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Shareholder Proposals: SEC's Proposed Revisions to Rule 14a-8

On July 25, 2007, the Securities and Exchange Commission ("SEC" or "Commission") at an open meeting, voted to publish for comment two different, seemingly conflicting, revisions to Rule 14a-8 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").[1] Both releases were voted by a 3-2 vote of the Commission, with Chairman Cox casting the deciding vote in each case, siding with Commissioners Nazareth and Campos voting with Cox in favor of the first release[2] and Commissioners Atkins and Casey voting with Cox in favor of the second release.[3]

The proposed rules aim to resolve what has become an open question concerning Rule 14a-8. In September 2006, the Second Circuit invalidated the SEC's interpretation that a shareholder proposal requiring a company to include certain shareholder-nominated candidates for the board of directors on the corporate ballot can be excluded from the corporate proxy materials on the basis that the proposal "relates to an election" under Exchange Act Rule 14a-8(i)(8).[4] This opinion created uncertainty as to whether the SEC's interpretation would remain valid in other circuits. The Inclusion Proposal,

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1 *See* Speech by SEC Chairman: Opening Remarks at the SEC Open Meeting by Chairman Christopher Cox, U.S. Securities and Exchange Commission, Washington, D.C. July 25, 2007, http://sec.gov/news/speech/2007/spch072507cc.htm. The text of the SEC staff's presentation of these two releases may be found at http://www.sec.gov/news/speech/2007/spch072507lcb.htm. Video footage of the open meeting is archived at http://sec.gov/news/speech/2007/072507openmeeting_c.wmv or http://sec.gov/news/speech/2007/072507openmeeting_c.mov.

2 SEC Release No. 34-56160; IC-27913; File No. S7-16-07, *Shareholder Proposals* (July 27, 2007) available at http://www.sec.gov/rules/proposed/2007/34-56160.pdf (the "Inclusion Proposal")

3 SEC Release No. 34-56161; IC-27914; File No. S7-17-07, *Shareholder Proposals Relating to the Election of Directors* available at http://www.sec.gov/rules/proposed/2007/34-56161.pdf (the "Exclusion Proposal")

4 *See American Federation of State, County & Municipal Employees, Employees Pension Plan v. American International Group, Inc.*, 462 F.3d 121 (2d Cir. 2006) *("AFSCME* v. *AIG").*

supported by Commissioners Nazareth and Campos, would replace the SEC's interpretation with a rule specifying that such a proposal could not be excluded, provided it was a binding proposal made by a holder of 5% of the company's stock. The Exclusion Proposal, supported by Commissioners Atkins and Casey, would validate and codify the SEC interpretation rejected by the Second Circuit.

Comments on the proposed rules should be received by the SEC by October 2, 2007.

I. The Inclusion Proposal: Bylaws Relating to Director Nomination Process

The Inclusion Proposal proposes amendments to Rule 14a-8 that would specify that a company is not allowed to exclude from the company proxy materials shareholders' bylaw proposals related to the nomination of board members, provided:

- the proposal would be binding on the company if approved;
- the proposal is submitted by a shareholder or group of shareholders that has continuously held more than 5% of the company's securities for at least one year; and
- that shareholder or group of shareholders is eligible to, and has, filed a Schedule 13G that contains all required information.

Thus, the allowable exclusion of proposals that "relate to an election for membership on the company's board of directors" under Rule 14a-8(i)(8) would be limited by a carveout for proposals of "bylaws related to the nomination of board members" made by certain major stockholders satisfying certain conditions. The staff stated that the release proposes no limitations as to the content of the proposed bylaws, but stated that any proposal would need to comply with applicable state law (which is already a requirement of Rules 14a-8(i)(1) and (2)) and governing corporate documents (which may be a new requirement).

The staff stated that it considers comprehensive disclosure regarding the shareholder proponent and the shareholder proponent's relationship and prior interactions with the company critical in allowing access to the company's proxy materials. Thus, the staff stated that, under the proposal, Regulation 14A and Schedule 13G would be amended to provide the shareholders with additional information about the proponents of shareholder nomination process bylaw proposals. Apparently prefiguring an increased number of shareholder nominees, requiring enhanced regulation of the shareholder director nomination process, the staff also stated that existing disclosure requirements for solicitations in opposition would apply to nominating shareholders and their nominees under any such shareholder nomination procedure, with the nominating shareholder being liable for any false or misleading statements made in disclosure they are required to make. Nominating shareholders and their nominees, as well as the company, would be subject to the additional Regulation 14A and Schedule 13G disclosures as well.

The staff also recommended revisions to the proxy rules to promote greater online interaction among shareholders by removing obstacles in the current rules to the use of electronic shareholder forums and to clarify the application of the liability provisions of the federal securities laws to statements or information on such a forum.

II. The Exclusion Proposal: Director Elections

The Exclusion Proposal would codify the SEC's current interpretation of Rule 14a-8(i)(8) regarding proposals that relate to an election of directors. Under that interpretation, companies may exclude from their proxy materials proposals that would (1) result in an immediate election contest or (2) set up a process for shareholders to conduct an election contest in the future by requiring the company to include shareholders' director nominees in the company's proxy materials for subsequent meetings. The staff stated that this proposal would also amend the text of Rule 14a-8(i)(8) to further clarify the exemption in accordance with the Commission's current interpretation.

III. Compromise within the Proposals

The Inclusion Proposal represents a compromise between the existing SEC interpretation and the interpretation espoused and, indeed, forced upon the SEC by the Second Circuit in *AFSCME* v. *AIG*, which does not allow the board to exclude any shareholder proposal from proxy materials under Rule 14a-8(i)(8) unless it would "result in an immediate election contest."[5] The result in that case was to allow AFSCME, a shareholder, to include its proposed bylaw allowing for shareholders to propose board nominees if they have held a 3% interest in the company for at least a year.[6] The Second Circuit based its interpretation on the amendments to Rule 14a-8 proposed by the SEC in 1976[7], The Second Circuit also held that the 1976 Statement "clearly reflects the view that the election exclusion is limited to shareholder proposals used to oppose solicitations dealing with an identified board seat in an upcoming election and rejects the somewhat broader interpretation that the election exclusion applies to shareholder proposals that would institute procedures making such election contests more likely."[8] In accord with the Second Circuit's view, the Inclusion Proposal adopts the position that a binding bylaw proposal (which presumably could not result in an immediate election contest or address who should be elected to a board seat in an upcoming election) could not be excluded by the company, on the condition that it was proposed by a holder of 5% of the company's securities.[9]

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5 462 F.3d 121, 127-128.

6 *See id.* at 125.

7 SEC Release No. 34-12598, 41 F.R. 29,982, 29,9845 (proposed July 7, 1976) (the "1976 Statement"). *See* 462 F.3d at 126-127.

8 *See id.* at 128.

9 Proposed regulations on shareholder nominators, should proposals such as AFSCME's pass, should, in the view of the SEC, be seen not as a compromise but rather as a necessary protective measure ancillary to the Second Circuit's position, which did not contemplate any additional regulation of shareholder nominators, since, as the Chairman put it, "the effect of applying the [Second Circuit's] decision as a rule of general application would be to permit director election contests without the disclosures required by the election contest rules"

The Commission has presented a further compromise in that the Exclusion Proposal, codifying the SEC's current interpretation, presents an alternative solution to the uncertainty created by the *AFSCME* decision. Thus, commentary will proceed on two alternative tracks, and the Commission will presumably adopt either one or the other proposal at the end of the comment period. The Chairman in his speech stated that it was his intention to have a "clear, unambiguous rule in place in time for the next proxy season."

While the Exclusion Proposal makes the Commission's support for the Inclusion Proposal somewhat equivocal, it must be noted that the Chairman made extensive comments that would, at the very least, tend to qualify his support for the Exclusion Proposal, which represents the status quo. The Chairman, a Bush appointee, spoke highly in his speech of the cause of "fair corporate suffrage" and twice made reference to the importance attached to this cause by the late Chairman Shad, a Reagan appointee. He also spoke out against those who "say the company's proxy materials, which are produced at the shareholders' expense, should under all circumstances be inaccessible to the shareholder, when it comes to nominating directors." The Chairman further described shareholders' access to the corporate proxy as a private property right and as necessary "to insure that boards of directors remain accountable to the interests of investors." He also pointed out the "irony" that while matters peripheral to the shareholder's interests are sometimes required to be included on the proxy statement, "if the proposal concerns [the right to choose the company's directors], the most fundamental of shareholder rights — the most unqualified, unbridled right that the shareholder has — then in the current system the answer is no, and indeed no under all circumstances."

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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 e-mail Jon Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com; or Arthur Dobelis at (212) 701-3359 or adobelis@cahill.com.