

August 25, 2010

SEC Adopts Mandatory Proxy Access

Rule Provides Proxy Access for 3% Shareholders or Groups with a Three-Year Holding Period, with No Right for Companies or Shareholders to Opt Out; Generally Applicable for 2011 Proxy Season, with Three-Year Delay for Smaller Reporting Companies

SUMMARY

At an open meeting today, the SEC voted to permit shareholders or groups holding 3% of the voting power of U.S. public companies who have held their shares for three years to include director nominees in company proxy materials. The proxy access regime set out in new Rule 14a-11 under the Securities Exchange Act of 1934 is mandatory, not simply a default rule – companies or shareholders are not permitted to opt out or select a more restrictive mechanism. In addition, the SEC voted to amend Rule 14a-8 to provide that companies may not exclude from their proxy materials shareholder proposals that seek to establish less restrictive proxy access procedures, and adopted a number of related rule amendments intended to facilitate proxy access.

The new rules were approved by a 3 to 2 vote, with two Commissioners vigorously opposing the rules at the open meeting. The rules will be effective 60 days after their publication in the Federal Register, and proxy access will apply for a company's 2011 annual meeting if the first anniversary of the mailing of the 2010 proxy materials occurs within 120 days of effectiveness. So, for example, if the rules are effective November 1, 2010, then shareholders will have a proxy access right in 2011 if the company mailed their 2010 proxy materials on or after March 1, 2010. The proxy access rules provide for a three-year delay in effectiveness for "smaller reporting companies" – generally, companies that have a public float of less than \$75 million.

The new rules apply to all companies that have a class of equity securities subject to SEC proxy rules, including investment companies registered under the Investment Company Act of 1940. Like the other proxy rules, the new rules do not apply to foreign private issuers.

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The full text of the final rules was published shortly after the meeting and is available at <http://www.sec.gov/rules/final/2010/33-9136.pdf>. This memorandum summarizes the more significant provisions in the new rules – we are in the process of preparing a more detailed memorandum.

Proxy Access under Rule 14a-11

The new proxy access regime is similar in many ways to the proxy access rules published by the SEC in June 2009, but differs from the proposal in several important details, including the ownership threshold.

The new mandatory federal proxy access right has the following key elements:

Eligibility of Nominating Shareholder or Group

- Available to a shareholder or group of shareholders that has owned 3% of the voting securities of the company continuously for a three-year period. This differs from the tiered threshold (1, 3 or 5% based on company size) and one-year holding period in the proposal. The shareholder or group must continue to own the shares through the annual meeting, and must not hold the shares for the purpose of changing the control of the company or gaining representation on the board beyond that contemplated by the rule.
- For purposes of calculating the ownership level, the voting power would be reduced by any shares that a nominating shareholder has sold in a short sale. In addition, a shareholder may not borrow shares to reach the 3% ownership threshold, but may count toward the threshold shares that it has lent out, so long as it has the right to recall the shares and will do so for the vote. The rule does not take into account hedging of the shares used to satisfy the threshold other than through short sales.

Eligibility of Nominee

- The number of shareholder nominees may be up to 25% of the board size (or one director, whichever is greater) at each election, consistent with the proposal.
- The nominees must meet the objective independent director standards of any stock exchange on which the shares are listed and their nomination or board membership must not violate applicable laws or regulations. The nominee will not be required to meet director qualification standards included in the company's governing documents, though (in a change from the proposal) the Schedule 14N must state whether, to the knowledge of the nominating shareholder(s), the nominee satisfies those standards.
- There are no restrictions on relationships between the nominating shareholder(s) and the nominee, though Schedule 14N would need to describe any such relationships. Neither the nominating shareholder(s) nor the nominee may have a direct or indirect agreement with the company regarding the nomination.

Nomination Process

- Nominating shareholders or groups would be required to provide to the company, and file with the SEC, a notice on a Schedule 14N providing specified information about the nominating shareholder(s) and the nominee. The Schedule 14N must be provided during the period from 150 days to 120 days prior to the first anniversary of the mailing date of the company's prior year proxy materials.
- In the event of multiple qualified proposals, priority will be given to the shareholder or group with the largest ownership level (in contrast to the "first in" mechanism contemplated by the proposal). If a nomination is withdrawn or is disqualified before the company prints its proxy materials, the company must include substitute nominees, if there are other qualified nominations.

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- A company may challenge a nomination that it believes it is not required to include through a no-action process similar to the process for shareholder proposals under Rule 14a-8.
- The final rule provides that companies are not responsible for information provided by the nominating shareholder(s) and included in the proxy statement.

Rule 14a-8

In addition, the SEC voted to amend Rule 14a-8, largely as proposed, to provide that a company may not exclude from their proxy materials shareholder proposals that seek to establish a procedure in the company's governing documents for the inclusion of shareholder director nominees in the company proxy materials. Prior to these changes, the SEC interpreted Rule 14a-8 as permitting companies to exclude these proposals as "relating to an election." As noted above, neither companies nor shareholders are permitted to limit the availability of Rule 14a-11; therefore, companies could exclude shareholder proposals that would do so.

Proxy Solicitation Exemptions

The SEC adopted, largely as proposed, two exemptions from the proxy solicitation rules applicable to nominating shareholders that are intended to facilitate proxy access – first, an exemption for written or oral communications of a shareholder's intent to form a nominating group and, second, an exemption for communications made in support of a nominee included in a company's proxy materials under Rule 14a-11. The availability of these exemptions is conditioned on written communications being limited to specified information and being filed with the SEC.

Section 13, Section 16 and Affiliate Status

As proposed, the SEC adopted rule amendments providing that a nominating shareholder will not lose Schedule 13G eligibility solely due to activities in connection with a Rule 14a-11 nomination. Also as proposed, the SEC did not provide guidance as to whether a nominating shareholder group has formed a "group" for purposes of Section 13 or Section 16 – thus, nominating shareholders would continue to analyze their "group" status under existing rules and interpretations.

In a change from the proposal, the SEC declined to provide a safe harbor from "affiliate" status under the securities laws for a nominating shareholder, indicating that a nominating shareholder should continue to analyze its affiliate status based on all relevant facts and circumstances, as under existing rules and interpretations.

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