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SEC issues proxy materials proposals

The two proposals, dealing with shareholder access, complicate a changing proxy environment.

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THE U.S. SECURITIES and Exchange Commission (SEC) has published its controversial proposals that include two opposing approaches to address the ability of shareholders to include director nominees in a company's proxy materials. These proposals are the culmination of a debate over what constitutes an appropriate shareholder nomination process.

The debate jumped into the spotlight with the SEC's 2003 "shareholder access" or "proxy access" proposal, which would have required companies to include in their proxy statements director nominees submitted by a shareholder or group owning 5% or more of the company's shares the year after the receipt of a 35% or more withhold vote by one or more of the company's director candidates, or the approval of a shareholder proposal that would subject the company to the shareholder nomination process. Facing intense opposition from all sides (business interests thought the proposal went too far in giving shareholders access to company proxy materials, while shareholder interests thought the proposal did not go far enough), the 2003 proposal stalled. Adding to the confusion was the 2d U.S. Circuit Court of Appeals' decision in *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006), which, contrary to the SEC's own interpretation of Rule 14a-8(i)(8) of the proxy rules, held generally that proxy-access proposals could not be excluded from company proxy materials.

One plan would allow companies to exclude some materials.

Against this backdrop, the SEC took the unusual step of proposing two alternative sets of rule amendments. One proposal would, in general terms, require companies to include in their proxy materials proposals for binding bylaw amendments that establish a procedure by which shareholder nominees would be included in company proxy materials, if the proposal is submitted by a more-than-5% shareholder (or shareholder group) that qualifies to file, and has filed, a Schedule 13G as an institutional or passive investor. This is known as the new shareholder-access proposal. See Exchange Act Rel. No. 34-56160 (July 27, 2007), www.sec.gov/rules/proposed/2007/34-56160.pdf. The other would codify the interpretation of Rule 14a-8(i)(8) that companies may exclude from their proxy materials any shareholder proposal that would result in an immediate election contest or set up a process for shareholders to conduct a future election contest by requiring the inclusion of a shareholder nominee in later proxy materials. This is known as the election-contest proposal. See Exchange Act Rel. No. 34-56161 (July 27, 2007) at www.sec.gov/rules/proposed/2007/ 34-56161.pdf.

Under the new shareholder-access proposal, a shareholder or group of shareholders owning more than 5% of a company's shares entitled to vote on the matter at an annual meeting could submit, and the company would be required to include in its proxy materials, a proposal to amend the company's bylaws to establish a procedure by which shareholder director nominees would be included in the company's proxy materials, if: the bylaw will be binding on the company once approved by the shareholders; the shareholder or shareholder group has continuously held more than 5%

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of the company's shares entitled to vote for at least one year by the date the proposal is submitted; and the shareholder or shareholder group is eligible to file, and has filed, a Schedule 13G as an institutional or passive investor.

The one-year ownership and Schedule 13G eligibility requirements would effectively limit the use of this proposed process to longer-term shareholders (such as institutional holders or pension funds) that, while seeking a greater voice on the board, have acquired shares in the ordinary course of their business and not with the purpose or effect of changing or influencing the control of the company. Further, Schedule 13G eligibility is a facts-and-circumstances analysis. The SEC itself asks, in its request for comment, whether there is any tension between the Schedule 13G requirement that the securities not be acquired or held for the purpose of changing or influencing control of the company and the desire of the holder of such shares to propose a bylaw amendment regarding the submission of director nominees. Thus, exactly how the Schedule 13G eligibility condition would work in practice remains a question.

Individuals or entities seeking to control the company would, of course, continue to be able to wage a traditional proxy contest under existing proxy rules using their own proxy statement.

The bylaw proposal may be written as the proposing shareholder deems appropriate, so long as it conforms with applicable state law and the company's governing documents. The SEC's proposing release lists as possible considerations specifying a minimum level of share ownership for those making director nominations, the number of director slots subject to the procedure or a method for allocating any costs related to the procedure.

Once a shareholder or shareholder group forms a "plan or proposal" to submit a bylaw proposal (which includes both actual submission of a proposal and an indication of an intent to management to submit such a proposal or to refrain from submitting such a proposal conditioned on the taking or not taking of a corporate action), the shareholder proponents would be required to file or update their Schedule 13G with new Item 8A-8C disclosures about their relationships with the company and other relevant background information about themselves. The company would also be required to include certain of these disclosures in its proxy statement pursuant to new Item 24 of Schedule 14A and may rely on the shareholder proponents' Schedule 13G to comply with this requirement.

If the bylaw amendment is approved by the requisite vote of shareholders under state law and the company's governing documents, shareholders later proposing director nominees for inclusion in a company's proxy materials pursuant to such bylaw would again be subject to new disclosure requirements. Upon the formation of a plan or proposal to submit a nominee, nominating shareholders would be required to provide the Schedule 13G Item 8A-C disclosures to the company.

Proposals come at a time of other new developments.

Then, when the nominating shareholders submit their director nominees for inclusion in the company's proxy materials, the nominating shareholders would also have to provide the disclosure currently required for shareholders soliciting proxies in opposition to the company with respect to the election or removal of directors under existing Items 4(b), 5(b), 7 and 22(b) of Schedule 14A and a statement that shareholder nominees consent to being named in the proxy materials and will serve if elected. If the nominating shareholders fail to provide any of the foregoing information, the company would not have to include the shareholders' nominees in its proxy materials.

Under the proposed rules, the company would also be required to make the following additional disclosures if it includes shareholder nominations in its proxy materials:

■ Immediately after receipt of the new Schedule 13G Item 8A-C information from the nominating shareholders, the company must provide the information on its Web site or provide a link to a Web site address where such information will appear. The company must also include this information in the related proxy statement under new Item 25(a) or on a Web site to which the proxy statement refers.

■ When the shareholder submits its director nominees to the company for inclusion in the company's proxy materials, the company must include the Schedule 14A Item 4(b), 5(b), 7 and 22(b) disclosure in its proxy statement under new Item 25(a) or on a Web site to which the proxy statement refers.

The company would also be required to include certain of the same Schedule 13G Item 8A-C disclosures in its Schedule 14A pursuant to new Item 25(b).

If a shareholder nominee is included in the company's proxy materials, the company would have to file its proxy statement in preliminary form and be subject to SEC review in the same manner as under the existing rules for proxy contests. The proposed rules explicitly state that companies would not be liable for information provided by nominating shareholders and that no such information would be deemed incorporated by reference into any other SEC filing unless the company specifically incorporates that information by reference.

The election contest proposal

The SEC also proposed an alternative amendment to Rule 14a-8(i)(8) that would codify the view that shareholder proposals that would result in an immediate election contest (e.g., by making or opposing a director nomination for a particular meeting) or would set up a process for shareholders to conduct an election contest in the future, by requiring the company to include shareholders' director nominees in its proxy materials for subsequent meetings, are excludable from company proxy statements.

In the proposing release, the SEC was careful to provide guidance to prevent an "inappropriately broad" reading of whether a

proposal relates to a director election, giving examples of proposals that are or are not excludable. Excludable proposals include proposals that could have the effect of disqualifying board nominees who are standing for election; removing a director from office before his or her term expired; questioning the competence or business judgment of one or more directors; or requiring companies to include shareholder director nominees in the company's proxy materials or otherwise resulting in a solicitation on behalf of shareholder nominees in opposition to board-supported nominees.

Nonexcludable proposals include proposals that relate to qualifications of directors or board structure (as long as the proposal will not remove current directors or disqualify current nominees); voting procedures (such as majority or cumulative voting). nominating procedures; or reimbursement of shareholder expenses in contested elections.

According to the proposing release, the SEC has long taken the view that shareholders wishing to nominate directors for election to the board of a company should do so under the existing rules for solicitations of proxies in opposition to the company's director nominees. These rules require the proponent to prepare its own proxy statement and call for more detailed disclosure regarding the nominees and the persons making the solicitation. These rules also subject the proponent to the anti-fraud provisions of the proxy rules. The new rules would not limit the ability of shareholders to make nominations or solicit proxies to vote in favor of their own nominees under existing rules. Rather, the proposal would clarify that the proponent must solicit proxies to vote for these nominees separately and in compliance with existing rules regarding solicitations in opposition.

As the controversial nature of these proposals warrants, the SEC sought comment on many aspects of these proposals. The questions posed by the SEC are too numerous to explore fully here, but notable are two interesting points with respect to the new shareholder-access proposal: As noted in particular by Commissioner Roel C. Campos at the SEC open meeting approving this proposal, there is concern about whether the 5% ownership threshold is appropriate even for medium-sized companies, where such a high threshold would effectively block any shareholder or shareholder group from using the proposed process. The SEC has asked whether a lower threshold or a staggered threshold depending on company size would be more appropriate.

The SEC has also asked whether there should be further clarification as to the intersection of Schedule 13G and this proposal. For example, would acquiring shares for the express purpose of meeting the ownership threshold under this proposal ruin Schedule 13G eligibility?

In addition, the SEC is seeking comment on whether it should propose separate rules to allow companies or their shareholders to propose and adopt bylaws that would establish the procedures that the company would follow for including nonbinding proposals in the company's proxy materials. Such shareholder proposals are popular among social-activist investors. These groups have reacted against encouraging such a proposal.

The proposals come at a time when the proxy process is adjusting to several other new developments and proposals. Shortly before making the new proposals, the SEC published final rules requiring companies and other soliciting persons to offer a notice and interest access method of distribution of proxy materials.

In addition, the New York Stock Exchange has proposed the elimination of broker discretionary voting in respect of the election of directors. Currently, when a person holds shares through a broker but does not instruct the broker as to how to vote, the broker may vote the shares in its discretion on "routine" matters, including uncontested director elections. The proposed change would eliminate such discretionary voting.

In an effort to harness the potential of the Internet, the new shareholder-access proposal also seeks to facilitate shareholder communication by eliminating certain federal securities law ambiguities surrounding the formation of online shareholder forums. Such activities are not now prohibited, but the proposed rules are intended to clarify various issues not addressed by the existing proxy rules, particularly liability and other issues, such as whether participation in such a forum constitutes a proxy solicitation.

The proposed rules would specify that companies or shareholders may establish, maintain or operate a shareholder forum to facilitate interaction among shareholders and between the company and its shareholders. The proposed rules would exempt from federal proxy rules any solicitation made in a shareholder forum by or on behalf of any person who is not seeking directly or indirectly any proxies so long as the solicitation is made more than 60 days before the next shareholder meeting. A participant in a shareholder forum would be eligible to solicit proxies within the 60 days before a shareholder meeting if he or she did so in accordance with the existing rules.

Comments on both the new shareholder-access proposal and the election-contest proposal were due in October. The members of the SEC were split on the proposals. Chairman Christopher Cox acted as the swing vote in favor of both proposals for now and hopes that the ensuing public debate will result in the adoption of a final, unambiguous rule in time for the 2008 proxy season. However, the recent departures of commissioners Campos and Annette L. Nazareth make it less likely that this timetable will be met. Nevertheless, the proposals will continue to draw comment and criticism until ultimately resolved. In the meantime, even without these issues fully resolved, 2008 is shaping up to being another busy proxy season, as pension funds, unions, socially responsible shareholder activists and activist investment funds continue to seek the attention of corporate boards and shareholders through the annual meeting proxy process. NLJ