

CORPORATE AND SECURITIES LAW

ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

SEC Adopts Proxy Access Rules: How to Prepare for 2011 Proxy Season

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On August 25, 2010, the SEC issued final rules on shareholder proxy access, whereby shareholders will be able to require a public company to include such shareholder's director nominees in the company's proxy materials. SEC commissioners voted 3-2 yesterday to approve the rules, which were subject to heavy criticism from the two dissenting Republican commissioners.

These rules will subject public companies to more frequent contested director elections, including multi-shareholder contests, and are likely to significantly alter the corporate governance landscape. In conjunction with other corporate governance developments, such as mandatory "say-on-pay" votes at public companies beginning with the 2011 proxy season under the Dodd-Frank Act, the elimination of brokers' discretionary authority in uncontested director elections and the spread of majority voting, the adoption of proxy access will likely further increase the leverage of activist shareholders and heighten the already pervasive influence of proxy advisory services, most notably RiskMetrics Group (formerly ISS).

The final rules will be in effect for the 2011 proxy season and are expected to become effective on or about November 1, 2010. Application of the new rules is delayed three years from the effective date for "smaller reporting companies," generally companies with a non-affiliated market capitalization of less than \$75 million. The SEC's adopting release on proxy access can be found at <http://www.sec.gov/rules/final/2010/33-9136.pdf>.

The SEC's authority to promulgate proxy access rules was arguably in question until President Obama signed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* last month which confirmed the SEC's ability to issue the final rules. The final rules will likely be challenged by groups such as the U.S. Chamber of Commerce in an attempt to block proxy access, but commentators generally expect the final rules to survive any such judicial challenge.

Below we summarize the final rules and suggest how public companies can begin planning for these significant changes in the director election process.

The SEC's New Rules – Limits on Number of Shareholder Nominees, Shareholder Eligibility Requirements and Other Mechanics

The SEC's new Rule 14a-11 under the Securities Exchange Act of 1934 sets out the requirements for shareholders to require a public company to include its nominees in the company's proxy statement. The rule applies to all public companies (including controlled companies and investment companies), except for debt-only issuers and foreign private issuers. The main provisions are as follows:

Number of Shareholder Nominees. Under the new Rule 14a-11, a shareholder (or groups of shareholders) meeting the eligibility requirements described below may nominate candidates representing no more than 25 percent of a company's board (or, if a company's board consists of three or fewer members, shareholders may nominate one candidate). If a company has a staggered board, then current directors up for re-election who came into office under the proxy access rules will count toward this 25 percent limit.

Additional shareholder nominees may still be nominated through a traditional proxy contest, in which a dissident shareholder distributes a separate proxy statement seeking votes for its director nominees. In other words, the new rules do not limit the existing process that dissident shareholders can already employ – at their own expense – to nominate their own directors. Moreover, the rules indicate that a company will be required to include Rule 14a-11 nominees in the company's proxy statement at the same time that this company is subject to a traditional proxy contest in which another shareholder or group of shareholders solicits votes for its nominees through its own proxy statement.

Shareholder Eligibility Requirements. The rules include the following shareholder eligibility requirements:

- A shareholder or group of shareholders must hold investment and voting power with respect to at least 3 percent of the voting securities of a company in order to nominate directors under Rule 14a-11. Securities that have been borrowed or sold short will not count toward the 3 percent threshold. The SEC had originally proposed a tiered minimum ownership requirement based on company size, but ultimately decided that the 3 percent threshold would apply to all public companies.
- A group of shareholders will be able to aggregate their securities to meet the 3 percent ownership threshold.
- A nominating shareholder or group of shareholders will be required to have held at least 3 percent of the company's shares for at least three years before being eligible to make a Rule 14a-11 nomination. In addition, shareholders making such a nomination must certify their intent to hold the shares through the election meeting date.
- If more shareholder nominations are properly submitted than are permitted under Rule 14a-11, then priority will be given to the nominations submitted by shareholders with the greatest ownership percentage of a company's stock. This differs from the proposed rules, which gave priority to nominations in the order submitted – a "first in time" rule that had been criticized as unworkable.
- If a nominating shareholder or group of shareholders fails to hold the shares through the meeting date, the nomination will be disqualified. If such disqualification occurs before a company commences printing its proxy materials, and shareholders had properly submitted more director nominations than permitted by Rule 14a-11, then the nominee from the shareholder or group of shareholders with the next highest ownership percentage (if any) must be substituted for the disqualified nominee. If a nominee is disqualified after the company commences printing its proxy materials, no substitute nominee must be included.
- The nominating shareholder or group of shareholders must certify that it has no intent to seek a change in control of the company.

Requirements for Nominees. To be eligible to be nominated under Rule 14a-11, a potential nominee must satisfy the generally applicable director independence requirements of the national securities exchange on which the company's securities are listed. There is no requirement that the nominee comply with any director qualification requirements set forth in the company's governing documents, although the nominating shareholder will have to disclose whether or not its nominees satisfy any such requirements. Moreover, there are no restrictions on the relationship between the nominating shareholder(s) and the nominee, despite calls for such a restriction by a large number of commentators during the SEC comment process.

Notification Requirements. Under Rule 14a-11, shareholder director nominations must be submitted no earlier than 150 days, and no later than 120 days, before the date that is one year after the company mailed its proxy statement for the prior year's annual meeting.

Exclusion of Improper Nominations. Rule 14a-11 provides a procedure for companies to exclude shareholder nominees if the eligibility requirements of the rule are not met. This exclusion process requires notice from the company to the nominating shareholder and the SEC. In addition, a company can request that the SEC provide (at its discretion) its views on whether the exclusion is permissible by way of a no-action letter.

No Opt-Out Mechanism. Despite widespread speculation that the final rules might include an opt-out mechanism through which shareholders of a company could vote to approve a bylaw amendment that would restrict or eliminate proxy access for that company, the rules provide that companies cannot, through shareholder action or otherwise, limit the ability of shareholders to submit nominations pursuant to Rule 14a-11. In contrast, Rule 14a-11 permits public companies, either through management- or shareholder-sponsored bylaw amendments, to adopt proxy access bylaws that are more permissive or "shareholder friendly" than Rule 14a-11. Moreover, under an amendment to existing Rule 14a-8(i)(8) that was adopted as part of these new rules, shareholders may request that companies include in their proxy statements proposed bylaw amendments that would provide for more permissive shareholder proxy access— for example, for more nominees than 25 percent of the board – than provided in the new SEC rules.

This framework and the lack of an opt-out mechanism disappoints critics of the SEC's proxy access rules. These critics argue that the SEC is imposing a one-size-fits-all proxy-access approach on all companies, when companies and shareholders would be better off fashioning their own proxy access rules that fit their specific circumstances. Such critics believe the new rules will embolden activist shareholders and create unnecessary expenses and management distractions for public companies.

Proxy Card. If a nomination is timely and properly submitted by a shareholder, a company will be required to include that nominee in the company's proxy statement and proxy card. On the proxy card, a company will be able to distinguish between company and shareholder nominees, but the company will not be able to provide a slate voting option (an option of voting for, or withholding authority to vote for, all of the company's nominees).

Schedule 14N. In conjunction with new Rule 14a-11, the SEC has also adopted a new Schedule 14N, a form that nominating shareholders will be required to file with the SEC on which they must provide certain information and make certain certifications.

Considerations for 2011 Proxy Season

The new proxy access rules reflect a shifting governance landscape in which activist shareholders are gaining more influence over corporate governance. In this environment, it is vital for public companies to maintain an active shareholder relations team which includes senior executives, investor relations professionals and outside counsel. A public company should be able to fluently articulate its strategic direction and initiatives to its shareholder base and to anticipate criticisms of company performance in a constructive manner.

More particularly, in response to these developments, we advise public companies to:

- ***Review their charter and bylaws in light of the new proxy access rules.*** We expect that most public companies will elect to amend their bylaws so that their advance notice bylaw provisions are consistent with the mechanics of Rule 14a-11. In particular, well-drafted advance notice bylaw provisions impose disclosure and other requirements on shareholders who desire to make director nominations, and these requirements will generally be invalid or inapplicable to nominations made under Rule 14a-11. Advance notice bylaw requirements with respect to director nominations made outside of Rule 14a-11 (that is, by a shareholder utilizing its own proxy statement) will continue to be valid if appropriately tailored, and will continue to be integral in the event a company becomes subject to a proxy fight outside of Rule 14a-11.
- ***Monitor and review their shareholder bases.*** Public companies are advised to closely monitor their shareholder bases. In particular, companies should attempt to ascertain which shareholders of the company (acting alone) would be eligible to nominate directors under Rule 14a-11 as the result of holding at least a 3 percent ownership interest for at least three years. In addition, companies should review whether any of their significant institutional shareholders have indicated an intent to utilize Rule 14a-11 by compiling a database of director candidates or otherwise.
- ***Maintain an ongoing dialogue with significant shareholders.*** The adoption of proxy access in conjunction with the enactment of say-on-pay effective for the 2011 proxy season further heightens the importance of maintaining a dialogue with significant shareholders, as well as being mindful of shareholder concerns obtained through this dialogue. Companies should continue to be mindful of the general prohibition under Regulation FD on communicating material nonpublic information when having these communications – for example, even if discussing certain corporate governance changes may not be viewed as material, management should be mindful about not disclosing material nonpublic financial information in the course of these discussions.
- ***Understand the voting practices of significant shareholders.*** Through conversations with shareholders, feedback from their proxy solicitor, and review of publicly available information, companies should attempt to gain an understanding of the voting practices of their significant shareholders, including their voting history, whether and the extent to which they follow the recommendations of a proxy advisory firm, and, if so, which proxy advisory firm they follow.
- ***Be mindful of the voting recommendations and significant influence of proxy advisory firms.*** Proxy advisory firms will have a significant influence on Rule 14a-11 director election contests, and companies are advised to be mindful of the policies of proxy advisory firms, particularly RiskMetrics Group.

- **Prepare the case for company nominees.** Companies should be prepared to advocate for their director nominees and to explain in their proxy statements and other communications the attributes of their director nominees and how they contribute to a long-term strategic plan beneficial to all shareholders.

Bass, Berry & Sims PLC's Shareholder Activism Subgroup monitors and advises on developments in the area of proxy contests, activist campaigns, takeover defenses and shareholder communications. If you have any questions regarding the issues addressed in this *Corporate and Securities Law Alert* or would like us to discuss these developments in greater detail with you, please feel free to communicate with your regular contacts in our Corporate and Securities Group or any of the attorneys in our Shareholder Activism Subgroup listed below.

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