ARNOLD & PORTER LLP

ADVISORY

July 2009

PROXY ACCESS, TAKE THREE:

SEC PROPOSAL WOULD FUNDAMENTALLY CHANGE DIRECTOR ELECTIONS BY GIVING SHAREHOLDERS A FEDERAL RIGHT TO NOMINATE DIRECTORS IN A COMPANY'S PROXY STATEMENT

Maybe third time's a charm, at least from the perspective of shareholder activists, institutional investors, and special interest groups. The Securities and Exchange Commission's latest proxy proposal—it's third in six years—would give shareholders, or groups of shareholders, unprecedented access to a company's proxy statement in two ways:

- First, a new Rule 14a-11 would give a shareholder or group of shareholders that owns a specified percentage of a corporation's common stock and satisfies a one-year holding period a substantive right to nominate directors in a company's proxy statement, provided certain limited conditions are satisfied; and
- Second, an amendment to Rule 14a-8(i)(8) would require companies under certain circumstances to include shareholder proposals in their proxy materials that seek to amend a company's charter or bylaws regarding nomination procedures or disclosures related to shareholder nominations, provided the proposal does not conflict with new Rule 14a-11.

The idea of shareholder access to a company's proxy materials appeals to populist notions of shareholder democracy. State corporate law gives shareholders the right to elect a corporation's directors, but in practical terms that right cannot be effectuated by nominating directors from the floor at the annual meeting because most shareholders vote in advance by proxy. Although a shareholder can request that a company's nominating committee include the shareholder's nominees in the company's proxy statement, the shareholder is likely to be turned down. The SEC's proxy rules give shareholders the ability to file their own proxy statement and to solicit other shareholders in favor of their nominees, but conducting a proxy contest is generally an expensive proposition. Meanwhile, the company is able to avail itself of the corporate coffers to fund its own proxy solicitation.

However, a world in which every shareholder has a substantive right to nominate candidates for directors as they fancy and use the company's proxy statement and card to campaign for their personal choices would be completely unworkable and undesirable. It could, among other things, waste corporate resources, distract the

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

board of directors from the business of the corporation, waste the time and attention of other shareholders, lead to divisions in the board, and dissuade qualified board candidates from agreeing to be included in the company's slate of nominees. Set the bar for proxy access too low, and every annual meeting could easily become the subject of one or more bitter contested elections, diverting the attention of the board and management from corporate business and ultimately harming corporate shareholders.

In balancing these competing interests, critics argue that the SEC's latest proposal may set the bar for shareholder access to a company's proxy statement and card too low for many companies. The SEC proposal would apply to all companies subject to the proxy rules—even if the shareholders of a particular corporation prefer to set the bar higher (e.g., by voting for a bylaw that imposes a higher ownership threshold or additional eligibility requirements for proxy access or which prohibits such access).

The vote on the current proposal was three-to-two, with affirmative votes by Chairman Schapiro and Commissioners Walter and Aguilar. In the midst of the most severe financial crisis since the Great Depression, it seems likely that some version of a proxy access proposal will pass under Chairman Schapiro's tenure, but it is not certain that it will be passed in time for the 2010 proxy season, as many have speculated. We expect there to be substantial opposition to the proposal from the corporate community, and a number of details in the rulemaking that the SEC may need to resolve. We believe that there is a possibility that faced with substantial opposition to the direct access component of the proposal, the SEC could pass the proposed amendment to Rule 14a-8(i)(8) in time for next year's proxy season, which is less controversial, and defer acting on proposed Rule 14a-11.

Opponents of the current SEC proposal include Commissioners Casey and Paredes, who both delivered strong dissenting opinions at the SEC's May 20, 2009 meeting. Both Commissioners argue that if the SEC were to grant shareholders a federal direct right of access to a corporation's proxy materials, as is proposed, it would encroach on a corporation's internal corporate affairs, which has traditionally been the province of the states. The DC Circuit Court, where a challenge to the SEC's rulemaking authority would be heard, takes seriously the substantive limits of agency rulemaking, as demonstrated by its invalidation of SEC rules on hedge fund registration in 2006. Therefore, in some ways it is surprising that the SEC is willing to press the limits of its own authority in the proxy area where state law plays such a prominent role.

This advisory highlights key aspects of the SEC's proxy access proposal, as well as some of the controversy surrounding the proposal. We also discuss the recent amendment to New York Stock Exchange Rule 452, which will prohibit discretionary voting by brokers in director elections. In addition, we briefly cover recent changes to Delaware law authorizing proxy access and proxy expense reimbursement bylaws, as well as two legislative initiatives that would bolster shareholder rights by creating a federal right to shareholder access. Finally, we suggest four actions that public companies might consider taking now.

HIGHLIGHTS OF THE SEC'S PROXY ACCESS PROPOSAL

Shareholder Eligibility to Use Rule 14a-11

The SEC is proposing that a shareholder or group be given access to a corporation's proxy statement and proxy card based on the percentage (and time) of beneficial ownership and the classification and net asset size of the issuer:

- One percent, for large accelerated filers and registered investment companies with net assets of $700 million or more;
- Three percent, for accelerated filers and registered investment companies with net assets of $75 million or more but less than $700 million; or
- Five percent, for non-accelerated filers and registered investment companies with net assets of less than $75 million.

Proposed Rule 14a-11 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 debt

registered under Section 12 of the Securities Exchange Act of 1934 (Exchange Act). In addition to the beneficial ownership requirements, the nominating shareholder or group would be required to have held the stock for at least a one-year holding period prior to the date of notice to the company on a Schedule 14N of the nominating shareholder's or group's intent to require that the company include its nominee(s) in the company's proxy materials. Shareholders would be permitted to aggregate their holdings in order to meet the ownership eligibility requirement.

Critics of the SEC's proposed beneficial ownership thresholds argue that the proposed thresholds are too low—well below the more than five percent threshold that would trigger reporting under Regulation 13D-G. The SEC's current proposal contains no triggering events, such as governance failures. It applies to public companies subject to the proxy rules irrespective of whether the company in question has excellent or poor governance, its board of directors has acted responsibly and has been accountable to its shareholders, or the interests of shareholders that seek to use the corporation's proxy machinery are aligned with other shareholders or are contrary to the interests of the corporation.

Maximum Number of Nominees to be Included in Company Proxy Materials

Under proposed Rule 14a-11, a company would be required to include one shareholder nominee or the number of nominees that represents 25 percent of the company's board of directors, whichever is greater, in the company's proxy statement and on its proxy card. Where more than one nominating shareholder or group is eligible to have its nominees included in the company's proxy materials, the SEC proposes to reward the first to provide timely notice to the company. Specifically, the company would be required to include in its proxy materials the nominees of the first nominating shareholder or group from which it receives timely notice, up to and including the total number of shareholder nominees required to be included by the company. Where the first nominating shareholder or group from which the company receives timely notice does not nominate the maximum number of directors required to be included by the company, the nominees of the next nominating shareholder or group would be included in the company's proxy materials.

The SEC's proposal could result in a race among nominating shareholders or groups to be the first shareholder or group to nominate directors. The SEC states that the "first-in" standard is fairer to small shareholders. However, it is difficult to understand how a procedure that rewards the first shareholder to provide notice is intrinsically fairer than a procedure that gives priority to shareholders or groups with a larger ownership stake in the company. This is another area where opponents of the SEC proposal can argue that the SEC is proposing to substitute its judgment for that of the states and even company shareholders, who could designate what procedures should apply in the case of multiple nominations through adoption of a proxy access bylaw.[1]

A further concern is that the SEC's proxy access proposal, when combined with the plurality voting standard for contested elections, could give a small minority of shareholders that have special interests the ability to unduly influence director elections. As more nominees appear on the ballot, the likelihood increases that a director supported by special interests but not supported by a majority of voting shareholders will be able to win.[2]

Shareholder Notice on Schedule 14N

The nominating shareholder(s) would be required to provide a notice on Schedule 14N to the company by the date specified in the company's advance notice bylaw provision, or where no such provision is in place, no later than 120

1 The SEC has requested comment on whether different criteria for selecting shareholder nominees should apply (e.g., largest beneficial ownership, length of security ownership, random drawing, allocation among eligible nominating shareholders or groups, etc.) or whether companies should have the ability to select among eligible nominating shareholders or groups and if so, what criteria the company should be required to use.

2 *See* Professor J.W. Verret, *Proxy Access: Chinese Menu Ballots Address Concerns*, published by DealLawyers.com Blog (June 4, 2009), available at http://www.deallawyers.com/blog/archives/001067.html.

calendar days before the date the company mailed its proxy materials for the prior year's annual meeting.[3] The notice would also be filed with the SEC.

The disclosure provided by the nominating shareholder or group would be similar to the disclosure currently required in a contested election and would be included by the company in its proxy materials. If the nominating shareholder or group elects to have a supporting statement included in the company's proxy statement, Schedule 14N would include any supporting statement in favor of the nominees, not to exceed 500 words.

Schedule 14N would disclose the amount and percentage of securities owned and the length of ownership of the securities,[4] as well as disclosures about the nominating shareholder or group and the nominee(s) for director, and the nature and extent of the relationships between the nominating shareholder or group and the nominee(s) with the company or any of its affiliates. Schedule 14N must also contain certain representations from the nominating shareholder or group.[5] The nominating shareholder or group would also be required to: (1) certify in Schedule 14N that it is not seeking to change the control of the company or to gain more than a limited number of seats on the board of directors; and (2) include a written statement of intent to hold the requisite shares through the date of the annual meeting, and a statement of intent with respect to continued ownership after the election. Schedule 14N must also contain a statement from the nominee(s) consenting to be named in the company's proxy materials and if elected, to serve on the board. Schedule 14N would be required to be amended promptly in the event of any material change in the facts set forth in the originally-filed Schedule 14N.

The nominating shareholders could be liable for any false or misleading statements in Schedule 14N or any amendments to Schedule 14N that are then included in the company's proxy materials. A company would not be liable for information that is provided by the nominating shareholder or group under Rule 14a-11 and 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. Any information that is provided to the company on a Schedule 14N and then included in the company's proxy materials would not be incorporated by reference into the company's SEC filings unless the company determines to incorporate that information by reference specifically into that filing. To the extent that a company does incorporate such information by reference or otherwise adopts the information as its own, the company's disclosure of that information would be considered the company's own statement for purposes of the antifraud and civil liability provisions of the federal securities laws.

Process for Excluding Shareholder Nominees

Under proposed Rule 14a-11, a company could exclude a shareholder nominee where: (1) applicable state law or the company's governing documents prohibit the company's shareholders from nominating a candidate for director; (2) the nominee's candidacy or, if elected, board membership, would violate controlling state law, federal law, or stock exchange rules (other than rules regarding director independence); (3) the nominating shareholder or group does not meet the rule's eligibility requirements;(4)

3 If the company did not hold an annual meeting during 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 and file its notice as of the date specified by the company in a Form 8-K under a new proposed Item 5.07 of Form 8-K. The date specified must be a reasonable time before the company mails its proxy materials for the meeting. The Form 8-K would be due within four business days after the company determines the anticipated meeting date.

4 Alternatively, if the nominating shareholder or group is not the record holder of the shares (and has not filed a Schedule 13D or 13G or reports on Forms 3, 4, or 5 under the Exchange Act), Schedule 14N must include a written statement from the record holder of the shares verifying that, as of the date of the Schedule 14N, the shareholder continuously held the securities for at least one year.

5 The nominating shareholder or group would be required to represent that (1) to their knowledge, the nominee's candidacy or board service would not violate state or federal law or applicable stock exchange rules (other than rules regarding director independence); (2) the nominating shareholder or group is eligible to submit a nominee under Rule 14a-11; (3) the nominee meets the objective criteria for "independence" that apply to directors generally (but not specific criteria that applies to audit committee members) in applicable stock exchange rules, if any (or, in the case of an investment company, the nominee is not an "interested person" as defined in section 2(a)(19) of the Investment Company Act of 1940); (4) neither the nominee nor the nominating shareholder (or any member of a nominating shareholder group) has an agreement with the company regarding the nomination of the nominee.

the nominating shareholder's or group's notice is deficient; (5) any representation in the nominating shareholder's or group's notice is false in any material respect; or (6) the nominee is not required to be included in the company's proxy materials due to the proposed limitation on the number of nominees required to be included.

If a company determines that it will include a shareholder nominee, it must notify the nominating shareholder or group in writing no later than 30 calendar days before it files its definitive proxy statement and proxy card with the SEC.

If a company determines that it has a basis to exclude a shareholder's director nomination(s), the following chart from the SEC's proposing release summarizes the Rule 14a-11 procedures and timetable that would apply:

Proposed Exemptions From Disclosure for Nominating Shareholders or Groups

The SEC has also proposed new exemptions from certain proxy rules (including the requirement to file or furnish a proxy statement) for: (1) certain solicitations made by shareholders that are seeking to form a nominating shareholder group; and (2) certain solicitations by a nominating shareholder or group in support of a nominee placed on a company's proxy card pursuant to Rule 14a-11 or against the company's nominees. Certain conditions must be met to qualify for the exemptions, including the filing of soliciting materials with the SEC no later than the date the material is first published, sent, or given to shareholders.

A shareholder or shareholder group would not, solely by virtue of nominating one or more directors under proposed Rule

Due Date	Action Required
Date set by company's advance notice provision or, in the absence of such a provision, 120 days before the anniversary of the date that the company mailed the prior year's proxy materials	Nominating shareholder or group must provide and file notice on Schedule 14N
Within 14 calendar days after the company's receipt of the nominating shareholder's or group's notice on Schedule 14N	Company must notify the nominating shareholder or group of any determination not to include the nominee or nominees
Within 14 calendar days after the nominating shareholder's or group's receipt of the company's deficiency notice	Nominating shareholder must respond to the company's deficiency notice
No later than 80 calendar days before the company files its definitive proxy statement and form of proxy with the Commission	Company must provide notice of its intent to exclude the nominating shareholder's or group's nominee or nominees and the basis for its determination to the Commission
Within 14 calendar days of the nominating shareholder's or group's receipt of the company's notice to the Commission	Nominating shareholder or group could submit a response to the company's notice to the Commission staff
As soon as practicable	Commission staff would, at its discretion, provide an informal statement of its views to the company and the nominating shareholder or group
No later than 30 calendar days before the company files its definitive proxy statement and form of proxy with the Commission	Company must provide the nominating shareholder or group with notice of whether it will include or exclude the shareholder's nominee or nominees

14a-11, soliciting on behalf of that nominee or nominees, or having that nominee or nominees elected, lose their eligibility to file as a passive or qualified institutional investor on Schedule 13G, rather than Schedule 13D. Any activity other than those provided for under Rule 14a-11 would make the exception inapplicable. The exception would only be available for purposes of the nomination. Following the election of directors, a nominating shareholder or group would need to reassess its eligibility to continue to report on Schedule 13G.

CONTROVERSIAL ISSUES

The Stated Rationale for the Proxy Access Proposal

Critics of proxy access argue that the stated rationale for the proposal does not support the broad federal proxy access regime being proposed. In her opening statement, Chairman Schapiro stated that the recent economic crisis has led to serious questions about the accountability and responsiveness of some companies and boards to the interests of shareholders, including whether boards are exercising appropriate oversight of management, are appropriately focused on shareholder interests, and need to be more accountable for their decisions regarding such issues as compensation structures and risk management. But as Commissioner Casey pointed out, the federal substantive proxy access regime which the SEC proposal creates would be imposed not only on "the country's largest banks and Wall Street firms, but also on thousands of other large and small public companies across the country" that "had little do with the financial crisis" or the "excessive risk-taking and compensation structures" that the SEC cites as the rationale for the proposal.[6] Therefore, critics of the proposal object that a fundamental problem with the SEC's proposal is that it applies to all corporations, whether or not their boards have failed to be accountable to shareholders for their decisions. A further problem, according to Professor Stephen M. Bainbridge, is that board accountability is not a primary concern of the SEC, but of state corporate law.[7]

6 *See* Commissioner Kathleen L. Casey, *Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations*, May 20, 2009, available at http://sec.gov/news/speech/2009/spch052009klc.htm.

7 *See* Professor Stephen M. Bainbridge, *SEC Proxy Access Proposal*, May 20, 2009, available at http://www.professorbainbridge.com/professorbainbridgecom/2009/05/sec-proxy-access-proposal.html.

Whether a Federal Right to Proxy Access is Needed and the Rising Power of Shareholder Activists

Although proxy access has been debated by the SEC for decades, the need for a federal substantive right to proxy access has dissipated as changes in regulation and technology have made it easier for shareholders to mount a proxy contest or replace individual directors. As Commissioner Paredes noted at the May 20, 2009 meeting, more than half of all companies in the S&P 500 now have some form of majority voting, and many boards have been destaggered. Ironically, majority voting gained force in part because of the failure of proxy access to move forward. Opponents of proxy access argue that majority voting is a powerful tool in the hands of institutional investors and activist shareholders—some of whom may have interests that are not necessarily aligned with those of the small, retail shareholder—because it generally requires that directors receive a majority of votes cast in uncontested elections. Vice Chancellor Strine of the Delaware Court of Chancery has noted that the effect of such a bylaw in Delaware is to turn a withhold vote into a no vote, and a majority vote bylaw cannot be amended by the directors.[8] In recent years, activist shareholders have organized "just say no" campaigns urging shareholders to withhold votes for certain directors. Many companies have adopted policies which require directors to tender their resignation if they fail to get a majority vote in an uncontested director election.

On July 1, 2009, the SEC approved amendments to New York Stock Exchange Rule 452 which eliminate the ability of brokers, as the record holder of shares, to cast uninstructed votes on behalf of beneficial owners in an uncontested director election. The changes to Rule 452 will apply to shareholder meetings held on or after January 1, 2010.[9] Under the current version of

8 *See* Remarks of Vice Chancellor Strine at the Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law, May 7, 2007, unofficial transcript available at http://www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf.

9 The vote on the Rule 452 amendment was three-to-two in favor, with Commissioners Casey and Paredes dissenting. Proponents of the change have argued that broker discretionary voting distorts elections because brokers have no economic interest in the shares and tend to vote in favor of company management. Commissioner Paredes noted that a competing view suggests that Rule 452 enfranchises retail shareholders by providing a means by which their voice can be expressed, in light of past experience which indicates that retail

Rule 452, an uncontested director election is considered to be a "routine" matter, which allows brokers to cast uninstructed votes in the election in their discretion. As a result of the amendments, no director election will be considered a "routine" matter under the rule, whether contested or not. Since most institutional investors exercise their voting power while many retail investors fail to vote, the changes to Rule 452 may further shift more power into the hands of institutional and activist shareholders. The changes to Rule 452 are likely to have a greater impact on companies that have depended on broker discretionary votes to establish quorums[10] or to elect board nominees for director, especially those with a majority vote standard for director elections. In combination with majority voting and the e-proxy rules, the changes to Rule 452 arguably make the need for a federal proxy access right less forceful.

The e-proxy rules make it significantly less expensive for institutional investors and activist shareholders mounting proxy contests or withhold vote campaigns to solicit proxies. At many corporations a majority of votes is held by relatively few institutions, and shareholders waging a proxy contest are not obliged to solicit every shareholder.

The SEC's Authority to Grant a Federal Right to Proxy Access and Conflict with State Law

The SEC's authority to grant shareholders a federal right to nominate directors in a company's proxy statement is debatable and is likely to be the subject of substantial comment. State law governs the internal affairs of a corporation, including such matters as voting rights, the mechanics of annual meetings, the power to vote by proxy, a proxy's validity, and execution and revocation of proxies. The federal proxy rules govern the solicitation of proxies. However, there are many areas of overlapping jurisdiction, including the form of proxy, its term, the authority to act by proxy, and even proxy disclosure, although states have generally deferred to the SEC with respect to disclosure.[11] The SEC's authority to regulate proxies goes beyond disclosure and extends to "the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of shareholders."[12] Nevertheless, the SEC's current authority in the proxy area is limited to disclosure and process.[13]

Recent changes to the corporate law of Delaware, for example, illustrate how a state can create proxy access. Effective August 1, 2009, Delaware adopted a new Section 112 of the Delaware General Corporation Law, explicitly authorizing corporations to adopt bylaws that provide for shareholder access to a corporation's proxy statement for director nominations.[14] In addition, new Section 113 of the Delaware law, effective August 1, 2009, permits corporations to adopt bylaws providing for the reimbursement by the corporation of expenses incurred by a shareholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaws may prescribe. Similar amendments to the Model Business Corporation Act are under consideration.

shareholders support management by a wide margin when voting. Both Commissioners Casey and Paredes argued that any changes to Rule 452 should be part of a comprehensive assessment of the proxy voting process rather than being amended in isolation. Commissioner Paredes pointed out that of 137 comment letters on the proposal, 95 expressed concerns about the amendment, and 93 recommended that the SEC defer action on the proposal so that it could be considered as part of a comprehensive review of the proxy system.

10 Companies that rely on the broker discretionary vote to establish quorums should consider including at least one routine item on the company's proxy card (e.g., the ratification of auditors) to ensure that broker discretionary votes are counted for purposes of establishing a quorum at the meeting.

11 *See* Aranow & Einhorn, *Proxy Contests for Corporate Control* (3rd Ed.), at §5.01[A], citing to the Securities and Exchange Commission, Division of Corporation Finance, Disclosure Operations: Proxy Rules Reference Book 1-3 (1980).

12 H.R. Rep. 73-1383 (1934), available at 1934 WL 1290 (Leg. Hist.)

13 *See* statements made by Professor Stephen M. Bainbridge at the Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law, May 7, 2007, transcript available at http://sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf (citing to *Business Roundtable* v. *SEC* for the proposition that "[n]othing in the 1934 Act was intended to let the Commission regulate the substance of corporate governance. Section 14(a) is not an exception to that. Your powers under Section 14(a) are limited to disclosure and process.") *See also* Commissioner Kathleen L. Casey, *Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations*, May 20, 2009, available at http://sec.gov/news/speech/2009/spch052009klc.htm, stating: "[t]he Supreme Court has made clear that, in the absence of an explicit federal law, state law governs the internal affairs of the corporation, and the DC Circuit has held that proxy rules that are substantive, rather than procedural or related to disclosure, are not valid."

14 Although Section 112 is effective August 1, 2009, in practice it cannot be fully implemented unless the SEC first amends SEC Rule 14a-8(i)(8), which currently gives corporations the ability to exclude shareholder proposals that relate to the nomination of directors or procedures for nominations from the company's proxy materials.

Commissioners Casey and Paredes have each suggested that the SEC may have exceeded its authority in the proxy area. Commissioner Casey has noted that the SEC's proposed proxy access rule includes the conditions under which a company will be obligated to provide proxy access, eligibility requirements for nominees and proponents of nominees, such as minimum share ownership and holding period requirements, and the required procedures for shareholders seeking proxy access. She points out that these are the exact same matters in a non-exclusive list that may be addressed in a proxy access bylaw in Delaware. This suggests that the SEC's proposal may not be merely procedural.

If the SEC passes the Rule 14a-11 component of its current proposal, it seems likely that the SEC's authority may be challenged on preemption grounds. As proposed, Rule 14a-11, would permit a company to exclude a shareholder nominee from its proxy materials if the nominee's candidacy or election to board membership would violate controlling state or federal law. If a company's charter and bylaws permit shareholder nominees to be included in the company's proxy materials but impose more restrictive eligibility standards (e.g., higher ownership thresholds) or mandate more extensive disclosures than those required by Rule 14a-11, the company could not exclude a nominee submitted by a shareholder in compliance with Rule 14a-11 on the grounds that the shareholder or the nominee fails to meet the more restrictive standards included in the company's governing documents. However, state law or a company's governing documents may provide shareholders with nomination or disclosure rights that provide greater proxy access than is provided under proposed Rule 14a-11.[15]

15 In order to illustrate the issue, suppose that the shareholders of a Delaware corporation adopt a proxy access bylaw under new Section 112 of the Delaware code that requires that a nominating shareholder or group has beneficially owned five percent of the company's voting stock for at least two years. If the Delaware corporation is a large accelerated filer, the SEC's proposed Rule 14a-11 would only require that the nominating shareholder or group has beneficially owned one percent of the company's voting securities for a period of one year. Conversely, if the SEC's rule required the nominating shareholder or group to beneficially own three percent of the voting shares (as is proposed for accelerated filers) for a one-year period prior to making the nomination and the Delaware bylaw included a one percent beneficial ownership requirement and a one-year holding period, the provisions of the bylaw would apply.

Commissioners Casey and Paredes contend that a one-size-fits-all mandate should not be decreed at the federal level and forced upon public companies and their shareholders. Rather, the SEC should leave proxy access decisions to the states, which can then act as laboratories for experimentation and use "private ordering" to allow different corporations and their shareholders to decide on the rules of the game depending on their particular circumstances.

Ironically, on the day of the SEC meeting to consider proxy access, President Obama sent a memorandum to the heads of executive departments and agencies stating the general policy that preemption of state law should be undertaken only with full consideration of the legitimate prerogatives of the states and with a sufficient legal basis for preemption. The memorandum requests a review of regulations issued within the past ten years that contain statements that preempt state law, in order to decide whether such statements or provisions are justified under applicable legal principles governing preemption. At the May 20, 2009 meeting, Commissioner Casey pointed out that the advantages of reserving authority to the states include the ability of states to respond to the needs of the constituents affected by their laws, as well as the ability of states to function as "laboratories," a process which is proceeding apace in the proxy access area. On that same day, President Obama stated in his memorandum to executive departments and agencies that, as Justice Brandeis explained over 70 years ago, "[i]t is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[16]

PENDING LEGISLATION

Two recent legislative initiatives would bolster shareholder rights by, among other things, creating a federal right to shareholder access. However, both bills also include provisions on a number of other shareholder rights, including giving shareholders a "say" on executive pay,

16 *See* The White House, *Memorandum for the Heads of Executive Departments and Agencies, Subject: Preemption*, May 20, 2009, available at http://www.whitehouse.gov/the_press_office/Presidential-Memorandum-Regarding-Preemption/.

and therefore seem less likely to move ahead in time for the 2010 proxy season. Nevertheless, in the event that the SEC's proposals get derailed due to strong opposition from corporations or Congress otherwise determines that action is necessary to bolster the SEC's authority in this area, at some point Congress could move ahead with a version of proxy access legislation.

The Shareholder Bill of Rights Act of 2009, sponsored by Senator Charles Schumer (D-NY) and Senator Maria Cantwell (D-WA), would affirm the SEC's authority to establish rules relating to the use of a company's proxy solicitation materials by shareholders who nominate directors provided that the shareholder, or a group of shareholders acting by agreement, has beneficially owned an aggregate of not less than one percent of the voting securities of the company for at least two years prior to the record date for the shareholder meeting.

The Shareholder Empowerment Act of 2009, sponsored by Congressman Gary Peters (D-MI), would require the SEC to adopt rules requiring public companies subject to the proxy rules to provide security holders that have held at least one percent of the company's voting securities for at least two years access to proxy forms to nominate directors. The SEC's rules adopted under this provision would specify the information to be provided to an issuer by security holders who nominate candidates and would only apply when less than a majority of directors is nominated. The legislation would require directors in uncontested elections to receive votes from a majority of shareholders, and to resign if they failed to obtain majority approval. The rules would apply for meetings held on or after January 1, 2010.

CONSIDERATIONS

The SEC's proxy access proposal would radically alter the balance of power at corporations in favor of shareholder activists and change the nature of shareholder meetings. Therefore, public companies might consider taking the following actions:

Submit a Comment Letter. Companies may wish to consider submitting a comment letter that supports the counterproposal that was suggested by Commissioner Paredes at the SEC's May 20, 2009 meeting on proxy access, or otherwise make their views known on various aspects of the proposal. The SEC has solicited comment on hundreds of questions, and the responses that the SEC receives may influence the final version of any rules adopted. Comments are due by August 17, 2009.

Commissioner Paredes' counterproposal would amend Rule 14a-8(i)(8) to permit shareholders to include a bylaw proposal in the company's proxy materials that would allow shareholders proxy access for nominating directors provided the company's jurisdiction of incorporation has adopted a provision explicitly authorizing a shareholder access bylaw.[17] Commissioner Paredes' counterproposal has a number of advantages over the current SEC proposal. It removes the question of the SEC's authority from the picture while leaving proxy access decisions to the states. Rather than mandating a one-size-fits-all solution, it would accommodate state corporate law developments and empower shareholders to consider adopting bylaw provisions on proxy access that the shareholders find suited to a particular corporation's circumstances. In addition, under Commissioner Paredes' proposal, the SEC would remain the neutral arbiter with respect to proposed shareholder access bylaws under its existing Rule 14a-8 procedures, without the need for the SEC to design and administer complex procedures to implement proxy access under tight timetables.

Review Advance Notice Bylaws. Public companies should review advance notice bylaws to make sure that their director nomination and election procedures allow sufficient time for the company to make use of the SEC's proposed no-action process for seeking the staff's concurrence that shareholder nominees may be excluded from the company's proxy materials under the proposed rules. Most advance notice bylaws establish a deadline for director nominations that would not give companies sufficient time to make use of

17 *See* Commissioner Troy A. Paredes, *Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations*, May 20, 2009, available at http://sec.gov/news/speech/2009/spch052009tap.htm. Currently Rule 14a-8(i)(8) provides that a company may exclude a shareholder proposal that relates to a director nomination or election, or a procedure for nomination or election.

the SEC no-action process. The SEC's proposal includes a detailed timeline and related procedures for seeking the staff's concurrence when a company wishes to assert a basis for excluding shareholder nominees from its proxy materials. The procedure is modeled on the no-action procedures that the SEC currently uses in the Rule 14a-8 area. However, the timeline that the SEC proposes conflicts with the advance notice period for nominating directors contained in most advance notice bylaw provisions. A typical advance notice bylaw provides that shareholders must give notice of director nominations to the company within 90 to 120 days prior to the annual meeting date. This would not give companies sufficient time to make use of the SEC's no-action process. If the SEC adopts final proxy access rules in time for the 2010 proxy season in the form proposed, companies will want to amend their advance notice bylaws before next year's proxy season.

Monitor Proxy Access Developments and Be Prepared to Act Promptly. The American Bar Association's Task Force on Shareholder Proposals of the Committee on the Federal Regulation of Securities has prepared a model shareholder access bylaw. This bylaw, as well as others we have seen, does not take the SEC's recent proposal into account. We encourage public companies to monitor proxy access developments and be prepared to act promptly in the event that either the SEC or Congress takes action before the beginning of the 2010 proxy season.

Improve Shareholder Communications. In light of the increasing power of shareholder activists, companies should continue to get to know their shareholder base and improve their investor relationships with institutional investors.

If you would like more information about any of the topics discussed, please contact your Arnold & Porter attorney or:

Richard E. Baltz
+1 202.942.5124
Richard.Baltz@aporter.com

Laura Badian
+1 202.942.6302
Laura.Badian@aporter.com