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SEC Clears the Way for "Private Ordering" for Proxy Access; Related Rules also Effective

The SEC's changes to Exchange Act Rule 14a-8(i)(8), which went into effect yesterday, generally will require companies to include in their proxy materials shareholder proposals addressing the director nomination process.[1] The new rule empowers shareholders to seek to implement proxy access on a company-by-company basis rather than through a universally applicable procedure as would have been the case under the now vacated Rule 14a-11.

The rule changes will affect U.S. public companies in the 2012 proxy season.[2] Since foreign private issuers are exempt from the proxy rules, the rule changes will not affect them.

Companies were previously permitted to exclude proxy access proposals under Rule 14a-8(i)(8). In August 2010, the SEC repealed the exclusion at the same time that it adopted Rule 14a-11. Following commencement of litigation challenging Rule 14a-11, all rule changes were stayed pending resolution of the Rule 14a-11 litigation. With that litigation resolved, and the SEC having concluded not to appeal the D.C. Circuit's decision vacating Rule 14a-11, the stay on Rule 14a-8 and related amendments has expired.

Unlike Rule 14a-11, which would have given shareholders the immediate ability to include director nominees in the company's proxy, the changes to Rule 14a-8(i)(8) pave the way for a two-step process. First, a shareholder may propose changes to the company's governing documents specifying *procedures* by which shareholders may include director nominees in the company's proxy materials (proposals to include *specific nominees* may still be excluded under Rule 14a-8(i)(8)(iv)). Second, if proxy access procedures are adopted, a shareholder may then require specific director nominees to be included in the company's proxy materials pursuant to the company's proxy access regime.

As a general matter, a company may exclude a shareholder proposal on procedural grounds or on certain substantive grounds specified under clauses (1)-(13) of Rule 14a-8(i).[3] As amended, companies will no longer be able to exclude a proxy access shareholder proposal under clause (8) unless it:

- would disqualify a nominee who is standing for election,
- would remove a director from office before his or her term expired,

[1] Under Rule 14a-8, a shareholder that meets the share ownership threshold and holding period requirement (1% or $2,000 of the company's voting securities for at least one year) and submits a proposal within the deadline (120 days prior to the anniversary of the previous year's proxy mailing) may submit a 500-word proposal for inclusion in the company's proxy statement.

[2] For calendar year-end companies, the deadline for submitting proposals under Rule 14a-8 usually falls within the period from November to January, which means that a shareholder proponent will have plenty of time for submitting a proxy access proposal in time for the upcoming proxy season.

[3] *See* Rule 14a-8(i)(1) (improper under state law), -(2) (violates law), -(3) (violates the proxy rules), -(4) (proponent has a personal grievance or special interest), -(5) (relates to less than 5% of a company's business and not otherwise significantly related), -(6) (company does not have power or authority to implement), -(7) (deals with the company's ordinary business), -(8) (could affect the particular outcome of the upcoming election of directors as specified), -(9) (conflicts with the company's proposal), -(10) (has been substantially implemented), -(11) (duplicative of another included proposal), -(12) (is being resubmitted and generally received low votes in prior years), or -(13) (asks for specific dividends). The burden is on the company to demonstrate an appropriate basis for exclusion.

- questions the competence, business judgment, or character of one or more nominees or directors,
- seeks to include a specific individual in the company's proxy materials for election to the board of directors, or
- otherwise could affect the outcome of the upcoming election of directors.[4]

A company may also attempt to exclude a proxy access proposal on one or more additional bases, including the fact that it "conflicts with the company's proposal," is "improper under state law," "violates law" or has been "substantially implemented."

A shareholder proposal may be drafted as an advisory (or "precatory") resolution or, if permitted under state law (as in Delaware), the proposal may seek to implement binding changes to a company's bylaws. Although shareholders might normally prefer a binding vote, Rule 14a-8's 500-word limit may create a difficult drafting hurdle for proponents seeking to implement a well-crafted bylaw. As a result, we expect that many proxy access proposals will be precatory, as is the case with the vast majority of other types of shareholder proposals.

There is much speculation in the governance community as to the extent to which shareholders will take advantage of the new Rule 14a-8(i)(8) in the 2012 proxy season and the form that the proposals will take. In addition, it is unclear how shareholders will vote in response and what share ownership and holding period thresholds will be favored by shareholder proponents. The 2012 proxy season may prove to be a fertile testing ground for whether proxy access is implemented through private ordering or whether shareholder groups will continue to pursue a federally mandated proxy access rule. Some advocates for proxy access have already stated that they intend to pursue both courses of action.

With this in mind and as a general matter, we do not see any advantage in companies proactively adopting a proxy access regime unless the board has concluded (as most have not) that proxy access is in substance a desirable idea. In any case, the adoption by a company of a proxy access mechanism would not prevent a shareholder from proposing a different, likely more lenient, proxy access proposal.

If your company receives a proxy access proposal under Rule 14a-8, your options will depend on a number of factors, including the specific request in the proposal, whether the proposal is binding or precatory, the board's desire and ability to negotiate with the proponent, the company's existing governance practices, its shareholder base and other potential fundamental and structural issues. All of these factors will need to be evaluated on a case-by-case basis.

The path of least resistance is to include the proposal in the proxy statement and to evaluate whether and how to proceed following the shareholder vote. This may be an appealing option because the level of support for these proposals is untested, and it is not yet clear how shareholders, particularly institutional investors, will cast their votes.

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[4] According to the SEC's adopting release, the enumerated exclusions were intended to codify prior SEC staff no-action letters and interpretations. *See, e.g.,* Dollar Tree Stores, Inc. (March 7, 2008), TVI Corporation (April 2, 2008) and First Energy Corp. (March 17, 2003) (permitting exclusion of proposals to declassify the board that applied to current directors and nominees), Waddell and Reed Financial, Inc. (February 23, 2001) (permitting exclusion of a proposal recommending that no board member of a specified company be nominated to serve as a director), Exxon Mobil Corp. (March 20, 2002) (permitting exclusion of a proposal whose supporting statement appeared to question the business judgment of the Chairman who stood for reelection at the upcoming meeting), N-Viro International Corporation (March 8, 2007) and Dow Jones & Company, Inc. (January 31, 1996) (permitting exclusion of proposals to include specific individuals for directorships). With respect to the catchall provision, the SEC's proposing release noted that, while the prior enumerated conditions specifically address particular types of proposals traditionally seen by the SEC staff, this language seeks to address "new proposals that may be developed over time that are comparable to the four specified categories and would undermine the purpose of the exclusion."

The company could as an alternative seek to exclude the shareholder proposal through the SEC no-action letter process by proposing or enacting its own proxy access bylaw. A company-sponsored proxy access regime would likely have more stringent ownership thresholds or holding periods or other requirements than those in the shareholder proposal. A company may consider *proposing* its own proxy access bylaws for a shareholder vote and attempt to have the proposal excluded on the basis that it "conflicts" with the company's own proposal, a method that is now well-recognized in the context of other types of shareholder proposals, such as in the special meeting context. As another possible basis for exclusion, a company may *adopt* proxy access bylaws without a shareholder vote (either proactively or in response to a shareholder proposal) and then seek to exclude the shareholder's proxy access proposal as having been "substantially implemented."[5]

The SEC has also declared effective its related changes to the proxy and beneficial ownership rules, including disclosure and timing requirements governing the nominations of directors if proxy access procedures *are* adopted (whether through a successful binding shareholder proposal or by the company). Generally speaking, the shareholder will be required to submit notice to the company with certain disclosures required on a new Schedule 14N by the date specified in the company's advance notice provisions, or if no provision is in place, not later than 120 calendar days before the date on which the company mailed its proxy materials for the prior year's annual meeting.

Other changes, such as the requirement to use a "universal proxy" if a shareholder nomination is included in a company's proxy materials, are also now in effect. Related rule amendments that only refer to Rule 14a-11, such as the exemption for solicitations made in connection with forming a nominating shareholder group or in support of or against a nominee, and rules clarifying that a shareholder or group will not lose Schedule 13G eligibility by virtue of their engaging in activities in connection with a nomination, are also now technically effective. However, since those rules only refer to the now vacated Rule 14a-11, unless the SEC adopts amendments mandating their applicability, they will have no practical effect.

- See a copy of the SEC's notice of effective date published in yesterday's *Federal Register*.
- See a copy of the SEC's August 2010 final rule release, "Facilitating Shareholder Director Nominations."
- See a copy of the Davis Polk newsflash "D.C. Circuit Vacates SEC Proxy Access Rule."

[5] Recent determinations by the SEC staff on other types of shareholder proposals indicate that the staff has at times found that company-sponsored bylaw amendments were sufficiently different from the shareholder proposal as to preclude no-action relief on this basis, such as in the special meeting context where proposals seeking a 10% threshold were generally not found to be excludable by companies with a 15% or 25% threshold.

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