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CLIENT MEMORANDUM

SEC ADOPTS "PROXY ACCESS" RULES TO FACILITATE DIRECTOR NOMINATIONS BY SHAREHOLDERS

On August 25, 2010, the Securities and Exchange Commission (the "SEC") adopted, in a 3-2 vote along party lines, a comprehensive set of "proxy access" rules that will allow shareholders and shareholder groups that have held 3% or more of a company's stock for at least three years to include director nominees in the company's annual meeting proxy materials.[1] The rules will be effective 60 days after publication in the Federal Register, in time for most companies' 2011 annual meetings, although implementation of the rules will be delayed three years for "smaller reporting companies."[2]

Citing the economic crisis and an erosion of investor confidence in the management practices of certain companies, the SEC proposed proxy access rules in June 2009 and reopened the comment period in December. The proposals received extensive comment, both favoring and opposing adoption, and were approved following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which expressly authorized the SEC's adoption of proxy access rules.[3] Important changes were made in the final rules as a result of public comment, including changes to the eligibility criteria for shareholders and shareholder groups seeking proxy access.

As adopted, the proxy access rules make two significant changes to the federal proxy rules by adding new Rule 14a-11 and amending existing Rule 14a-8(i)(8) under the Exchange Act. Subject to shareholder eligibility qualifications and other limitations, these rules require most Exchange Act reporting companies to include in their proxy materials:

- director nominees proposed by a shareholder or group of shareholders; and
- shareholder proposals to amend the company's governing documents regarding nomination procedures or disclosures related to shareholder nominations.

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[1] *Facilitating Shareholder Director Nominations*, Securities Exchange Act of 1934 Release No. 62764 (August 25, 2010), available at http://www.sec.gov/rules/final/2010/33-9136.pdf.

[2] "Smaller reporting companies" is defined in Rule 12b-2 under the Securities Exchange Act of 1934 (the "Exchange Act"). The category generally consists of companies, other than registered investment companies and asset-backed issuers, having a public float of less than $75 million, as measured annually at the end of the second fiscal quarter.

[3] Section 971 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, amending Section 14(a) of the Exchange Act.

In connection with these central changes to its proxy rules, the SEC has adopted a number of conforming and related changes to other rules and regulations. Among other things, the SEC has exempted from most of its proxy rules solicitations made for the limited purpose of forming a nominating group to take advantage of proxy access. In a similar vein, the SEC has revised its beneficial ownership reporting requirements under Regulation 13D-G to provide that participation in a nominating group under Exchange Act Rule 14a-11 does not by itself bar a participant from meeting the "passivity" requirement for Schedule 13G eligibility. In addition, because Rule 14a-11 does not preclude states, foreign jurisdictions or companies from granting shareholders the right to include their nominees in a company's proxy materials,[4] the SEC adopted new Rule 14a-18, which imposes disclosure requirements substantially similar to those under Rule 14a-11 when shareholder nominees are submitted for inclusion in a company's proxy statement pursuant to applicable state or foreign law or a company's governing documents.

The New Proxy Access Rules

New Exchange Act Rule 14a-11

Under Rule 14a-11, companies are required, subject to shareholder eligibility qualifications and other limitations, to include shareholder nominees for director in their proxy materials for annual or special meetings at which directors are to be elected. This requirement applies unless state or foreign law, or a company's governing documents (which must be consistent with applicable law), prohibits shareholders from nominating directors. Rule 14a-11 applies to all companies subject to the proxy rules under the Exchange Act (including investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act")), other than companies that are subject to the proxy rules solely because they have a class of debt registered under Section 12 of the Exchange Act.[5] As noted above, the effective date of Rule 14a-11 has been delayed three years for "smaller reporting companies," as defined in Exchange Act Rule 12b-2.

(a) ***Number of Shareholder Nominees/Directors.*** A company is required to include in its proxy materials no more than the greater of one shareholder nominee or the number of shareholder nominees (with any fraction rounded down) that represents 25 percent of the company's entire board of directors, whether or not all directors are elected annually. Any director previously elected as a shareholder nominee pursuant to Rule 14a-11 and whose term of office extends past the date of the shareholder meeting will count toward

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[4] Delaware recently added Section 112 to its General Corporation Law, effective August 1, 2009, which allows a company's bylaws to include a provision requiring the inclusion of a shareholder's nominees in the company's proxy materials. Section 112 provides a list of permissible conditions that may be included in such a bylaw in order to limit the scope of the right.

[5] Foreign private issuers are not subject to the proposed rule because they are exempted from the SEC's proxy rules under Exchange Act Rule 3a12-3. However, foreign issuers that do not qualify as foreign private issuers and that are subject to the SEC's proxy rules generally will be covered.

that total. If multiple qualifying nominations are made, they will be honored based on the size of each nominating shareholder or shareholder group's stake in the company, up to the maximum number, rather than on a "first-come, first-served" basis as proposed in June 2009.

(b) ***Stock Ownership Requirements.*** To be eligible to nominate directors under Rule 14a-11, a shareholder or group of shareholders must:

- beneficially own, as of the date of the shareholder notice on new Schedule 14N, at least 3% of the company's voting securities;
- have beneficially owned such securities continuously for at least three years as of the date of the shareholder notice on Schedule 14N; and
- represent that it intends to continue to own those securities through the date of the annual or special meeting.

For purposes of these eligibility requirements, beneficial ownership requires both investment and voting power, but shares out on stock loan are considered beneficially owned (even though a lender of stock gives up the power to vote) if the stock loan *can* be recalled and *will* be recalled if the company advises the shareholder or shareholder group that one or more of its nominees will be included in the company's proxy materials. Shares sold in a short sale that is not closed out, and shares borrowed for purposes other than a short sale, reduce beneficial ownership under the eligibility requirements. Other hedging techniques that reduce economic exposure, such as taking the short side of an equity swap on a company's shares, do not affect this beneficial ownership calculation.

(c) ***New Schedule 14N.*** To take advantage of Rule 14a-11, the nominating shareholder or group must provide to the company and file with the SEC a notice on new Schedule 14N. In addition to requiring disclosure about the nominee or nominees to be included in the company's proxy materials, the Schedule 14N must:

- include a certification by the nominating shareholder or group that it does not hold its securities for the purpose or with the effect of changing control of the company or to gain more than the maximum number of seats on the board permitted under Rule 14a-11;
- be filed and transmitted to the company no earlier than 150 days, and no later than 120 calendar days, before the anniversary of the date on which the company mailed its proxy materials for the prior year's annual meeting, except that if the company did not hold an annual meeting the prior year, or if the date of the meeting has changed by more than 30 days from the prior year, then the nominating shareholder

or group must provide notice a reasonable time before the company mails its proxy materials;[6] and

- include disclosure about the amount and percentage of securities owned by the nominating shareholder or group, the length of ownership of such securities, the nominating shareholder or group's intent to continue to hold the securities through the date of the meeting as well as its intent with respect to continued ownership after the election, and certain other information regarding the nominating shareholder or group. The nominating shareholder or group may also include in its Schedule 14N a statement in support of its nominees, not to exceed 500 words per nominee, which the company is required to include in its proxy statement.

(d) ***Director Nominee(s).*** The nominating shareholder or group is required to represent that each shareholder nominee satisfies the "bright-line" independence requirements of the national securities exchange or national securities association rules applicable to the company, if any, but is not required to satisfy those elements of any such rule that impose an independence standard requiring a subjective determination by the board or committee of the board.[7] The nominating shareholder or group also is required to represent that neither the shareholder or group nor any nominee or group member has an agreement with the company regarding the nomination. Rule 14a-11 does not include any limitations on agreements or relationships between the nominating shareholder and its nominee.

(e) ***Process and Timing for Excluding Shareholder Director Nominations.***

- Within fourteen (14) calendar days after the company's receipt of the nominating shareholder or group's notice on Schedule 14N, the company must notify the nominating shareholder or group of any determination not to include the nominee or nominees, or the shareholder or group's supporting statement, and the basis for the exclusion.

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[6] To facilitate implementation of this provision, the SEC has amended Form 8-K by adding Item 5.08, which requires a company to disclose the "reasonable time" by which this notice is due if the company did not hold an annual meeting the prior year or has changed the date of its next annual meeting by more than 30 days from the date of the prior year's annual meeting. This Form 8-K filing requirement applies to all reporting companies, including investment companies, even though investment companies are generally not required to file Form 8-K.

[7] For investment companies, the nominating shareholder or group must instead represent that no nominee is an "interested person" of the investment company as defined in Section 2(a)(19) of the Investment Company Act.

- Within fourteen (14) calendar days after the nominating shareholder or group's receipt of the company's exclusion notice, the nominating shareholder must correct any eligibility or procedural deficiencies identified in that notice that are permitted by the rule to be corrected.

- No later than eighty (80) calendar days before the company files its definitive proxy statement and form of proxy with the SEC, the company must provide to the SEC and to the nominating shareholder or group notice of any intention to exclude a nominee or supporting statement and the basis for its determination. At this time, the company may also seek the informal views of the SEC staff as to the intended exclusion, in the form of a no-action letter request.

- Within fourteen (14) calendar days after receipt of the company's notice of an intention to exclude a nominee or supporting statement, the nominating shareholder or group must respond to that notice and may also respond to any no-action letter request. Following these submissions, the SEC staff may, at its discretion, provide no-action guidance to the company and the nominating shareholder or group.

- Finally, no later than thirty (30) calendar days before the company files its definitive proxy statement and form of proxy with the SEC, the company must notify the nominating shareholder or group whether it will include or exclude the nominee or nominees. The exclusion of a shareholder nominee by a company when that exclusion is not permitted is a violation of Rule 14a-11.

(f) ***Prohibition on Slate Voting.*** Under Rule 14a-11, if a shareholder nominee is included in a company's proxy materials, the proxy card cannot provide to shareholders the customary option of voting for all company nominees as a group. Instead, each nominee must be voted on separately.

(g) ***Liability Provisions.*** A nominating shareholder or group relying on Rule 14a-11, an applicable state or foreign law provision, or a company's governing documents to include a nominee in company proxy materials will be liable for any materially false or misleading statement in its Schedule 14N that is included in the company's proxy materials. Conversely, the rules provide that the company is not responsible for any such information included in its proxy statement. In addition, the rules provide that any such shareholder-supplied information included in a company's proxy statement will not be incorporated by reference into any filing under the Securities Act of 1933, the Exchange Act or the Investment Company Act unless the company determines to incorporate that information by reference specifically into that filing.

Amended Exchange Act Rule 14a-8(i)(8)

Exchange Act Rule 14a-8 provides shareholders with an opportunity to place a proposal in a company's proxy materials for a vote at an annual or special meeting of shareholders. However, under Rule 14a-8(i)(8) prior to its amendment, a company could exclude shareholder proposals concerning director elections.[8] In interpreting this provision, the SEC took the position in 2007 that Rule 14a-8(i)(8) permits exclusion of a proposal that would establish a procedure that might result in a contested board election.

Under amended Exchange Act Rule 14a-8(i)(8), companies can no longer rely on Rule 14a-8(i)(8) to exclude from their proxy materials shareholder proposals by qualifying shareholders that would amend, or that request amendment of, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations, provided that the proposal does not conflict with Rule 14a-11. Among other things, Rule 14a-8(i)(8), as amended, allows shareholders to include in a company's proxy materials proposed bylaw provisions that would afford proxy access to shareholders under conditions other than those permitted under proposed Rule 14a-11. However, to the extent that such a proposal would, if adopted, prevent a qualifying shareholder from making a nomination under Rule 14a-11, that proposal could be excluded under Rule 14a-8(i)(8) because it would conflict with Rule 14a-11.

Related Rule Changes

In connection with adoption of Rule 14a-11, the SEC has added two new proxy rule exemptions, one to facilitate the formation of nominating groups and the other to allow for solicitations in favor of shareholder nominees under Rule 14a-11 (or against company nominees) that are conducted outside of the company's proxy materials. The SEC has also amended the Schedule 13G filing criteria so that shareholders or groups that nominate directors under Rule 14a-11 are not necessarily forced to file any required beneficial ownership reports on Schedule 13D.

Communications among shareholders who seek to form a group for the purpose of nominating one or more directors generally are considered to be "solicitations" within the meaning of the SEC's proxy rules. In order to facilitate group formation without imposing significant burdens on the process, the SEC has adopted a proxy rule exemption, Rule 14a-2(b)(7), that is narrowly tailored to "solicitations" in connection with nominating group formation. Under the exemption, written communications are significantly limited as to content, but oral communications are not so limited. Written communications must be filed with the SEC under cover of Schedule 14N no later than the time they are first published, sent or given, and notice of oral communications must be given by filing the Schedule 14N cover page no later than the date of the first such

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[8] Rule 14a-8(i)(8) currently provides, prior to effectiveness of this amendment, that a company need not include a proposal that "relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election."

communication.[9] The Rule 14a-2(b)(7) exemption, though, is subject to a significant limitation in that it is not available for any shareholder that subsequently engages in solicitations other than those in connection with the election of a director nominee under Rule 14a-11.

The other proxy rule exemption adopted, Rule 14a-2(b)(8), allows solicitations in support of the election of nominees who are included in the company's proxy materials under Rule 14a-11. The exemption does not allow a soliciting party to seek the power to act as a proxy for another shareholder, and it requires that any written communication contain certain information about the soliciting party and a legend about the availability and advisability of reading the company's proxy statement. Written solicitations under Rule 14a-2(b)(8) must be filed under cover of Schedule 14N when they are first published, sent or given, and reliance on this exemption precludes the use of any other exemption from the proxy rules.

The SEC has also adopted changes to its Schedule 13G filing requirements to reflect its belief that shareholders or groups that would otherwise be eligible to file beneficial ownership reports on Schedule 13G rather than Schedule 13D (including shareholder nominating groups) should not lose this eligibility solely as a result of engaging in nominating or soliciting activities, or as a result of the election of one or more of their nominees. For most Schedule 13G filers, who file under Rule 13d-1(b) or Rule 13d-1(c), there is a requirement that the filer not have acquired its shares with the purpose or effect of changing or influencing control of the company. To allow shareholders and shareholder groups to meet these requirements, the SEC has modified Rule 13d-1(b) and Rule 13d-1(c) to carve out any activities undertaken solely in connection with a nomination under Rule 14a-11.

These new proxy rule exemptions, and the modification of the Schedule 13G eligibility requirements, are limited to activities under Rule 14a-11 and do not apply to solicitations and activities where shareholder nominees are included in a company's proxy statement under state or foreign law or the company's governing documents. The SEC has limited their application in this way because there is no assurance that state or foreign law, or a company's governing documents, would require that nominating shareholders not have a control intent or be limited to proposing the number director of nominees permitted under Rule 14a-11.

Looking Forward and Next Steps for Companies

The SEC's proxy access rules are likely to have a profound effect on the election of corporate directors and corporate governance. Before adoption of the proxy access rules, corporate boards chose the director nominees whose candidacies would be funded by the company, and contested elections were relatively few due to the significant cost of mounting an election contest and the

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[9] For the formation of a nominating group where ten or fewer shareholders will be contacted, shareholders can rely on the proxy rule exemption under Rule 14a-2(b)(1), which allows both written and oral solicitations and does not require any filing with the SEC. If additional shareholders are contacted, the additional communications can be made subject to Rule 14a-2(b)(7) without jeopardizing the first exemption.

reality that such costs are unlikely to be reimbursed absent a successful change in board control or a negotiated settlement. With the adoption of proxy access, non-control election contests are likely to become more frequent, and shareholders may gain additional leverage in discussions with corporate managements in advance of annual meetings.

While most of the focus of the corporate community has been placed on Rule 14a-11 and federally-mandated proxy access, the SEC's amendment of Rule 14a-8 may prove to be a "sleeper" provision. Under amended Rule 14a-8, shareholders in many cases will be able to propose bylaw amendments to implement proxy access, on a *mandatory* basis, with even lower eligibility requirements than those imposed by Rule 14a-11. The amendment of Rule 14a-8 will also open the door to shareholder proposals for other significant changes to proxy access rights, as well as to other types of shareholder proposals that can affect future corporate elections. Whether or not any of these shareholder proposals pass, they will likely bring about a much greater focus on corporate elections than public companies have experienced in the past.

With the 2011 proxy season just around the corner, we recommend that companies begin to review their governance provisions in light of the altered landscape and start to consider how they would handle a contested election. This analysis should involve, at least, a review of nominating and governance committee charters, familiarization with the rules and practices in contested elections, and developing an understanding of the issues that are most frequently raised in election contests by "passive" investors and whether and how those issues might play out in the context of their own company.

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If you have any questions regarding the SEC's proxy access rules or would like assistance in working through the challenges of proxy access, please contact Serge Benchetrit (212-728-8798, sbenchetrit@willkie.com), David K. Boston (212-728-8625, dboston@willkie.com), Steven J. Gartner (212-728-8222, sgartner@willkie.com), William H. Gump (212-728-8285, wgump@willkie.com), Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), Michael A. Schwartz (212-728-8267, mschwartz@willkie.com), Steven A. Seidman (212-728-8763, sseidman@willkie.com), Adam M. Turteltaub (212-728-8129, aturteltaub@willkie.com) or the Willkie attorney with whom you regularly work.

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