HUNTON& WILLIAMS

SECURITIES LAW ALERT

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SEC Issues Proposed New Rules to Facilitate Nominations of Directors by Shareholders

On June 10, 2009, the Securities and Exchange Commission published proposed amendments to the federal proxy rules addressing shareholder access to reporting companies' proxy materials. The proposed amendments were approved by a 3 to 2 vote of the Commission on May 20, 2009. If adopted, these proposed amendments would, subject to certain conditions, allow shareholders of publicly traded companies that meet minimum ownership standards to nominate candidates for election to the company's board of directors and to include information regarding such nominees in the company's proxy materials. This current shareholder access proposal represents the SEC's third major attempt to address this topic in the past six years. The amendments would also permit shareholders to include proposals relating to the nomination or election of directors in the company's proxy materials, including proposals to adopt proxy access bylaws.

The SEC's stated goal in proposing these proxy amendments is to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders. The SEC believes that it should structure the proxy rules to better facilitate the exercise of shareholders' rights to nominate and elect directors, because the right to nominate is inextricably linked to a right to vote for a nominee. The SEC also believes that parts of the currently operative federal proxy process may unintentionally frustrate voting rights arising under state law, and thereby fail to provide fair corporate suffrage.

The amendments, if adopted as proposed, would likely impact the director election process significantly, and not necessarily to the advantage of the company and its long-term shareholders. The deadline for comments on the proposed amendments is August 17, 2009.

Key Highlights of the SEC's Proposal

Proposed Rule 14a-11

The SEC is proposing a new proxy rule (Exchange Act Rule 14a-11) that would, under certain circumstances, require a company to include a limited number of shareholder nominees for director in the company's proxy materials. Rule 14a-11 would not be available to shareholders seeking to gain or change control of the company. The nominating shareholder or shareholder group would be required to certify that, to the best of its knowledge and belief, it is not holding the securities for the purpose or with the effect of changing control of the company or to gain more than a limited number of seats on the board. If adopted, Rule 14a-11 would apply unless state law or a company's governing documents prohibits shareholders from nominating directors.

Applicability: Rule 14a-11 would apply to all companies subject to the Exchange Act proxy rules (including investment companies registered under Section 8 of the Investment Company Act of 1940), 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.

Shareholder Eligibility Requirements: Shareholders wishing to exercise their rights under Rule 14a-11 would be required to meet certain eligibility requirements.

- *Ownership Threshold* – The amount of a company's voting securities that a shareholder or shareholder group must own to submit a nomination would vary with the size of the company. A shareholder or shareholder group must beneficially own, as of the date of the shareholder notice on Schedule 14N (described below), either individually or in the aggregate:

- for large accelerated filers (i.e., companies with a public float of at least $700 million) and registered investment companies with net assets of $700 million or more, at least 1 percent of the company's voting securities;
- for accelerated filers (i.e., companies with a public float of at least $75 million but less than $700 million) and registered investment companies with net assets of $75 million or more but less than $700 million, at least 3 percent of the company's voting securities; and
- for non-accelerated filers (i.e., companies with a public float less than $75 million) and registered investment companies with net assets of less than $75 million, at least 5 percent of the company's voting securities;

- *Holding Period* – The securities counted toward the ownership threshold described above must have been owned continually by the shareholder or each member of the shareholder group for at least one year as of the date of the shareholder notice on Schedule 14N; and
- *Intent to Hold Through Meeting Date* – The shareholder or each member of the shareholder group must represent that it intends to continue to own the securities counted toward the ownership threshold through the date of the annual or special meeting.

Shareholder Nominee Requirements: A company would not be required to include a shareholder nominee in its proxy materials if the nominee's candidacy or, if elected, board membership would violate controlling state law, federal law or the rules of a national securities exchange or national securities association (other than rules regarding the independence of directors), and such violation could not be cured. As noted below, each nominating shareholder or each member of the nominating shareholder group would be required to represent that, under the applicable national securities exchange or national securities association rules, the nominee satisfies the objective standards of director independence that apply to the company.

Maximum Number of Shareholder Nominees: Rule 14a-11 would limit 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 25 percent of the company's board of directors. If, as of any shareholders' meeting, the incumbent board includes any director elected following nomination by a shareholder or shareholder group in accordance with Rule 14a-11 and such director's term of office extends beyond the date of the meeting where directors are being elected, as is the case for companies with classified boards, the incumbent shareholder director would be counted toward the foregoing threshold.

In situations where more than one shareholder or shareholder group would be eligible to have its nominees included in the company's proxy materials, Rule 14a-11 would apply a "first-in-time" standard: the company would be required to include the nominee or nominees of the first nominating shareholder or group from which it receives timely notice of intent to nominate a director pursuant to the rule, up to and including the total number of shareholder nominees required to be included by the company.

Notice and Disclosure Requirements: To submit a nominee for inclusion in the company's proxy statement and form of proxy, Rule 14a-11 would require that the nominating shareholder or shareholder group provide to the company and file with the SEC a notice on new Schedule 14N with certain required disclosures. These disclosures include:

- a written statement of the shareholders' intent to continue to own the requisite shares through the shareholder meeting at which directors are elected;
- a certification that the securities are not held for the purpose of, or with the effect of, changing the control of the company or gaining more than a limited number of seats on the board of directors;
- a representation that the nominating shareholder or group is eligible to submit a nominee under Rule 14a-11;
- a representation that, to the knowledge of the nominating shareholder or group, the candidate's nomination or initial service on the board, if elected, would not violate controlling state law, federal law or applicable listing standards (other than a standard relating to independence);
- a representation that, to the knowledge of the nominating shareholder or group, the nominee meets the objective criteria (i.e., "bright line" criteria) for independence from the company; and

- information regarding the nature and extent of the relationships between the nominating shareholder or group and nominee and the company or any affiliate of the company.

The nominating shareholder or shareholder group would also be permitted to include in the company's proxy statement a statement of support for its nominee(s), not exceeding 500 words. The notice on Schedule 14N would be required to be provided to the company and filed with the SEC by the date specified in the company's advance notice bylaw or, where no such bylaw is in place, 120 days before the date the company mailed its proxy materials for the prior year's annual meeting.[1]

Company Recommendations: Under Rule 14a-11, a company would be entitled to recommend that shareholders vote for, vote against or withhold votes for nominees submitted by shareholders pursuant to Rule 14a-11. However, unlike the current rules governing the form of proxy used in connection with an annual meeting, which permits shareholders to vote for or against the company's nominees as a group, under proposed Rule 14a-11, each nominee would need to be voted upon separately.

Liability: A nominating shareholder or group relying on Rule 14a-11, an applicable state law provision or a company's governing documents to include a nominee in company proxy materials would be liable for any materially false or misleading statements in the information provided by the nominating shareholder or group to the company that is then included in the company's proxy materials. The proposed rules release the company from responsibility for information that is provided by the nominating shareholder or group under Rule 14a-11 and then repeated by the company in its proxy statement, except where the company knows or has reason to know that the information is false or misleading.

Proposed Amendment To Rule 14a-8

Exchange Act Rule 14a-8(i)(8) currently permits a company to exclude proposals from its proxy statement that "relate 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." The SEC has proposed to narrow the exclusion provided by Rule 14a-8(i)(8) so that proposals by eligible shareholders that would amend, or request an amendment to, provisions of a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations would be permitted if the other procedural requirements of Rule 14a-8 are satisfied and the proposal is not subject to one of the other exclusions permitted by Rule 14a-8. The SEC has made clear in the proposing release that Rule 14a-8(i)(8) would supplement Rule 14a-11, not replace it. As a result, a shareholder proposal regarding nominating procedures and/or disclosures that conflicted with Rule 14a-11 would not be eligible for inclusion in the proxy statement. According to the proposing release, a shareholder proposal would conflict with Rule 14a-11 in the event that, among other things, the proposal would purport to prevent a shareholder or shareholder group that met the requirements of proposed Rule 14a-11 from having their nominee for director included in the company's proxy materials. However, a shareholder proposal that would provide procedures more lenient than proposed Rule 14a-11 for shareholders seeking to nominate directors would not be deemed to conflict with Rule 14a-11.

Potential Consequences of the Proposed Amendments

The potential impact of the proposed rules, if adopted as proposed, is uncertain. For example, they could, if widely used by shareholders or groups of shareholders to push their own agenda, operate to disrupt boards of directors and management. The extent of the disruption presumably will depend on the extent to which proxy access leads not only to shareholder nominations but also to frequent instances in which incumbent directors fail to get reelected. The proposed rules could serve as a backdoor for a shareholder to seek control of a company as the proposed rules do not penalize the shareholder that changes its non-control intent following the election of its nominee or nominees.

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, 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. In any event, even the SEC acknowledges that the constant threat of extensive changes

[1] Advance notice bylaws often require that the shareholders who submit proposals provide information beyond that required in the proposed rule (such as derivative holdings and hedging positions). The SEC needs to address whether companies could require compliance with these bylaw provisions or exclude shareholder nominees if their proponents fail in complying with them.

in board membership has the potential to be disruptive to the board, while also being potentially confusing to shareholders. To be effective, boards of directors need to understand, among other things, their company's business, short-term and long-term goals and management's plans for achieving such goals. The process of gaining this understanding takes time. Rule 14a-11 could cause constant change and prevent boards from acting effectively.

Director Quality: The SEC's release itself acknowledges that the proposed amendments may lead to lower-quality boards since the proposed amendments do not contain any minimum experience or education criteria for board nominees. The SEC proposal purports to preempt companies from establishing reasonable criteria for shareholders and their nominees and seems to bar companies from adopting more restrictive criteria than those presented in the proposal even if they are identical to those applied to company nominees.[2] The role of companies and their boards in making independence determinations, so crucial in Sarbanes-Oxley compliance, remains unclear. Failure to take into consideration the director qualification criteria currently in place could result in a company electing directors who have little experience working with a public company or who have little experience or training with niche industries or markets.

[2] The proposing release states that, if a company's governing documents impose eligibility standards that are more restrictive than the proposed rule, the company could not exclude a shareholder nominee for failure to meet the stricter standard. Nevertheless, the proposed rule itself makes a shareholder nominee ineligible if board membership would violate the company's governing documents. Most corporate statutes permit the charter and bylaws to prescribe director qualifications. The SEC needs to address this inconsistency.

No Demonstrated Increase in Shareholder Value: Even if one accepts the validity of studies indicating that hybrid boards composed of company-selected directors and those put forth by activist shareholders increase shareholder value, these studies include companies where significant resources have been expended by shareholders to get their nominees on the ballot. Under the proposed amendments, minimal expenditures are required to be incurred by the proponent in connection with the nomination. When shareholders such as hedge funds are forced to fund the proxy nomination, they generally have extensive knowledge of the company, a strategic plan of how to resolve perceived problems and carefully researched board nominees. In addition, the greatest benefit to the company has been reported when the shareholder that nominates new board members had a large ownership stake in the company. The proposed proxy access rule requires no expenditures, and relatively trivial holdings (permitting shareholders to aggregate their holdings to reach specified levels, depending on firm size).

Authority/Balance of Federal/State Law: The SEC's statutory authority to adopt the proposed rules has been debated numerous times and will likely become the subject of litigation. It is possible that Congress will adopt legislation granting the SEC such authority to resolve this controversy. Absent federal legislation, elements of the proposed rule might, for example, be subject to attack on the grounds that Congress has not manifested an intent to supplement traditional state power to regulate the nominating process and qualifications of directors of state-chartered corporations. Furthermore, the proposed rule would raise significant concerns regarding inconsistencies and conflicts with state corporate law. The conflicts between two regimes may lead to extensive court battles.

Arguments have also been made by commentators, industry insiders and SEC Commissioners that the proposed amendments impose a federal proxy regime that is unnecessary in light of recent state initiatives that seek to expand proxy access. For example, Delaware enacted a new law addressing the director nomination process, which will be become effective on August 1, 2009. Section 112 of the Delaware General Corporation Law will allow Delaware corporations to adopt bylaw provisions requiring the company to include in its proxy materials one or more candidates nominated by shareholders for election to the company's board of directors. Bylaw provisions adopted under this section may include conditions related to such shareholder nominations, including minimum stock ownership, duration of ownership, and a limitation on the number of directors that can be nominated. New Section 113 permits a corporation to adopt a bylaw provision setting forth the circumstances under which shareholders may be reimbursed by the corporation for proxy-related expenses. In addition, the ABA Business Law Section's Committee on Corporate Laws has approved on second reading similar amendments to the Model Business Corporation Act, which is the basis for many states' corporate laws. These new private-ordering provisions will increase shareholder opportunities to nominate candidates, either by including them in the proxy materials or by shifting the cost of soliciting proxies to the corporation. Rule 14a-11, as proposed by the SEC, would override these

statutes. Because differences exist among public companies, we believe that an approach based on reasonable individually established criteria is more sensible than the SEC's "one size fits all" approach under Rule 14a-11.

Recommendations

There are a number of different forces, economic and political, driving the proposed proxy access amendments. No one knows the extent to which adoption of the proposed rules will lead to shareholder demands for proxy access. Nor do we have any way to predict the extent to which shareholders will vote for shareholder nominees instead of the company's nominees.

We do recommend that companies pay careful attention to the ways in which they communicate with their major shareholders. Clear lines of communication must be maintained with shareholders in order to build confidence in the company's board and management.

Companies must review their bylaws to ensure that their governance provisions, such as advance notice bylaws, are consistent with state law and best practices, keeping in mind that it is necessary to maintain the delicate balance between protecting the integrity of the board structure while being open to valid shareholder concerns. It may be best to wait until the final proxy access rules are adopted by the SEC to determine the best course of action as certain bylaw provisions may be preempted by federal law and conflicts between a company's bylaws and federal law may be confusing to shareholders.

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

The SEC has requested comments on hundreds of questions posed in the proposing release and the public comments will be important in shaping the final rules. Companies should consider working with counsel to provide comments. The SEC intends to have proxy access rules in place for the 2010 proxy season.

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