 13G after the election.

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Practical Considerations

Given the timing, terms and complexity of the new rules, it remains to be seen how many shareholders will seek to use the new rules to nominate and elect directors during the 2011 proxy season. Some shareholder nominations almost certainly will surface later this year and early next year, though, so companies will need to be prepared. The SEC will need to clarify some of the requirements and address gaps that appear to exist today (such as how to calculate the three-year holding period in various situations) and anomalies that will surface over time. A set of CDIs can be expected, and ongoing monitoring and flexibility will be important. As companies and shareholders engage with each other over the propriety of nominations, the eligibility of nominees, the terms of proposals for new nomination and election procedures, and the permissibility of strategies and tactics to enhance or blunt proxy access, the specific interpretation and scope of the rules will undoubtedly be tested and refined, both through the dispute resolution mechanism and outside it.

While a company may not have viewed itself as a likely target for a traditional proxy contest, with the proxy access rules providing a less daunting path for shareholder involvement in board composition issues, companies need to re-assess the potential for future contested elections. The answers to some relatively straightforward questions can help a company evaluate its "profile" as a potential candidate for proxy access activity:

- Have there been any significant "withhold" votes or campaigns for one or more directors in recent elections?
- Has the company been presented with any shareholder nominees in the past several years, and if so, how has it handled those nominations?
- Does the company have an established and well-functioning process for shareholders to communicate with the board on a periodic basis?
- How are relationships with significant shareholders? Are significant shareholders supportive of the current board and of the company's strategy?
- Has the company been criticized (by RiskMetrics or otherwise) for the composition of its board, decisions on executive compensation, the occurrence of related-party transactions with directors, its governance structure (e.g., lack of a separate chair and CEO, lack of a strong and active lead director), the board's oversight of senior management, or the general strategic direction of the company?
- Has the company received a poor governance score from any of the various well-known organizations that evaluate corporate governance?

At the same time, companies should ensure they have up-to-date information on the composition of their shareholder base. Companies will want to consider whether to engage selected shareholders, on a pro-active basis, in conversations about board composition and governance as a way of forging alliances that may prove helpful in the future and in identifying any "early warning signs" of potential future nominating activity.

Companies also should assess some of the more technical aspects of their preparedness for shareholder nominations and proposals on nominations and elections. For example:

- Companies should review the relationship between the 150/120 day advance notice window under Rule 14a-11 and the window for shareholder

nominations likely currently contained in their advance notice bylaws provisions. While having two different notice windows—one for nominations under the new rules and one for other nominations permitted by state law—does not necessarily create a conflict, there are pros and cons to harmonizing the two time periods. Companies should keep in mind that the Rule 14a-11 window (like the Rule 14a-8 window) is based upon the date of mailing of the prior year's proxy, while most companies' advance notice bylaws provisions (based on state law requirements) look to the date of the prior year's meeting.

- Companies also should review their internal nominating procedures (including the charter of the nominating and governance committee (or similar committee with involvement in the nomination process)). While there may be nothing inconsistent between these procedures and the requirements of Rule 14a-11, companies may want to consider changes to these procedures to ensure that their interplay with the new rules provide for a rational and appropriate process of taking account of Rule 14a-11 nominations in the course of setting a slate of nominees, developing a strategy for overall board composition, and developing and describing the rationale for (and against) nominees in the proxy statement.
- Companies cannot use board eligibility criteria (including any independence requirements that supplement existing exchange requirements) to restrict or disqualify an otherwise eligible Rule 14a-11 nominee. However, as the SEC made clear in its release, these criteria can (and should) be a basis for discussion, in a proxy statement, of a nominee's suitability to serve as a director. Accordingly, companies may want to consider whether existing criteria satisfactorily address the appropriate range of qualifications for service on the board. While companies may, in the past, have been content to do this on an informal basis because they had control over the composition of the board slate, their ability to address effectively a shareholder nominee's qualifications to serve may be limited if the service criteria are not set forth clearly and in a publicly available document.
- Similarly, companies should review their board self-evaluation procedures to ensure that they are robust and well-documented.
- Companies should review procedures governing board confidentiality and conflicts of interest, given the possibility of new board members that may have close ties to individual shareholders or special interest agendas that may conflict with the larger interests of a company or its shareholder base as a whole.
- Working with inside and outside lawyers, investor relations professionals and communications experts, companies should develop and document procedures for evaluating and responding to Rule 14a-11 nominations. Just as companies typically have processes for addressing shareholder proposals and, in many cases (and more importantly) takeover proposals, they should establish a protocol and ensure that the proper resources are and will be available. The deadlines for action under Rule 14a-11 are tight in some cases, and companies may need to act very quickly if facts change regarding a nominee's eligibility (particularly where a nominee is disqualified or withdraws and the company needs to include a nominee that did not make the initial cut-off (because more than the maximum number of nominees was proposed)). Companies will not want to be scrambling to round up resources, or to start calculating deadlines and setting schedules, in the face of competing nominations. At the most basic level, companies will want to review the meeting schedule for their nominating and governance committees, and for the full board, in light of the 120/150 day window for Rule 14a-11 nominations.

Together with the new and additional proxy disclosures that were required last year, plus the obligation to address new requirements imposed by the recently passed Dodd-Frank Act, the new proxy access rules add to the already considerable burdens and challenges that companies face during the annual proxy process. As a result, even if the 2011 proxy season sees only a modest number of Rule 14a-11 nominations, companies would be well-advised to begin preparing for next year's annual meeting as soon as practicable.

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[1] A copy of the 451-page adopting release for the new "proxy access" rules is available here. A copy of the August 2009 *Kirkland Governance Watch* discussing the original proposing release concerning "proxy access" is available here. A copy of the Kirkland & Ellis LLP comment letter mentioned on eight occasions within the adopting release is available here.

If you have any questions about the matters addressed in this *Kirkland Governance Watch*, please contact the following Kirkland authors or your regular Kirkland contact.

Thomas W. Christopher
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/tchristopher
+1 212-446-4790

Mark D. Director
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
http://www.kirkland.com/mdirector
+1 202-879-5151

Robert M. Hayward, P.C.
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
http://www.kirkland.com/rhayward
+1 312-862-2133

Andrew M. Herman
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
http://www.kirkland.com/aherman
+1 202-879-5224

Theodore A. Peto
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
http://www.kirkland.com/tpeto
+1 312-862-3045

James S. Rowe
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
http://www.kirkland.com/jrowe
+1 312-862-2191

George P. Stamas, P.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 202-879-5090

601 Lexington Avenue
New York, NY 10022
+1 212-446-4666
http://www.kirkland.com/gstamas

Daniel E. Wolf
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884