SEC Adopts New Rules Strengthening Shareholders' Ability to Nominate Members of the Board of Directors

On August 25, 2010, the Securities and Exchange Commission ("SEC"), by a vote of 3 to 2 of its commissioners, published an adopting release (the "Release")[1] establishing new rules to provide shareholders with the ability to more effectively nominate and elect directors to boards of directors of publicly reporting companies. Specifically, the new rules will allow a shareholder or shareholders holding at least 3% of the outstanding shares of a company continuously for three years to nominate a director for inclusion using the company's proxy solicitation materials. Until now, the inclusion of shareholder nominees in a company's proxy materials has been principally governed by state law, and the federal proxy rules, as promulgated by the SEC, have focused on some aspects of the process by which nominees are included. The new rules are part of the overall initiative of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*,[2] which expressly authorized the SEC to enact rules increasing shareholders' ability to access proxy materials. Additionally, the Release amends certain rules previously enacted by the SEC under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), which aim to strengthen shareholders' ability to propose amendments to a company's governing documents to establish procedures for including shareholder nominees in proxy materials.

The highlights of the new rules and amendments are as follows:

- Exchange Act reporting companies must include the nominee or nominees for director of an eligible shareholder in the company's proxy materials.

- Shareholders that have owned at least 3% of the company's voting securities for at least three years are eligible to propose a nominee.

- An eligible shareholder may nominate up to one quarter of the total number of directors comprising the board so long as such nominees meet the requirements therefor under applicable federal and state law and the applicable rules of any national securities exchange or association.

- Any shareholder holding at least $2,000 in market value (or 1%, whichever is less) of the company's voting securities for at least a year may propose amendments to the company's governing documents to establish procedures for shareholders to nominate directors.

The new rules and amendments will be effective 60 days after the date the Release is published in the Federal Register. However, "smaller reporting companies," as defined in the Exchange Act, will not be subject to the new rules until three years after the effective date.

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[1] Release Nos. 33-9136; 34-62764; IC-29384; File No. S7-10-09, *Facilitating Shareholder Director Nominations* (Aug. 25, 2010) *available at* http://www.sec.gov/rules/final/2010/33-9136.pdf.

[2] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, §971, 124 Stat. 1376 (2010). For a more detailed discussion of the Dodd-Frank Act, see *Dodd-Frank Act Makes Significant Changes in Governance Rules for Public Companies*, Cahill Gordon & Reindel LLP Firm Memorandum (July 21, 2010) available at http://www.cahill.com/news/memoranda/100227.

I. Background

On June 10, 2009, the SEC proposed new Exchange Act Rule 14a-11 and amendments to existing Exchange Act Rule 14a-8(i)(8).[3] These rules, as proposed and now adopted, are designed to facilitate the ability of shareholders with a "significant, long term stake in the company" to nominate directors and to narrow a company's ability to exclude from its proxy materials shareholder proposals that seek to establish procedures for inclusion of nominees. The SEC considered comments to the Proposal, including, in particular, concerns that the new rules and amendments inappropriately encroached upon an area of law traditionally reserved for the states and that the new rules and amendments would provide "special interests" and activist shareholders with yet another tool to disrupt the operations of a company, forcing it to focus on short term results rather than long term profitability. Despite these and other concerns, the SEC concluded that "facilitating shareholders' ability to exercise their state law rights to nominate and elect directors" outweighed any potential disruption to the company. As for the concern that the SEC may be improperly overstepping its bounds into matters of state law, the rules and amendments were made expressly subject to any state law which would prohibit shareholders from nominating directors, unless such state law provides lesser rights to shareholders in matters relating to nominating directors.

II. New Exchange Act Rule 14a-11

In general, new Rule 14a-11 will allow shareholders holding at least 3% of the voting securities of a reporting company for at least three years to nominate individuals for election to the company's board of directors in the company's proxy materials.

Applicable to all reporting companies

New Rule 14a-11 will apply to all companies that are subject to the reporting requirements of the Exchange Act. This includes all investment companies registered under the Investment Company Act of 1940, controlled companies, those companies with a class of securities voluntarily registered and smaller reporting companies. However, a company that is subject to reporting requirements under the Exchange Act solely due to it having a class of debt securities registered under the Exchange Act will not be required to comply with Rule 14a-11.

To allow smaller reporting companies time to develop infrastructure to manage proxy matters and to allow the SEC and others to observe other companies operating under the new rule, the new rule will not apply to smaller reporting companies for a period of three years from its effective date.[4]

Eligible Shareholders

The SEC designed the new rule to provide shareholders with a "significant, long-term interest" in the company with direct access to the company's proxy materials. In order to satisfy this standard, a shareholder

3 See Facilitating Shareholder Director Nominations, Release No. 33-9046, 34-60089 (June 10, 2009) [74 FR 29024] (the "Proposal").). For more information on the Proposal, see *SEC Seeks Public Comment on Reform of the U.S. Proxy System*, Cahill Gordon & Reindel LLP Firm Memorandum (July 16, 2010) available at http://www.cahill.com/news/memoranda/100226.

4 In general a "smaller reporting company" is an issuer with a public float of less than $75 million. See Exchange Act Rule 12b-2.

must, on the date it files notice with the company on Form 14N, beneficially own at least 3% of the voting power of the company's securities that are entitled to vote at the company's annual meetings (and which are subject to the Exchange Act's proxy voting rules) and must have continuously owned such securities for a period beginning at least three years prior to the date of such notice through the date of election. The 3% threshold can be satisfied by an individual shareholder or by a group of shareholders acting together. The rule also allows securities loaned to a third party to be considered held during the period, provided that the nominating shareholder or group has the right to recall the loaned securities during the period.

In an effort to avoid shareholder nominations for the purpose of effecting a change of control or of gaining more than the maximum number of seats provided for under the rule, as described below, the rule requires nominating shareholders to not only certify the absence of such intent, but to refrain from associating with any group of shareholders engaged in solicitations with respect to the subject of election of directors. In addition, the nominating shareholder (or group of shareholders) may not enter into any agreement with any other shareholder, the company or its management with respect to such nomination.

Nominees

The new rule allows eligible shareholders to nominate up to 25% of the company's board of directors (or if such board of directors has fewer than 4 members, an eligible shareholder will be permitted to nominate one member). All nominees must meet the requirements of applicable federal and state law and the applicable rules of any national securities exchange or association (including the objective independence standards of the relevant securities exchange). Otherwise, a company can rightfully exclude such nominee from the proxy materials, subject to the cure of any such violation.

There is no requirement contained in the new rule concerning the relationship between the nominating shareholder and the nominee. Therefore, an eligible shareholder is free to nominate any person that objectively meets the requirements of applicable state law and applicable rules of securities exchanges and associations, including any affiliates or family members. Before being elected to the board, any nominee would still have to gain the support of the shareholders in general and, after taking office as a director, the nominee would be subject to the fiduciary duties applicable to all directors.

Conflicts with Applicable State or Foreign Law

If applicable state law (or in the case of a non-U.S. domiciled company that does not meet the definition of "foreign private issuer" under the federal securities laws, applicable foreign law) prohibits shareholders from nominating directors, then new Rule 14a-11 shall have no effect. However, if applicable law allows shareholders to nominate directors, then the new Rule 14a-11 will operate to expand on that right to the extent the applicable state or foreign law provides lesser rights. For example, if applicable law were to allow only those shareholders holding 10% or more of the voting securities of a company to nominate directors, the new rule would operate to allow shareholders holding 3% or more to exercise such rights. On the other hand, if applicable law were to allow shareholders holding 1% or more to nominate directors, that standard would apply.

Companies cannot "opt out" of the new rule and shareholders may not modify the governing documents of the company to restrict its operation, though shareholders can supplement the procedures and standards of Rule 14a-11.

III. Amendment to Exchange Act Rule 14a-8(i)(8)

In general, the amendment to Rule 14a-8(i)(8) narrows a company's ability to exclude a shareholder's proposal seeking to amend the company's governing documents to establish or modify the procedure by which directors are nominated and elected. The amendment is intended to codify the staff's prior interpretations of the rule and to provide more clarity to companies and shareholders. As amended, a company may only exclude a shareholder's proposal relating to director nomination procedures if the proposal:

- Disqualifies a nominee currently standing for election;
- Removes a director currently in office;
- Questions the competence, business judgment or character of a nominee or director;
- Seeks to include a specific individual; or
- Otherwise could affect the outcome of the upcoming election of directors.

In addition, companies will be permitted to exclude proposals put forth by shareholders holding less than $2,000 in market value of the company's voting securities (or 1% of such total market value, which ever is less).

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Banks Bruce at 212.701.3052 or bbruce@cahill.com.