Client Advisory

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# SEC Proxy Access Proposals Expected in May

*Proposed New Rules Will Likely Effectuate New Delaware Law Permitting Proxy Access Bylaws While Expanding Federal Regulation of the Proxy Process*

On April 10, the Governor of Delaware signed into law a new provision of the Delaware General Corporation Law allowing stockholders "access" to the proxy statement in director elections. Specifically, new Section 112 of the DGCL, which becomes effective on August 1 of this year, will permit a Delaware corporation to adopt a bylaw that would require the corporation to include in its proxy statement one or more candidates for membership on the company's board who has been nominated by eligible stockholders.

The new Delaware rules cannot be fully effectuated without action by the SEC. The SEC has indicated that it will propose its own "proxy access" rules this month, and those rules may be based in whole or in part on the new Delaware legislation.

## New DGCL Sections 112 and 113

Bylaws adopted under the new Section 112 of the DGCL may include, but are not required to include, procedures and conditions that would apply to such nominations. The new law includes a non-exclusive list of conditions that a stockholder and their nominees could be required to satisfy in order to be included in a company's proxy materials, relating among other things to:

- minimum stock ownership and duration of ownership by the nominating shareholder(s);
- specified information about the director nominees, and about the nominating shareholder, including amount and duration of stock ownership;
- a limit on the number or proportion of directors that may be nominated (e.g., nominations could be limited to a "short slate");
- preclusion of nominations by persons who have acquired a certain percentage of stock ownership, or who have publicly proposed to acquire such a percentage; and
- appropriate indemnification of the company for any false or misleading statement made or provided by the nominating stockholder.

A corporation's adoption of any bylaws adopted under Section 112 will be subject to any procedures, including voting thresholds, already included in the company's charter and bylaws. The new statute does not impose any additional procedures or disclosure requirements.

For more information, please contact one of the Katten Muchin Rosenman LLP Securities attorneys listed below:

**Matthew S. Brown**
312.902.5207 / matthew.brown@kattenlaw.com

**Robert L. Kohl**
212.940.6380 / robert.kohl@kattenlaw.com

**Herbert S. Wander**
312.902.5267/ hwander@kattenlaw.com

**Mark D. Wood**
312.902.5493 / mark.wood@kattenlaw.com

**Frank Zarb**
202.625.3613 / frank.zarb@kattenlaw.com

In addition to new Section 112, new Section 113 (also effective on August 1, 2009) permits the bylaws of a Delaware corporation to provide for the reimbursement of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, again subject to such procedures and conditions that the bylaw may include. The new Section provides a few examples, such as:

- conditioning reimbursement on the number or proportion of persons nominated by the stockholder seeking reimbursement, or on whether the stockholder had sought reimbursement in the past;
- limitations on the amount of reimbursement based on the proportion of votes cast in favor of one or more of the persons nominated by the stockholder seeking reimbursement, or based on the amount that the company spent soliciting proxies for the election; and
- limitations tied to the availability of cumulative voting in the election.

## SEC Proposals on "Access" Are Expected

As a practical matter, unless or until the SEC modifies its own rules, a stockholder may not succeed in having a bylaw amendment placed on the ballot under new Section 112 of the DGCL. That is because the SEC's rule that governs which proposals can be included on a corporation's proxy card currently prohibits proposals that relate to the election of directors. In December 2007, the Commission definitively reaffirmed its longstanding position that its rule in question—Rule 14a-8(i)(8)—would exclude from a corporation's proxy materials any stockholder proposal that proposed the nomination for membership on the board of directors, or procedures for such nominations. Thus, any stockholder proposal for a bylaw amendment establishing procedures for the election of directors under new Section 112 of the DGCL could be blocked by the corporation under Rule 14a-8(i)(8).

Of course, prior to any SEC rules changes, the corporation could permit the proposal to be included on its proxy card, since the SEC's rules allow, but do not require, a corporation to block such a proposal under Rule 14a-8(i)(8).

In all events, the SEC is expected to amend Rule 14a-8(i)(8) to permit stockholder proposals relating to director elections. In a speech to the Counsel of Institutional Investors in April, SEC Chairman Mary Schapiro stated that next month "the Commission will consider a proposal to ensure that a company's owners have a meaningful opportunity to nominate directors." Indeed, the new Delaware law may provide the SEC with an additional tool as it considers ideas for providing stockholders with more input into director elections. In her speech, Chairman Schapiro elaborated that the Commission will reexamine its own prior proposals on the subject in 2003 and 2007, but that "we're also considering the potential impact of proposed changes to Delaware's corporate law."

The Commission's 2003 and 2007 proposals for proxy access would have granted stockholders a federal right to propose bylaw amendments that would permit stockholders to have their director nominees included in the company's proxy statement, but subject to disclosure and other preconditions, including information about the nominating shareholder and the director nominees, as well as to minimum beneficial or record ownership thresholds. The recent Delaware amendments provide the Commission with the option of taking an approach that would be less intrusive of state laws governing stockholder meetings as compared to the Commission's 2003 and 2007 proposals. While new Section 112 will provide a state-law right to adopt a bylaw allowing stockholders to nominate director candidates who would be required to be included in the company's proxy materials alongside the company's nominees, the SEC could simply impose corresponding disclosure requirements. Under that approach, each corporation would be free to set its own ownership, holding period and other eligibility criteria.

Alternatively, the SEC could decide to adopt rules that preempt the new Delaware provision only in part. The Commission's 2007 proposals on proxy access would have established certain federally imposed criteria for the submission of proxy access bylaws—such as a 5% ownership threshold for submission of such a bylaw—but would have left other aspects of the process to be governed by state law. In forming new proposals, the SEC could take a similar approach, by preempting the new Delaware legislation in some respects, but deferring to it in others. For example, while the Delaware legislation does not attempt to prescribe specific ownership thresholds for proposing proxy access bylaws, the SEC could do so under its Rule 14a-8.

One hurdle to an approach that is based on the new Delaware legislation is that many companies are not incorporated in Delaware, so the new legislation will not be available to their stockholders. Of course, the Commission could adopt an approach premised on the Delaware amendments and urge other states to follow Delaware's lead. In fact, the Committee on Corporate Laws of the Section of Business Law of the American Bar Association, which is responsible for the Model Business Corporation Act, is actively considering amending the Model Business Corporation Act to address the issue. The SEC could also opt for a two-track approach, by both imposing disclosure requirements on those that invoke the Delaware procedures, and also creating a separate federal right to propose and implement stockholder nominee proxy access bylaws.

Some groups have consistently questioned the SEC's authority under existing legislation to adopt a federal approach to proxy access. Absent new legislation on the subject, an approach that preserves a role for state law (such as new DGCL Section 112) stands a better chance of avoiding or surviving legal challenge.

## Other SEC and Congressional Actions Seem to Presage Swift Change

Senator Charles Schumer of New York very recently announced plans to introduce legislation that appears to presage more federal preemption of state law in the administration of proxy voting and other areas of corporate governance at public companies. Senator Schumer's "Stockholder Bill of Rights of 2009" would:

- require annual stockholder advisory votes on executive compensation policies and stockholder approval for "golden parachute" arrangements;
- confirm the SEC's authority (vis-à-vis state law) to grant stockholders "access to the corporate proxy for nominations to the board of directors";
- require annual election of all directors, to be conducted by majority voting rather than plurality voting;
- require separation of the roles of CEO and chairman; and
- require boards to create a separate risk committee.

Finally, on a different but related note, further evidence of the SEC's commitment to quickly change the status quo regarding stockholder influence in governance matters was reported by *The Wall Street Journal* on April 24. As reported, the SEC will significantly curtail the rule on "broker discretionary voting," which currently allows brokers to vote their customers' shares in director elections in the absence of specific voting instructions.

## What Companies Should Do Now

In addition to monitoring developments closely, we believe that companies and other industry participants should begin to think about how they should respond to the new developments.

Companies incorporated in Delaware should await further developments before taking any concrete action. They and their counsel should, however, begin to evaluate whether or not they would want to adopt a proxy access bylaw amendment that includes eligibility conditions and procedures for stockholder proxy access with which they are comfortable. Such a bylaw amendment might serve as a proactive measure that anticipates shareholder proposals on the same subject. For example, companies may wish to limit the number of stockholder nominees to a "short slate" of directors, and they may also wish to exclude stockholders that have announced an intent to seek control of the company. Companies should also consider minimum stock ownership levels and holding periods that would apply to stockholders or groups of stockholders that wish to promote nominees for director. Of course, future guidance to be provided by proxy advisory firms, such as Risk Metrics Group, Inc., should be considered in designing any bylaws on the subject.

Finally, because any SEC action will involve proposals and an opportunity to comment, all companies and industry participants should consider submitting comments individually and/or through industry organizations. We understand that the SEC is committed to issuing proposals imminently. As of now, it appears that the SEC will likely adopt final rules on the subject in time for the 2010 proxy season. Any such rules may bring fundamental change to the manner in which companies are governed, and we expect that the SEC will, accordingly, be particularly sensitive to comments and suggestions from all interested parties that are focused on making any new rules as practical as possible.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK PALO ALTO WASHINGTON, DC

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