Legal Affairs

An eye on change

How proposed SEC Rule 14a-11 could affect your business

By Meredyth McKenzie
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A new rule could be in place if the Securities and Exchange Commission votes in favor of it in 2010, as expected. Proposed Rule 14a-11 would require public companies subject to the proxy rules contained in the Securities Exchange Act of 1934 to allow for shareholder nominations in the company's own proxy materials, instead of having shareholders take on this process and incur expenses themselves. Similar rules were proposed in 2003 and 2007 but were not approved. This new proposal would make boards of directors more shareholder focused.

"There's a fear that directors are not paying attention to shareholder needs," says Erin E. Reeves, associate with Baker, Donelson, Bearman, Caldwell & Berkowitz PC. "The thought is that if boards are fearful that shareholders will be able to nominate their own candidates more easily, directors will have to be more responsive to shareholders."

Smart Business spoke with Reeves about proposed SEC Rule 14a-11 and its implications for businesses.

What are the specifics of proposed Rule 14a-11?

Boards of directors are elected annually by a company's shareholders from a slate of candidates. Typically, the current board proposes the slate of nominees and the company distributes information about them in a proxy statement. Shareholders can nominate their own candidates for the board at the annual meeting, but this is usually ineffective because most votes have been cast by proxy before the actual meeting. Shareholders do have the option to launch a proxy fight and nominate their own candidate in their own proxy materials, but the expense of doing so often deters shareholders from that option. This new rule attempts to remove that barrier.

In addition to some limitations on the percentage of directors that can be nominated through this process and a one-year share ownership requirement, the proposed rule contains a tiered system to determine which shareholders can take advantage of it:

- A shareholder must own 1 percent of shares for companies with net assets of $700 million or more.
- A shareholder must own 3 percent of shares for companies with net assets between $75 million and $700 million.
- A shareholder must own 5 percent of shares for companies with net assets of less than $75 million.

The rule would allow for aggregation among shareholders to meet these threshold amounts. It may seem like 5 percent of shares is a lot, but it might be possible with aggregation.

What implications would this proposed rule have on businesses?

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The rule may not be approved in its current form, so the implications may change. There may be changes made before the vote next year or the SEC might decline to vote on it at all.

If it is passed in its current form, it would cause a big change in the way public company boards operate. Companies would have to brace for the possibility of shareholder nominees to the boards. There might be more dissident shareholder groups that end up with representation on the board.

Companies will also have to be receptive to information from shareholders before annual meetings. All of the information regarding shareholder nominees will have to be gathered and included in proxy materials for the meeting.

What are the benefits and drawbacks of the proposed rule?

Boards of directors may be more focused on the shareholders and less prone to making unnecessary and risky decisions for the company.

Some drawbacks include increased costs for companies to gather shareholder information to be included in proxy materials. The cost increase will depend on the size of the company and the number of shareholder nominees. There are limits on the number of directors who can be nominated through this process, so that would control some of the costs.

Another argument against the rule is that it would make companies vulnerable to the interests of dissenting shareholders. Directors who previously felt secure in their positions may be worried about being ousted, and they may also be worried more about the short term and what will happen in the next year with the shareholders instead of the company's long-term results.

How can you keep up to date on everything happening with the proposed rule?

Pay attention to any further discussion of the rule in the coming weeks, and the vote as well, if it happens. Back in May before the comment period, the SEC was split 3-2 in favor of the rule. There's been a push toward getting something done about this issue, but the rule may not be passed in this exact form, depending on the comments received and any changes that are made. Companies should read the proposed rule, which can be found in SEC Release 33-9046, and be prepared to factor in the potential costs of including shareholder nominations in company proxy materials. There will be an effective date if the rule is passed, which would give you time to do more research and adapt to the rule's requirements. If the rule is not passed next year, but the issue is something that would affect your company, make sure to stay alert to the issue and send in comments if a similar rule is proposed again.

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