

Legal Alert

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SEC Proposes Rule to Facilitate Rights of Shareholders to Nominate Directors

The Securities and Exchange Commission (the "SEC") has proposed a rule to facilitate director nominations by shareholders of public companies. The precise language of the proposal has not yet been released.

Summary of SEC's Proxy Access Proposal

Under the proposed rule, eligible shareholders would be able to include their nominees for director in a company's proxy unless the shareholders are otherwise prohibited by applicable state law or the company's bylaws from nominating a candidate for election as a director. Shareholders would be eligible to have their nominees included in the proxy materials if:

- They own at least 1 percent of the voting securities of a large accelerated filer (a company with a worldwide market value of \$700 million or more).
- They own at least 3 percent of the voting securities of an accelerated filer (a company with a worldwide market value of \$75 million or more but less than \$700 million).
- They own at least 5 percent of the voting securities of a non-accelerated filer (a company with a worldwide market value of less than \$75 million).

Shareholders would be able to aggregate their holdings to meet these requirements and would be required to have held their shares for at least one year. A nominating shareholder group may include in the company's proxy statement nominees totaling no more than 25% of the board of directors or at least one nominee if 25% of the board of directors is less than one. The nominees must meet the independence requirements of the applicable national securities exchange and have no direct or indirect agreement with the company regarding their nomination.

The nominating shareholder would be required to file with the SEC and submit to the company a new Schedule 14N. Schedule 14N would require disclosure of the amount and percentage of securities owned by the nominating shareholder, the length of ownership, and intent to continue to hold the securities through the date of the annual meeting at which directors are elected. Schedule 14N also would require a certification that the nominating shareholder is not seeking to change control of the company or gain more than minority representation on the board of directors. The company would include disclosure in its proxy concerning the nominating shareholder and the shareholder nominees that is similar to the disclosure currently required in a contested election.



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Current Shareholder Nomination Process

Under the current system, shareholders most often are only given the opportunity to vote for candidates nominated by the company's board of directors, and shareholder-nominated candidates rarely are elected to the board.

Under Pennsylvania law, shareholders of a company may nominate candidates for election to a company's board of directors in compliance with its bylaws. Upon satisfying the nomination requirements, a company must include valid shareholder nominees on the ballot of the shareholders meeting to elect directors. However, current federal proxy rules allow companies to exclude valid shareholder nominees from the company's proxy statement. Though a ballot and proxy are related, the two instruments serve different purposes. The ballot is the means by which votes are cast for a board nominee; the proxy is the means by which shareholders appoint a proxy holder to complete and submit a ballot on the shareholders' behalf.

Unless the nominating shareholders independently solicit a proxy for the election of their nominees, shareholders may only vote for shareholder nominees if they complete and submit a ballot because shareholder nominees are not required to be included in a company's proxy. Since most shareholders submit a proxy rather than a ballot, shareholders rarely see the ballot for a shareholders meeting. Consequently, shareholders who typically authorize a proxy to vote their shares will not have an opportunity to cast their votes for shareholder nominees unless the nominating shareholders independently solicit proxies for their candidates. Independent proxy solicitation costs for shareholders of smaller public companies could require legal and other expenses totaling between \$20,000 to \$80,000. The time and costs involved make independent proxy solicitations prohibitive. Therefore, it is unlikely that nominees of shareholder groups will be elected to a company's board of directors.

Impact of SEC's Proposal on Current Shareholder Nomination Process

The SEC proposal regarding proxy access will mitigate some of the financial obstacles shareholder nominees face when seeking a board seat and shift some of the compliance costs to the company. Requiring a company to include shareholder nominees in the company's proxy substantially reduces the legal and other expenses necessary to independently solicit proxies.

Accordingly, decreasing these costs may encourage shareholder groups to nominate candidates for election to a company's board of directors. If shareholder groups look to take advantage of access to a company's proxy, it is possible that shareholders may be presented with considerably more nominees for election to the board of directors than there are board seats available.

Though the proposed rule is not yet final, it appears that shareholders will be granted some level of access to a public company's proxy statement. Despite this access, board nominees may have an advantage over shareholder nominees because shareholders may infer that a board endorsement indicates that board nominees may be more qualified than shareholder nominees. Nonetheless, it is important that companies take steps to ensure that shareholders have confidence in board nominees. A transparent corporate governance structure will help instill this confidence.

Transparency in corporate governance matters helps create a sense of confidence in shareholders regarding the board's management of the company. Boards should consider providing on their company's website corporate governance documents, such as the company's articles of incorporation, bylaws, committee charters, corporate governance guidelines, job descriptions for the chairman and directors, director recruitment and nomination protocols, and the procedure for evaluating the CEO and board members. Details of some of these items, such as the recruitment of directors and evaluations of the CEO and board members, should be discussed generally. However, including a discussion of these matters in the company's corporate governance guidelines will assure shareholders that the company has an active program to maintain CEO and board performance.

If you have questions regarding the SEC's proxy access proposal or your company's corporate governance programs, please contact any of the following by phone at 717-731-1700 or by email:

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