

SEC Seeks To Expand Director Nomination Process

July 2009

In June 2009, the Securities and Exchange Commission (the "SEC") issued for public comment proposed new rules regarding the proxy process for nominating and electing public company boards of directors. These rules would require that, in certain circumstances, company proxy materials for director elections include information and balloting for limited numbers of shareholder nominees. They would also require affected companies to include in their proxies certain shareholder proposals to amend corporate governance documents regarding nomination procedures or disclosures.

For a copy of the SEC proposal, see SEC Release nos. 33-9046; 34-60089 at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

The SEC's concern is summarized in the overview to the release: "The nation and the markets have recently experienced, and remain in the midst of, one of the most serious economic crises of the past century. This crisis has led many to raise serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in the loss of investor confidence. These concerns have included questions about whether boards are exercising appropriate oversight of management, whether boards are appropriately focused on shareholder interests, and whether boards need to be more accountable for their decisions regarding such issues as compensation structures and risk management. In light of the current economic crisis and these continuing concerns, the SEC has determined to revisit whether and how the federal proxy rules may be impeding the ability of shareholders to hold boards accountable through the exercise of their fundamental right to nominate and elect members to company boards of directors."

The release noted that institutional investors and academic observers have both provided

analysis and opinions suggesting that:

- It is difficult for shareholders to replace directors, and electoral challenges to incumbent directors are very infrequent.
- While shareholders can recommend a nominee for director to a company's nominating committee, these recommendations are rarely accepted.
- Arrangements further insulating public company directors from removal are associated with lower share values and performance.
- Companies with "hybrid" boards (composed partly of shareholder nominated directors) have generally grown share values better than their peers.
- The presence of shareholder-nominated directors would make boards more accountable to the shareholders who own the company and that this accountability would improve corporate governance and make companies more responsive to shareholder concerns.
- Without competition for director elections, directors are effectively unaccountable to shareholders and may lose sight of their proper role as representatives of the company.

According to the SEC, the proposed rules were designed to minimize disruptions for management while delivering the benefits of shareholder participation, including:

- Reductions in cost for shareholder participation in elections of directors;
- Improved disclosure regarding shareholder-nominated candidates;
- Potential improved performance by boards of directors; and
- Enhanced opportunities for adoption of preferred nomination procedures.

SHAREHOLDER NOMINEES: EXCHANGE ACT RULE 14A-11

Proposed Exchange Act (Securities Exchange Act of 1934, as amended) Rule 14a-11 spells out in detail: (1) which public companies are subject to proxy access requirements; (2) which shareholders or groups are entitled to gain access to a company's proxy materials; (3) the requirements applicable to shareholder nominees for directors; (4) the maximum number of shareholder nominees a company must put in its proxy materials (and which nominees are entitled to proxy access among multiple contestants); (5) the notice and disclosure requirements associated with expanded proxy access; (6) a company's required actions in response to notices from shareholders; and (7) the application of proxy solicitation rules to nominating shareholders.

1. Companies Subject to Proxy Access Requirements of Rule 14a-11

The proposed Rule 14a-11 governing expanded proxy access would apply to all companies subject to Exchange Act proxy rules, including investment companies registered under the Investment Company Act of 1940, except that it would not apply to companies that have registered only bonds or debt obligations under Section 12 of the Exchange Act.

Also, a company would not be subject to Rule 14a-11 if applicable state law or company governance documents prohibit shareholders from nominating candidates to the board. But for a company having such a prohibition in its governance documents, shareholders may propose to change that provision via proxy access under proposed Rule 14a-8(i)(8).

2. Who Can Use Expanded Proxy Access under Rule 14a-11

In order to prevent disruption to companies from shareholders having minimal investments or mere short-term interests, the

proposed rule contains certain eligibility requirements for shareholders seeking to utilize it. A company may exclude from its proxy materials information about any shareholder nominees offered by any shareholder or group that does not own:

- For large accelerated filers (as defined in Exchange Act Rule 12b-2) and for investment companies with net assets of \$700 million or more, at least one percent of the company's securities entitled to vote on the election of the directors;
- For accelerated filers and for registered investment companies with net assets of \$75 million or more, at least three percent of the company's securities entitled to vote on the election of the directors;
- For non-accelerated filers and for registered investment companies with net assets of less than \$75 million, at least five percent of the company's securities entitled to vote on the election of the directors.

A company may also exclude from its proxy materials any shareholder nominees offered by any shareholder or group that:

- Has not beneficially owned the securities used for purposes of determining eligibility for at least one year as of the date of the shareholder notice required on Schedule 14N (as explained below).
- Has not represented that he/she/they intend to continue owning those securities through the date of the annual or special meeting.

The SEC noted that more than 99 percent of large accelerated filers have at least one shareholder who can meet the one percent standard, while 85 percent of accelerated filers have at least one shareholder that can meet the applicable three percent threshold, and nearly 60 percent of non-accelerated filers have at least one shareholder that can meet the five percent requirement.

In order to meet eligibility requirements under the new rule, a nominating shareholder or group must also refrain from acquiring or holding the securities "for the purpose of or with the effect of changing control of the company or gaining more than a limited number of seats on the board."

The nominating shareholder or group must also provide to the company and file with

the SEC a notice on proposed new Schedule 14N concerning the intent to require inclusion of a nominee in proxy materials.

3. Shareholder Nominee Requirements

The proposed rules contain requirements and exclusions that are designed to prevent illegal action or abuse of the rules by either shareholders or management.

First, a company is not required to include any nominee in its proxy materials if that nominee's candidacy or election would violate applicable state law, federal law or rules of any national securities exchange or association. In addition, the nominating shareholder(s) would be required to represent that their nominee is in compliance with any independence requirements of any applicable exchange or association (other than subjective requirements applied by the company's board). The company could also preclude the nominee from serving on board committees based on failure to meet subjectively applied independence standards.

Second, the nominating shareholder or group would be required to represent that no relationships or agreements exist between the nominee and the company or its management, or between the nominating shareholder or group and the company or its management. This is designed, in part, to prevent agreements with the company regarding nominees interposed to block other shareholder nominees.

4. Maximum Number of Shareholder Nominees

Under the proposed rule, a company would be required to include in its proxy materials no more than one shareholder nominee, or the number of nominees that represents 25 percent of the existing board of directors, whichever is greater.

Furthermore, proposed Rule 14a-11(d)(3) provides that where more than one shareholder or group offers up nominees for proxy inclusion (and more nominees are offered than the company is obliged to include), the company is required to include only the chosen nominee(s) of the first nominating shareholder(s) from which it receives timely notice of intent on Schedule 14N. By using a "first-in" standard, the SEC sought to allow companies to begin prompt preparation of proxy materials upon receiving the maximum number of eligible nominations.

5. Notice and Disclosure Requirements

In order to submit a nominee for inclusion in the company's proxy statement, a shareholder or group would be required by Rule 14a-11 to provide the company and file with the SEC a new Schedule 14N notice by the date specified in the company's advance notice bylaw provisions. If there is no company notice provision, then notice must be provided no later than 120 calendar days before the date that the company mailed its proxy materials for the prior year's annual meeting.

The Schedule 14N would be filed with the SEC on the same date that it is sent to the company and would include:

- The name and address of the nominating shareholder(s).
- The amount and percentage of securities beneficially owned and entitled to vote at the meeting.
- A written statement of the record holder of shares or each member of a group verifying that, as of the date of notice, the shareholder(s) continuously held the securities for at least one year.
- A written statement of the nominating shareholder or group evidencing their intent to continue owning the requisite shares through the shareholder meeting at which directors are elected.
- A certification that, to the best of the nominating shareholder's or group's knowledge and belief, the securities are not held for the purpose of or with the effect of changing the control of the issuer.

Schedule 14N would also contain a number of other statements constituting representations and disclosures to the company, including:

- A representation that the nominating shareholder(s) are eligible to submit a nominee under Rule 14a-11.
- A representation that, to the knowledge of the nominating shareholder(s), the candidate's nomination or service on the board would not violate controlling state law, federal law, or applicable listing standards.
- A representation that, to the knowledge of the nominating shareholder(s), the

nominee meets the objective criteria for independence from the company set forth by any applicable national securities exchange or association.

- A representation that neither the nominee nor the nominating shareholder(s) has an agreement with the company regarding the nomination of the nominee.
- A statement from the nominee that he/she consents to be named in the company's proxy statement and to serve on the board if elected.
- A statement that the nominating shareholder(s) intend to continue to own the requisite amount of securities through the date of the meeting.
- Disclosures about the nominee complying with the requirements of Items 4(b), 5(b), 7(a), 7(b), and 7(c), and for investment companies, Item 22(b) of Exchange Act Schedule 14A.
- Disclosures about the nominating shareholder(s) as currently required pursuant to Item 4(b) and Item 5(b) of Schedule 14A in a contested election.
- Disclosure about the nominating shareholder(s) having been involved in any legal proceeding during the past five years, as in Item 401(f) of Regulation S-K.
- Disclosure of any Website address on which the nominating shareholder(s) may publish soliciting materials.
- If desired by the nominating shareholder(s), any statement of less than or equal to 500 words in support of the nominee for inclusion in the proxy materials.

The nominating shareholder(s) would also be required to include the following disclosures about the nature and extent of any relationships with the company:

- Any direct or indirect material interest in any agreement between the nominating shareholder(s) or the nominee and the company or any of its affiliates (including employment or consulting agreements).
- Any material pending or threatened litigation in which the nominating

shareholder(s) are a participant that involves the company, any of its officers or directors, or any affiliate of the company.

- Any other material relationship between the nominating shareholder(s) and the company or any affiliate of the company.

6. Requirements for a Company Receiving a Schedule 14N Notice

Upon receipt of a Schedule 14N notice from any shareholder(s), a company must determine whether any of the events permitting exclusion of a shareholder nominee from its proxy materials have occurred (as described below). If not, the company must notify the shareholder(s) in writing no later than 30 calendar days before the filing of the company's definitive proxy materials that it will include the nominee(s). Under proposed Rule 14a-11, a company may exclude a nominee if:

- Rule 14a-11 is not applicable to the company.
- The nominating shareholder(s) have not complied with Rule 14a-11.
- The nominee does not meet the requirements of Rule 14a-11.
- Any representation supplied on Schedule 14N is materially false or misleading.
- The company has received more nominees than it is required to include, and the excluded nominee was offered too late under Rule 14a-11(d)(3).

When any shareholder nominee(s) are included in the proxy, then a company can identify any shareholder nominee(s) that were not selected by the board or its nominating committee, and can recommend how shareholders should vote for each nominee. However, the proposed rules would not permit a company to provide shareholders with the option of voting for the company's nominees as a group, instead requiring votes for each individual nominee.

Any written soliciting materials provided by the shareholder(s) outside of the company's proxy statement would be required to filed with the SEC in accord with proposed Rule 14a-2(b)(7) or (b)(8) on the date of first use.

7. Application of Other Proxy Rules to Solicitations by Nominating Shareholder(s)

Under the SEC proposal, Exchange Act Rules pertinent to proxy solicitations, Rules 14a-3 to 14a-6 ("Information to be Furnished to Security Holders", "Requirements as to Proxy", "Presentation of Information in Proxy Statement" and "Filing Requirements"[except subparagraphs 14a-6(g) and (p)] and 14a-8, 14a-10, and 14a-12 to 14a-15, would not apply to any solicitation by or on behalf of any shareholder in connection with a nominating shareholder group, provided that:

- Each communication includes only: (1) a statement of the shareholder's intent to form a nominating group to nominate a director under the proposed rule; (2) a brief statement regarding the potential nominee(s) or the characteristics of desirable nominee(s); (3) the percentage of securities the nominating shareholder beneficially owns or the aggregate amount held by a shareholder group; and (4) the means to contact the soliciting party.
- Any written soliciting material is filed with the SEC by the nominating shareholder(s) no later than the date of first publication, delivery or communication.

GOVERNING DOCUMENTS: EXCHANGE ACT RULE 14a-8(i)(8)

Proposed amendments to Rule 14a-8(i)(8) would also enable shareholders, under certain circumstances, to require a company to include in its proxy materials any proposal to amend company governance documents pertinent to shareholder nominations for director. Such a proposal would still be subject to exclusion if its implementation would violate any applicable state, federal or foreign rule, or if it would conflict with Proposed Rule 14a-11.

1. Disclosure Requirements

The SEC specifically declined to create new disclosure requirements for any shareholder(s) proposing amendments to company governance documents, stating that shareholder(s) "may simply want to amend the company's [nominating] procedures, but may not intend to nominate any particular individual." However, when a nomination is made pursuant to a new

governance provision, proposed Rule 14a-19 would require any nominating shareholder(s) to include in Schedule 14N similar information to that described above for director nominees.

2. Codification of Prior Staff Interpretations

The SEC has also proposed to amend Rule 14a-8(i)(8) to codify certain prior staff interpretations, which spell out the types of shareholder proposals that will still be excludable from a company's proxy materials. These permitted exclusions relate to proposals that:

- Would disqualify a nominee already standing for election.
- Would remove a director from office before his/her term expires.
- Question the competence, business judgment or character of one or more nominees or directors.
- Nominate a specific individual for election outside of the procedures, rights and rules created by a company's governing documents, state law or federal rules.
- Otherwise are designed to affect the outcome of upcoming director elections.

Proposals that deal with "matters relating to the company's ordinary business operations" or to matters that have been "substantially implemented" by the company would continue to be excludable, as under the existing rules.

OTHER RULE CHANGES

A shareholder group formed solely for the purpose of nominating directors pursuant to proposed Rule 14a-11 would not become subject to filing requirements of Schedule 13D (applicable to investors who could effect a change of control by virtue of owning more than five percent of an equity class) provided that the group would still have to file limited disclosures on Schedule 13G (for those not seeking to effect a change of control). The right to utilize schedule 13G would not apply where nominations are submitted pursuant to state law (rather than Rule 14a-11) or a company's governing documents because those provisions may not limit the number of board seats open to nomination.

The SEC explicitly rejected, however, proposals by various commentators to exclude nominating shareholder groups from certain Exchange Act Section 16 rules applicable to insider trading and disclosures by those holding 10 percent equity ownership (including the filing of Form 3, Form 4 and Form 5).

GENERAL REQUESTS FOR COMMENT

In its release, the SEC also posed numerous specific questions for public comment concerning the adequacy, workability and likely effectiveness of the proposed rules.

Comments must be received by the SEC on or before August 17, 2009.

Explanatory Notes:

This update is intended to call your attention to a number of proposed rule changes of possible interest and relevance, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these rule changes or if you want to learn more about our expertise in this area.

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In the securities compliance area, we advise our clients on corporate governance/Sarbanes-Oxley and SEC and stock exchange reporting and compliance. Specifically, we assist our clients in fulfilling their ongoing SEC and stock exchange reporting obligations, managing sensitive disclosure issues internally and with industry analysts, preparing proxy statements and handling stockholder meetings, structuring employee benefit plans and executive compensation packages under the SEC's "short-swing profit" reporting and liability rules, effecting re-sales of securities in the public trading markets under the SEC's Rule 144, and advising boards of directors and board

committees concerning the requirements and restrictions imposed on their actions by the securities laws and corporate governance laws such as Sarbanes-Oxley. We have served as special securities counsel to the Boards and Audit Committees of publicly traded companies looking for opinions or advice of counsel other than their regular outside counsel.

We have counseled clients both domestic and international, from high technology and life sciences to emerging growth companies, and are positioned to provide clients with timely, expert, efficient and cost effective advice that they need to meet their business objectives. We take a practical and proactive approach to the rapidly changing securities disclosure and corporate governance laws, providing our clients with timely updates, identifying specific situations in which the new laws will impact particular clients either operationally or structurally, and working with clients to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

Underwriters and Investment Banks

Our attorneys also represent underwriters in initial and follow-on public offerings and investment banks in private placements and mergers and acquisitions.