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To: Interested Persons

Re: SEC Publishes Proxy Access Proposal

The SEC's proposed proxy access rules were released on June 10. Comments are due by August 17.

The SEC's apparent goal is to adopt some form of proxy access rule in time for the 2010 proxy season. Some have argued that this goal is not achievable given the contentious nature of the issues, the extreme detail of the release (which is 250 pages long and seeks comment on hundreds of questions) and various procedural and other timing issues. However, the key issues on proxy access have been debated for over a decade, with the SEC having previously floated proposals in 2003 and again in 2007. The SEC is now, in the wake of the financial crisis, under tremendous political pressure to adopt a proxy access rule this year. A failure to act could well lead to Congress seizing control of the issue. For now, therefore, we believe it prudent to assume that proxy access, in some form, will be a fact of life for U.S. public companies in 2010.

We expect that the SEC will receive extensive comments from companies, shareholders and organizations. We also expect litigation challenging the SEC's authority to adopt the proposed rules, particularly in the absence of federal legislation specifically authorizing the SEC to do so. Our corporate governance lawyers will keep our clients informed on our analysis of the issues, as well as other important developments, over the coming weeks and months. On Tuesday, June 30, we will host a webcast entitled "Proxy Access: What Will It Mean For Your Company?" to discuss the implications of proxy access for companies. This memo will summarize the proposal and highlight some of the key questions raised in the proposing release.

I. Overview

Under existing rules, a shareholder cannot require a company to include a director nominee in the company's proxy materials. A company may also exclude from its proxy statement, under Exchange Act Rule 14a-8(i)(8), any shareholder proposal relating to the election or nomination of directors including any proposal to adopt a proxy access bylaw. Thus, a shareholder seeking to elect a director without the company's consent is required to prepare and distribute its own proxy materials.

The SEC's proposal would make two significant changes:

Access for nominees: A new Exchange Act Rule 14a-11 would permit shareholders owning a specified percentage of a company's shares for a one-year period to nominate up to 25% of the company's board of directors and solicit proxies in favor of those nominees using the company's proxy statement. In order to avail themselves of the new rule, nominating shareholders would have to provide a variety of disclosures regarding the nominee and the nominating shareholders and make several representations and certifications, including a certification that they do not hold their shares for the purpose or with the effect of "changing control" of the company or to gain more than a limited number of board seats. As proposed, new Rule 14a-11 would establish a "floor" for shareholder proxy access that could not be undercut by state law or a company's governing documents.

Process proposals: The Rule 14a-8(i)(8) "election exclusion" would be repealed. This means that companies generally would no longer be able to exclude shareholder proposals dealing with the director nomination process unless the proposal conflicts with the proposed rules.

The proposed rules would apply to all companies subject to the proxy rules, other than companies that are subject to the proxy rules solely because they have a class of registered debt. This includes companies registered under the Investment Company Act but does not include foreign private issuers.

II. Rule 14a-11

Eligibility

Under proposed new Rule 14a-11, a shareholder or group would be able to require that shareholder nominees be included in the company's proxy materials if the nominating shareholder or group meets the following criteria:

- ***Minimum ownership threshold***. The shareholder or group of shareholders beneficially owns at least the following percentage of the company's securities that are entitled to be voted on the election of directors:
    - 1% for large accelerated filers and registered investment companies with net assets of $700 million or more;
    - 3% for accelerated filers and registered investment companies with net assets of $75 million or more but less than $700 million; and
    - 5% for non-accelerated filers and registered investment companies with net assets of less than $75 million.

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- ***One-year holding period***. The nominating shareholder or each member of the nominating shareholder group has held the securities continuously for at least one year (as of the date of its Schedule 14N relating to the nomination) and intends to hold those securities through the date of the election.

- ***Submission of timely notice on Schedule 14N***. The nominating shareholder or group must file a Schedule 14N containing required disclosures, representations and certifications. The Schedule 14N must be filed within the specified time periods described below.

- ***Certification of no "control" purpose***. The nominating shareholder or group certifies on Schedule 14N that the shares were not acquired "for the purpose of or with the effect of changing control of the company" or "to gain more than a limited number of seats on the board."

- ***Independence of nominee***. The nominee must satisfy the "objective" director independence criteria of the applicable stock exchange (or, in the case of an investment company, the nominee must not be an "interested person" under the Investment Company Act). The nominee need not satisfy any "subjective" stock exchange director independence standards or meet stricter criteria established by individual companies. In addition, Rule 14a-11 does not require the nominee to be independent vis-à-vis the nominator(s).

- ***Conformity with law***. The nominee's candidacy or board membership must not violate law or applicable stock exchange rules (other than with regard to "subjective" independence criteria).

Limit on Number of Nominees

A company would not be required to include in its proxy materials any nominees under Rule 14a-11 representing in excess of 25% of the company's board of directors. If the company has a staggered board, any director who was elected pursuant to Rule 14a-11 whose term extends past the election would count toward the 25% cap.

If the company receives competing nominations, access under Rule 14a-11 would be allocated on a first-come, first-served basis up to the 25% cap. If a shareholder nominates more individuals than it is entitled to under Rule 14a-11, the shareholder would be permitted to choose among its nominees in order to reduce its nominees to the correct number.

If a nominee or a nominating shareholder or group has an agreement with the company to nominate a director then such nominee does not count for the purpose of this 25% cap. This requirement is intended to prevent a company from

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filling up the number of seats eligible under Rule 14a-11 by including a shareholder nominee as a surrogate for management.

Notice and Disclosure

In order to avail itself of direct access, a shareholder or group would be required to provide a Schedule 14N no later than the date set forth in the company's advance notice bylaws or, if the company does not have such a provision, 120 calendar days before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting. If the company did not hold an annual meeting in the prior year or if the meeting date was changed by more than 30 days, the company would be required to disclose under a new Item 5.07 to Form 8-K the date by which a nominating shareholder must submit its Schedule 14N, which date must be a reasonable time before the company mails its proxy materials.

The Schedule 14N must contain the certifications described above and disclosures regarding the shareholder nominee and the nominating shareholder or group similar to the disclosure required in a proxy contest. If the company includes a shareholder nominee in its proxy materials under Rule 14a-11, the company would also be required to include certain disclosures from the Schedule 14N, including an up to 500-word supporting statement by the nominating shareholder.

Liability for false and misleading statements. The proposed rules prohibit a nominating shareholder or group from causing any false or misleading statements to be included in a company's proxy materials. This standard is very similar to the current antifraud rule for proxy contests contained in Exchange Act Rule 14a-9. The proposed rules also provide that the company will not be liable for any information contained in the company's proxy statement that was provided by a nominating shareholder, except where the company knows or has reason to know that the information is false or misleading. None of the information provided by a shareholder and included in the company's proxy materials will be incorporated by reference into any of the company's SEC filings, unless the company specifically incorporates it.

Process for Determining Eligibility

Once a company receives a Schedule 14N, it must determine whether it can exclude the nominee. If the company cannot exclude the nominee, it must notify the shareholder or group no later than 30 days before the company files its definitive proxy statement with the SEC that it will include the nominee.

Reasons for excluding a nominee. A company may determine that it can exclude a nominee under Rule 14a-11(a) for any of the following reasons:

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- The nominating shareholder or group has not complied with the requirements of Rule 14a-11 (e.g., the Schedule 14N was not delivered on time or was deficient).

- The nominee does not meet the requirements of Rule 14a-11 because the nominee, if elected, would violate law or regulations applicable to the registrant (e.g., the nominee is an officer or director of a competitor and would not be permitted to serve on the company's board under the Clayton Act).

- Any representation in the Schedule 14N is false or misleading in any material respect.

- The company received more nominees than it is required to include.

Procedures for excluding a nominee. If the company determines it may exclude a nominee, the company must notify the nominating shareholder or group within 14 calendar days after the receipt of the Schedule 14N. If after 14 calendar days of the notice the shareholder is not able to cure the deficiency, the company can exclude the nominee by filing a no-action request with the Commission. (Note that the shareholder may not change the composition of the nominating shareholder group or the identity of the shareholder nominee to correct a deficiency.) This no-action request must be filed no later than 80 calendar days before the company files its definitive proxy statement with the SEC. The company would have the burden of demonstrating why the nominee could be excluded. Within 14 calendar days of receipt of the company's notice to the SEC, the nominating shareholder or group may submit a response to the SEC staff. The staff would then, at its discretion, provide a no-action letter with its views. No later than 30 calendar days before the company files its definitive proxy statement and proxy with the SEC, the company must provide the nominating shareholder or group with notice of whether it will include or exclude the shareholder's nominee(s).

Proxy Mechanics and Voting

The proposed rules require a company that includes a shareholder nomination in its proxy materials to use a "universal proxy" in which each nominee for director is listed on the proxy card. Since there will be more nominees than directorships, the proxy card will only allow shareholders to deliver a proxy for up to the number of seats up for election. While the company is allowed to indicate for each nominee whether the board recommends a vote "for" the nominee, the company cannot otherwise discriminate among the nominees and cannot provide shareholders with the ability to check a box and vote for the entire company-recommended slate. This mechanic will as a practical matter require companies to use plurality voting, since the universal

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proxy increases the likelihood that some or all of the directors will fail to receive majority votes. Companies that have adopted majority voting will need to examine their bylaws or policies relating to contested elections to make sure they function properly under this process.

Proxy Solicitations by Nominating Shareholders

The proposed rules simplify how a nominating shareholder may communicate with other shareholders regarding the election. The proposed rules would allow a shareholder who is considering forming a nominating shareholder group to provide a brief written notice of its intention and to freely communicate orally with other shareholders regarding forming a nominating group. The nominating shareholder or group would also be permitted to communicate freely, orally or in writing, in support of its nominee or against the company's nominees so long as (i) they do not furnish a form of proxy or otherwise seek the power to act as proxy, (ii) specified legends are included on all written communications and (iii) all soliciting material that is published, sent or given to shareholders is filed with the SEC.

III. Changes to the "Election Exclusion" in Rule 14a-8

The SEC has proposed to amend Rule 14a-8 in a manner that generally would require companies to include in their proxy materials shareholder proposals to include proxy access procedures in the company's bylaws, so long as those procedures do not conflict with Rule 14a-11. Specifically, the proposed rules would amend Rule 14a-8(i)(8) to allow companies to exclude proposals relating to the election of directors based only on one of the following enumerated conditions:

- The proposal would disqualify a nominee who is standing for election;
- The proposal would remove a director from office before his or her term expired;
- The proposal questions the competence, business judgment or character of a nominee;
- The proposal nominates a specific individual, other than pursuant to Rule 14a-11, an applicable state law provision or the company's governing documents; or
- The proposal otherwise could affect the outcome of the upcoming election of directors.

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The proposing release makes clear that a shareholder proposal submitted under Rule 14a-8 that prevents a shareholder from nominating a director under Rule 14a-11 by, for example, including a higher ownership threshold or longer holding period, would not be permitted. Bylaw proposals that provide *additional* means for a shareholder to nominate a director, on the other hand, would be permitted.

IV. Other Changes

The proposed rules would also amend Exchange Act Rule 13d-1(b)(1)(i) to clarify that a shareholder or group would not lose Schedule 13G eligibility solely by virtue of nominating one or more directors under Rule 14a-11, soliciting on behalf of that nominee or nominees, or having that nominee or nominees elected. The proposed rules do *not*, however, exempt members of a nominating shareholder group from obligations to aggregate their shareholdings and, if required, file under Exchange Act Section 13(d) or Exchange Act Section 16, if they have formed a "group" for purposes of those sections.

Rule 14a-11 would also make clear that a nominating shareholder will not be deemed an "affiliate" of the company under the Securities Act or the Exchange Act solely as a result of nominating a director or soliciting the election of the director under Rule 14a-11. The safe harbor would also apply after the nominee is elected so long as the shareholder does not have an agreement or relationship with the director apart from the nomination.

V. SEC Questions Raised in the Proposing Release

We believe that the proposed new rules raise very fundamental questions and, if adopted in their current form, could significantly affect the election of directors of public companies. Interestingly, while the release expresses the SEC's view that the proposal represents "an incremental approach" to proxy access, it also raises and seeks comments on a large number of key questions, including the following:

- Is it appropriate to permit proxy access at all in light of recent changes in the corporate governance landscape, including the adoption by companies of majority voting and changes in state law?

- Will the proposed means of providing access (i.e., Rule 14a-11 and state law/governing documents) likely achieve the Commission's stated objectives of increasing board accountability and shareholder participation? What other revisions would better achieve these objectives?

- To the extent the proposed rules conflict with law or regulation, what should be the appropriate interplay? Should the proposed rules preempt

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state law? A company's governing documents? Should companies be permitted to opt out? What if the conflicting bylaws were adopted by shareholders?

- Is it appropriate to apply the proposed rules to all companies subject to the U.S. proxy rules except companies solely registering debt, regardless of corporate governance practices, economic performance or business practice? Should certain triggering events be required?

- Should the 1%, 3% and 5% ownership thresholds be revised?

- The one-year holding period applies only to shares required to meet the ownership threshold and only until the date of the meeting. Should it apply to all shareholdings? Beyond the date of the meeting? Should the shareholder be required to have a net long position in the shares at the time of the meeting? What other revisions should be made to address the problem of empty voting?

- Is it appropriate to require shareholders to represent that they will not seek to change the control of the company or gain more than 25% of the board? How should the rules address the possibility that this intent may change?

- Is the requirement regarding independence of the shareholder based on "objective" standards appropriate? Should the shareholder be subject to subjective standards? What if the company has stricter standards? Should those apply? Who should bear the burden of determining independence? Should the company have a role?

- Should shareholder nominees be required to be independent from the nominating shareholders?

- Is the 25% cap on the number of seats available for a nomination appropriate? Should it be higher or lower? The rules provide for incumbent directors elected pursuant to Rule 14a-11 to be taken into account for purposes of the cap. Is this appropriate? Should there be provisions specifically addressing staggered boards? Should there be an exception for companies with shareholder-designated representatives? For controlled companies?

- Is the first-come, first-served preference in the case of competing proposals fair? If not, what other criteria should apply? Would this result in a race to file? How should the rule address the situation where a nominating shareholder qualifies, provides its notice and submits all of the nominees a company is required to include, then becomes ineligible under the rule?

- Should disclosure similar to that required in a proxy contest be required? Should additional disclosure be required? Should there be a distinction

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between the disclosure required under Rule 14a-11 and the disclosure required for shareholders nominating pursuant to state law or a company's governing documents?

- Is the deadline for submitting a notice appropriate? Should a company's advance notice bylaws govern, or should there be a set deadline? Are these deadlines compatible with the arbitration timeline applicable to a company and a shareholder when a company determines it can exclude the nominee?

- Under the proposal, companies would not be able to provide shareholders the option of voting for a slate of directors. Should companies be allowed to vote for a slate of directors as a whole? Would a "universal ballot" be confusing or result in logistical difficulties? What other changes should be made to the form of proxy?

- Should proposed Rule 14a-8(i)(8) be adopted even if proposed Rule 14a-11 were not adopted? Are there changes to the rule that should be made if proposed Rule 14-11 were not adopted?

A copy of the SEC's proposing release, "Facilitating Shareholder Director Nominations," is available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

If you have any questions regarding this memorandum, please contact any of the lawyers listed below or your regular Davis Polk contact.

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