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SEC Adopts Final Rules on Proxy Access and Facilitation of Nominations of Directors by Shareholders

On August 25, 2010, the Securities and Exchange Commission (“SEC”) adopted [final rules](#) to facilitate nominations of directors by shareholders, including so-called “proxy access” rules. As adopted, the rules permit any shareholder or group of shareholders that has owned three percent or more of the company’s voting stock for at least three years to include director nominees in that company’s proxy materials. Shareholders will be entitled to include the greater of one nominee or the number of nominees that represent twenty-five percent of the total number of the company’s directors. As explained in the SEC’s 451-page release, the rules are mandatory and will become effective sixty days after publication in the federal register, though the SEC granted a three-year reprieve to “smaller reporting companies.” The rules fundamentally affect the manner in which directors are elected and deserve close attention.

Key Highlights of the Final Rule 14a-11

The proxy access rules, which the SEC was authorized to adopt by the Dodd-Frank Wall Street Reform and Consumer Protection Act, are set forth in new Rule 14a-11 of the Securities Exchange Act of 1934 (the

“Exchange Act”). Rule 14a-11 is not available to shareholders seeking to gain or change control of the company or to obtain board representation in excess of the number of board seats subject to shareholder nominations under the new rule. Nominations must be submitted by shareholders on a new Schedule 14N and will have to be included in the company’s proxy statement and form of proxy.

Applicability: Rule 14a-11 applies to all companies subject to the Exchange Act proxy rules, including investment companies and controlled companies. The only exception is for companies that are subject to the proxy rules solely because they have a class of debt securities registered under Section 12 of the Exchange Act. Also, the rule will not become effective for “smaller reporting companies” (as defined in Rule 12b-2 of the Exchange Act) for a period of three years. Generally speaking, a smaller reporting company is a company with a public float of less than \$75 million.

Rule 14a-11 is mandatory, meaning there is no “opt out” mechanism. Nor can companies adopt bylaws imposing additional requirements beyond those set forth in Rule 14a-11. In addition, the rule is available to shareholders

even if the company is engaged in a concurrent proxy contest.

Shareholder Eligibility and Disclosure Requirements:

Shareholders or a group of shareholders (the “nominating shareholder”) seeking to include nominees in a company’s proxy materials under Rule 14a-11 must meet certain eligibility and disclosure requirements, the most significant of which are set forth below.

- *Ownership Threshold:* The nominating shareholder must hold at least three percent of the total voting power of a company’s securities that are entitled to vote on the election of directors. Only shares for which the nominating shareholder has voting and investment power will be included. This requirement differs from the SEC’s earlier proposal in June 2009, which would have imposed a one percent ownership requirement for large accelerated filers, a three percent requirement for accelerated filers, and a five percent requirement for non-accelerated filers. In response to concerns raised about the use of derivative transactions, shares that have been sold in short sales or that have been borrowed are

excluded from the ownership calculation. Shares that have been loaned to third parties, however, will be included if the nominating shareholder has the right to recall the loaned securities and will recall them if its nominees are included in the company's proxy materials.

- *Holding Period:* The nominating shareholder must have held the required three percent ownership continuously for at least three years prior to the date that it submits its nomination.
- *Intent to Hold Through Meeting and Afterwards:* The nominating shareholder must certify that it intends to hold the securities necessary to satisfy the required ownership threshold through the date of the shareholders meeting. It also must provide a statement regarding its intent with respect to continued ownership of the company's securities after the election, though there is no holding requirement following the election.
- *No Intent to Change Control:* The nominating shareholder must certify that it does not own its securities with the purpose, or with the effect, of changing control of the company or to gain board representation in excess of the maximum number of nominees available under Rule 14a-11 (*i.e.*, the greater of twenty-five percent of the board seats or one, as described below).

Shareholder Nominee Requirements

The nominee must meet the objective criteria for "independence" under the

applicable exchange rules, although the nominee would not need to meet the requirements that pertain to audit committee members. To the extent an exchange requires the board to make a subjective determination of a nominee's independence (*e.g.*, the board must determine the person has no "material relationship" with the company), the subjective requirement would not apply. In the case of an investment company, the nominee cannot be an "interested person" as defined in the Investment Company Act of 1940. Importantly, the nominee does not have to be independent of the nominating shareholder. A nominee also is not required to satisfy any director qualification standards adopted by a company.

Contents of Schedule 14N

The nominating shareholder's Schedule 14N must include, among other things, disclosure of (1) the number of securities to which it is entitled to vote and the length of ownership of those securities, (2) biographical and other information about the nominating shareholder and the nominee(s), and (3) the certifications described above with respect to the nominating shareholder's eligibility under Rule 14a-11.

Notice of Shareholder's Intent to Include Nominees

A nominating shareholder must submit its Schedule 14N to the SEC and the company between the 120th and 150th day before the anniversary of the mailing date of the company's proxy materials for the prior year's annual meeting (the "nominating period"). For the 2011 proxy season, therefore, companies should identify the 120th day prior to the anniversary

of the mailing of their 2010 proxy statement, which will be the deadline for inclusion next year. If the deadline falls on a Saturday, Sunday, or holiday, the deadline will be the following business day. There is an exception, however, where the shareholder meeting date is changed by more than thirty days from the prior year's meeting, in which case the Schedule 14N must be submitted by "a reasonable time before the registrant mails its proxy materials" as determined by the company and disclosed under new Item 5.08 of Form 8-K.

Maximum Number of Shareholder Nominees

Rule 14a-11 limits the number of shareholder nominees a company is required to include in its proxy materials to the greater of one or the number of nominees that represent twenty-five percent of the total number of the company's directors (rounded down if twenty-five percent does not result in a whole number). If the company decides not to oppose a shareholder nominee, that nominee will still be considered a shareholder nominee for purposes of determining whether the maximum number of nominees has been met.

Order of Priority Due to Multiple Nominations

If a company receives nominations from multiple nominating shareholders, Rule 14a-11 gives priority to the nominating shareholder with the highest voting power percentage rather than the first nominating shareholder to submit a nomination. However, if the nominations by the largest nominating shareholder do not exceed the maximum number permitted under

Rule 14a-11, then the rule creates a “waterfall” by giving priority to the next largest nominating shareholder and so on, until the maximum number of permitted nominees is met.

Statement of Support

The nominating shareholder will be entitled to include in the company’s proxy statement a statement of support with respect to its nominee(s), which is not to exceed 500 words.

Excluding Nominations and No-Action Requests

If a company wishes to exclude a nomination because, for example, the nominating shareholder fails the eligibility requirements, it must give notice no later than the fourteenth day after the close of the nominating period. The nominating shareholder then has fourteen days to respond. Following that period, the company must then give notice to the SEC at least eighty days prior to filing its definitive proxy statement if it still intends to exclude the nominee.

A company also can seek the SEC staff’s informal view in a no-action letter as to whether the company may exclude the nominee(s).

Final Amended Rule 14a-8

The SEC also amended Rule 14a-8 to prevent companies from excluding shareholder proposals that seek to establish procedures relating to the election of directors or disclosures relating to director nominations. As amended, a company will be able to exclude a shareholder proposal under Rule 14a-8(i)(8) if it:

- would disqualify a nominee who is standing for election;
- would remove a director from office before his or her term expired;
- questions the competence, business judgment, or character of nominees or directors;
- seeks to include a specific nominee in the company’s proxy materials; or
- otherwise could affect the outcome of the upcoming election of directors.

Thus, shareholders can propose bylaw amendments establishing proxy access with requirements that are more (but not less) lenient than those in Rule 14a-11, such as a lower ownership threshold, shorter holding requirements, and permitting shareholders to nominate a greater number of nominees. Amended Rule 14a-8, however, is in addition to, and not a substitute for, proxy access under Rule 14a-11.

Consequences of the Final Rules

The SEC’s rule changes have pushed public companies into uncharted waters with a mandatory “one-size-fits-all” approach. It is difficult to predict whether proxy access will be utilized sparingly or become ubiquitous. The three percent ownership threshold and three-year holding requirement are intended to “demonstrate a shareholder’s long-term commitment and interest in the company,” but shareholders can aggregate their stock by forming nominating groups. It also is notable that, according to the SEC’s final rules release, approximately

twenty-five percent of non-accelerated and large accelerated filers have at least two 2.5 percent shareholders and approximately thirty-three percent have at least two 1.5 percent shareholders.

Most commentators believe that activist hedge funds will continue to wage traditional proxy contests in order to control and spread their “message,” though proxy access may appeal to some hedge funds that can satisfy the three-year holding requirement. Individual shareholder activists and corporate governance gadflies are unlikely to qualify as a nominating shareholder due to the three percent ownership requirement unless they take part in a group. This leaves large institutional investors, including unions and government employee pension funds, as likely candidates.

It also is difficult to predict how shareholders will react to nominees included pursuant to Rule 14a-11. In contested elections, the leading proxy advisory firms have generally supported short-slates. This trend could apply to nominees submitted pursuant to Rule 14a-11, although such support presumably will be influenced by the identity and background of the nominating shareholder and the qualifications of each nominee. In that regard, recent reports indicate that institutional investors are considering creation of a “database” of potential director candidates.

Frequent contested elections under Rule 14a-11 could be a serious, timely, and costly distraction to management and boards. We also have concern about the effects of Rule 14a-11 on board composition. Corporate boards typically are made up of carefully

selected individuals skilled in different fields and diverse in a number of different respects. If proxy access leads to regular turnover and frequent contested elections, the balance of skills, interests, and backgrounds likely will be impacted negatively. There also is the risk that if proxy access results in annual election contests becoming the norm, highly qualified individuals will be disinclined to serve. Thus, proxy access risks potentially significant disruption to boards.

The implications and technical aspects of the new rules will evolve with time. In light of the foregoing, however, we suggest the following potential steps that should be taken:

- Ensure that boards are informed about the new SEC rules and their implications for corporate governance. Nominating committees may want to pay particular

attention since they could play a key role in reviewing the eligibility of a nominating shareholder or its nominee(s).

- Evaluate the likelihood of receiving a nomination under Rule 14a-11, including by examining your shareholder base.
- For companies that believe they might be targeted, examine the turnout of retail voters, which might be important in a contested election. This is particularly so for companies using “notice and access” under the SEC’s e-proxy rules.
- Focus on maintaining good relations with key shareholders—clear lines of communication with large shareholders are necessary to build investor confidence in a company’s board and management.

- In connection with shareholder relations, review key corporate governance practices that may be “hot buttons” for shareholders.
- Review bylaws to ensure they do not conflict with Rule 14a-11—advance notice provisions purporting to be the sole means by which a shareholder can nominate a director may need to be revised to acknowledge Rule 14a-11.

Because the potential effects of the new rules are so far-reaching, companies should begin discussing these issues with their boards and legal counsel as soon as possible.

If you have any questions about these matters, please contact [Allen Goolsby](#), [Gary Thompson](#), [Lake Taylor](#), [Steven Haas](#) or your Hunton & Williams LLP contact.

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