

## SEC Adopts Controversial ‘Proxy Access’ Rules

On August 25, the SEC adopted the highly controversial “proxy access” rules requiring company proxy materials to provide shareholders with information about, and an ability to vote for, shareholder-nominated candidates for director. The new rules also permit shareholder proposals to establish procedures that are less restrictive than the SEC-mandated procedures for including shareholder nominees in the company’s proxy materials. The stated purpose of the new rules is to facilitate the exercise of shareholders’ rights under state law to nominate and elect directors.

Prior to adoption of these rules, shareholders who wanted to nominate their own candidates for director (without the support of the Company’s nominating committee) had to launch a proxy contest, requiring them to prepare and distribute their own proxy statements – normally an expensive and daunting prospect. The new rules make it significantly easier for shareholders to nominate candidates and solicit votes for their nominees. However, as described below, the rules limit the number of director slots that can be filled under this process and are not intended to be used to effect a change of control.

The “proxy access” rules apply to all companies that are subject to the Exchange Act proxy rules – including investment companies and controlled companies – other than companies that are subject to the Exchange Act solely because they have debt securities registered under the Act. (Foreign private issuers are not subject to the Exchange Act proxy rules, and thus are not subject to the proxy access rules.) The rules will become effective 60 days after publication in the Federal Register, with a 3-year delayed effective date for “smaller reporting companies” – generally, companies with a public float of less than \$75 million.

### The Shareholder Nomination Process

The cornerstone of the new rules is a new Rule 14a-11, establishing the conditions under which a shareholder nominee for director must be included in the Company’s proxy statement and proxy card, and a new Schedule 14N, prescribing the information which the nominating shareholder (or shareholder group) must file with the SEC and provide to the Company as notice of its intent to use Rule 14a-11. (If applicable law or Company governing documents provide different rules, compliance with such rules would be an alternative to compliance with Rule 14a-11, but they could not curtail the availability of Rule 14a-11.)

- The nominating shareholder (or shareholder group) must hold at least 3% of the voting power of the securities entitled to be voted on the election of directors at the meeting. The ownership must reflect both investment and voting power – a different standard than the traditional “beneficial ownership” definition. Shares loaned to a third party can be counted as owned for purposes of the 3% test if the owner has the right to recall them (and will do so) in time for the meeting, but shares sold short or borrowed cannot be counted.
- The nominating shareholder or group must have held the number of shares constituting the required 3% ownership level for a continuous period of at least three years prior to the date of filing its Schedule 14N and must continue to hold them through the date of the shareholder meeting.
- A company will not be required to include more than the number of shareholder nominees that represents 25% of the board (or one shareholder nominee, if greater). If the Company has a staggered board, the 25% is determined based on the size of the entire board, not the number up for election at the particular meeting. A shareholder-

nominated director who was elected in a previous year and whose term is continuing beyond the meeting in question continues to be counted as one of the shareholder-nominated directors for purposes of this limit. If more than one shareholder or group submits nominees, the Company must first include all nominees of the shareholder or group with the highest percentage ownership. If this shareholder or group does not nominate the maximum number of directors eligible for shareholder nomination, the shareholder or group with the next highest ownership percentage can fill the remaining slots.

- The nominee's membership on the Company's board must not violate any controlling federal, state, or foreign law, or applicable stock exchange rules, and the nominee must meet applicable stock exchange objective criteria for "independence." The nominee would not need to meet any special independence criteria, such as those for audit committee members, or to satisfy any subjective board determination of independence as part of the shareholder nomination process. A nominee would not be disqualified for failure to meet director qualifications adopted by the Company, but disclosure of any such failure would be required in the Schedule 14N.
- There are no restrictions on relationships between the nominating shareholder(s) and the nominee, but the Schedule 14N must describe any such relationships.
- The nominating shareholder (or any member of the nominating group) cannot hold shares with the purpose or effect of changing control of the Company or electing more directors than permitted under Rule 14a-11, and cannot participate in any other person's solicitation activities in connection with the election in question.
- The nominating shareholder (or any member of the nominating group) or the nominee cannot have an agreement with the Company regarding the nomination of any person prior to filing the Schedule 14N. A nominating shareholder would not be disqualified under this provision solely as a result of unsuccessful negotiations with the Company seeking to have the shareholder nominee included as a Company nominee. However, if there were no discussions between a nominating shareholder and the Company until after filing of the Schedule 14N and the Company subsequently agreed to include that shareholder's nominee as a Company nominee, that nominee would continue to be counted as a shareholder nominee for purposes of the 25% shareholder nominee limit.

The Schedule 14N requires information demonstrating the nominating shareholder's (or group's) satisfaction of the requirements of Rule 14a-11, as well as biographical and other information about the nominating shareholder and nominee(s) similar to the disclosure required in a contested election. At its option, the nominating shareholder may include a statement in support of its nominees, not to exceed 500 words per nominee.

The Schedule 14N must generally be provided to the Company and filed with the SEC no earlier than 150 calendar days and no later than 120 calendar days before the anniversary of the date the Company mailed its proxy materials for the prior annual meeting (with special rules in the event of a significant change in the date of the annual meeting). The rules contain deadlines by which the Company must notify nominating shareholders of whether their nominees will be included or excluded from the Company's proxy statement, procedures for shareholders whose nominations were excluded to remedy any eligibility or procedural deficiencies, requirements that the Company notify the SEC of nominees it intends to exclude, and procedures for seeking informal (no-action) advice from the SEC staff with respect to proposed exclusions.

### **Proxy Disclosure Requirements**

The Company's proxy statement would be required to include specified information about the shareholder nominees for director, the nominating shareholder or group, and the solicitation, including the shareholder's statement in support of its nominee(s). All of the required information would be taken from the Schedule 14N filed by the nominating shareholder. The nominating shareholder – and not the Company – would be subject to liability if any of this information (or any other information in the Schedule 14N) is false or misleading. The Company's proxy statement

would also have to include the disclosures typically required to be made by a company in response to a contested election.

The Company's proxy card would be required to list both the Company nominees and the shareholder nominees. The Company could group the Company nominees separately from the shareholder nominees, and could identify each group together with the Company's voting recommendation. However, the proxy card could no longer provide a single box to be used to vote for all of the Company's nominees as a group if the card contained a shareholder nominee.

The inclusion of a shareholder nominee in the Company's proxy statement will not trigger the requirement to file a preliminary proxy statement.

The rule requiring companies to include in their proxy statements the deadline for submission of shareholder proposals has been amended to also require them to disclose the deadline for submitting shareholder nominees under Rule 14a-11 (and under any alternative nomination procedure applicable to the Company).

### **Changes to Proxy Solicitation Rules**

The SEC has also created two new exemptions from the proxy solicitation rules for solicitations in connection with use of Rule 14a-11.

- Solicitations by persons seeking to form a nominating shareholder group will be exempt from the proxy solicitation rules under new Rule 14a-2(b)(7) if certain conditions are satisfied. Written solicitations under this exemption must be limited to (i) a statement of the intent to form a nominating group under Rule 14a-11; (ii) identification of the potential nominee(s) or characteristics of a desired nominee; (iii) voting power of the soliciting shareholder(s); and (iv) the means to contact the soliciting party. There are no restrictions on the content of oral communications.
- Solicitations by the nominating shareholder or group whose nominee(s) are included in the Company's proxy materials will be exempt under new Rule 14a-2(b)(8). The solicitation may seek support for the shareholder nominee(s) and support for or against one or more Company nominees, but cannot solicit proxies. Instead, the solicitation must direct shareholders to the Company's proxy materials.

Solicitations by persons seeking to form a shareholder nominating group may be made under any available exemption, including the exemption permitting solicitations of up to ten shareholders. However Rule 14a-2(b)(8) is the exclusive exemption for solicitations by a shareholder nominating group whose nominee is included in the Company's proxy materials. Neither of the new exemptions is available for persons seeking a change of control or seeking to elect more than the number of directors permitted by Rule 14a-11 or for solicitations in connection with shareholder nominations that are not made under Rule 14a-11. Filing requirements apply to both exemptions.

Formation of a shareholder nominating group for purposes of Rule 14a-11 would not trigger loss of eligibility to file Schedule 13G. The rules do not exempt such nominating groups from Section 16 or from status as "affiliates", leaving the application of those provisions to be analyzed under existing rules and interpretations.

### **Shareholder Proposals To Establish Other Nominating Procedures**

The new rules also amend Rule 14a-8 to permit shareholder proposals that would establish a procedure under the Company's charter or bylaws dealing with the shareholder nomination process. (Prior to adoption of these rules, the Company had the right to exclude from its proxy materials any shareholder proposal relating to a nomination or election of directors or a procedure for such nomination or election.) The shareholder proposals permitted under the new rule could be either binding or advisory. However, such proposals can only provide an additional alternative nomination process, and cannot eliminate or curtail the availability of the process established by Rule 14a-11.

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September 2010



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