



SEC Seeks Public Comment on Proposed Shareholder Proxy Access Rules

On May 20, 2009, the Securities and Exchange Commission (the “SEC”) voted in favor of proposed new rules that would require public companies to include in their proxy materials director nominees proposed by shareholders in addition to those proposed by management. The new proposal thus would allow shareholders to bypass the traditional process for nominating directors. On June 10, 2009, the SEC issued the proxy access proposing release, which seeks comment on more than 170 points comprising almost 500 individual questions.¹ The proposed new rules signal a reversal in policy by the SEC, which voted against so-called “investor access” proposals in both 2003 and 2007. The new proposal, as reflected by the SEC’s 3-2 vote, is highly controversial, and many questions of both proponents and opponents of shareholder proxy access remain unanswered.

This client briefing summarizes the key terms of the proxy access rules described in the SEC’s proposing release (the “Release”) dated June 10, 2009 and identifies important issues arising from the proposal. It updates our client briefing on this topic that we distributed on May 29, 2009.

The Proposed New Rules

CHARLOTTE

The SEC’s proposed proxy access rules have two key components.

CHICAGO

- *New Rule 14a-11*: The SEC proposes to create new Rule 14a-11 under the Securities Exchange Act of 1934 (the “Exchange Act”), which would allow shareholders who, for at least one year, have exceeded an ownership threshold of between one and five percent (depending on the market capitalization of the company) of a company’s outstanding common stock to include their nominees for director in the company’s proxy materials unless otherwise prohibited by the company’s governing documents or state corporation law.

GENEVA

HONG KONG

LONDON

LOS ANGELES

- *Rule 14a-8*: The SEC proposes to amend Exchange Act Rule 14a-8 to narrow the “election exclusion” and allow shareholder proposals relating to the procedures for election of directors to be included in a company’s proxy statement.

MOSCOW

NEW YORK

The proposed rules would not apply to foreign private issuers, which generally are not subject to the SEC’s proxy rules.

NEWARK

PARIS

SAN FRANCISCO

WASHINGTON, D.C.

¹ The proposing release, “Facilitating Shareholder Director Nominations,” (Rel. No. 33-9046), can be found on the SEC’s Web site at www.sec.gov/rules/proposed/2009/33-9046.pdf.

Shareholders Eligible to Nominate Directors

Proposed Rule 14a-11 provides proxy access to shareholders of the largest reporting companies who have held at least one percent of the company's outstanding shares for one year or more, while shareholders of smaller companies would need to meet higher ownership thresholds. To take advantage of the new rule, shareholders would have to own at least:

- 1 percent of the outstanding common stock of a large accelerated filer (non-affiliate market value of \$700 million or more);
- 3 percent of the outstanding common stock of an accelerated filer (non-affiliate market value of \$75 million or more but less than \$700 million); or
- 5 percent of the outstanding common stock of a non-accelerated filer (non-affiliate market value of less than \$75 million).

Shareholders would be able to aggregate their holdings with those of other shareholders to meet the applicable thresholds required for proxy access. To facilitate the creation of shareholder groups to nominate directors, the SEC has proposed an exemption from the proxy rules for communications between shareholders that contain limited information, such as the identity of and contact information for the soliciting shareholder and the identity and background information for the proposed nominee or the characteristics of the nominee the shareholder proposes to nominate. Notice of a shareholder's intent to nominate a director must be filed with the SEC on Schedule 14A. Rule 14a-11 would apply to all companies subject to the SEC's proxy rules, including investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act"), unless state law or a company's governing documents prohibit its shareholders from nominating directors.

Number of Shareholder Nominees

As proposed, a company would be required to include in its proxy materials no more than one shareholder nominee or the number of nominees that represents 25 percent of the company's board of directors, whichever is greater. Where more than one nominating shareholder or group of shareholders (referred to herein as a "nominating shareholder") would be eligible to have their nominees included in the company's proxy statement, the company would be required to include the nominees of the first nominating shareholder to provide the company with timely notice

of its intent to nominate. If the first nominating shareholder does not nominate the maximum number of directors allowed under proposed Rule 14a-11, the nominee or nominees of the next nominating shareholder from which the company receives timely notice of intent to nominate a director would be included in the company's proxy materials, up to and including the total number of shareholder nominees that may be included.

Nominating Shareholder Representations and Filing Requirements

To take advantage of the new rule, a nominating shareholder has to send to the company and file with the SEC a proposed new Schedule 14N stating the shareholder's intent to nominate a director to be included in the company's proxy materials. This notice must be filed by the date specified in the advance notice provision of the company's bylaws or, where no such provision is in place, no later than 120 days before the date the company mailed its proxy materials for the prior year's annual shareholders' meeting.² Schedule 14N would require the following:

- information regarding the amount and percentage of securities beneficially owned by the nominating shareholder;
- a written statement from the record holder of the shares verifying that the shares have been held continuously for at least one year;
- a statement that the nominating shareholder intends to continue to hold the shares through the date of the annual meeting and after the election of directors at the meeting;
- representations about the nominating shareholder's eligibility to use Rule 14a-11;
- a certification that the securities are not held for the purpose, or with the effect, of changing control of the company or gaining more than a limited number of seats on the board of directors;
- representations that neither the nominee nor the nominating shareholder has an agreement with the company regarding the nomination of the nominee;
- biographical information regarding the nominating shareholder;
- personal and professional information about the nominee for director, including the nominee's business experience; and
- information regarding certain legal proceedings involving the nominee, as specified in Item 401(f) of Regulation S-K.

² In the case of a company that did not hold an annual shareholders' meeting during the prior year, notice must be provided to the company a "reasonable time" before the company mails its proxy materials, as specified by the company in a Form 8-K filed within four days of the company determining the annual meeting date.

Nominating Shareholder Liability

A nominating shareholder may be liable for any materially false or misleading statements in information provided to the company by the nominating shareholder in its Schedule 14N or any amendment thereto that is included in the company's proxy materials. Under proposed Rule 14a-9(c), nominees and nominating shareholders are prohibited from making any statement that, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or that omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter that has become false or misleading.

The proposed rule also provides that the company would not be responsible for information that is provided by the nominating shareholder 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. Additionally, any information provided by a nominating shareholder and later included in the company's proxy materials would not be incorporated by reference into any SEC filing unless the company chooses to incorporate it by reference in a specific filing. However, if a company does incorporate such information by reference, it would be considered the company's own statement for purposes of the antifraud and civil liability provisions of the Securities Act of 1933 (the "Securities Act"), the Exchange Act or the Investment Company Act.

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 applicable state law, federal law, or rules of a national securities exchange and such violation could not be cured. However, an exception would apply in determining the independence of director nominees. A nominating shareholder generally would be required to represent on Schedule 14N that a nominee satisfies the applicable standards of a national securities exchange regarding director independence. However, where an applicable independence standard requires a subjective determination by the board or a group or committee of the board, the nominating shareholder would not have to represent that such element of the independence standard has been satisfied. In the case of an investment company, the nominating shareholder would have to represent that its nominee is not an "interested person" of the company as defined in the Investment Company Act.

Determining Eligibility

Upon receipt of a nominating shareholder's Schedule 14N providing notice of its director nominee, the company would determine whether any of the events permitting exclusion of the nominee have occurred. Such events of exclusion include a finding that:

- proposed Rule 14a-11 does not apply to the company;
- the nominating shareholder has not complied with Rule 14a-11;
- the director nominee does not meet the requirements of Rule 14a-11;
- a representation required to be included in Schedule 14N is false or misleading in any material respect; or
- the company has received more shareholder nominees than it is required to include in its proxy statement.

If no events of exclusion exist, the company must provide the nominating shareholder with written notification, at least 30 days before the filing of its definitive proxy statement, that it will include the nominee in its definitive proxy statement and form of proxy filed with the SEC. The company could identify any shareholder nominees as such on the form of proxy and could recommend that shareholders vote for or against, or withhold votes from, the shareholder nominees as well as management nominees. In addition, a company would be required to include in its proxy statement, if requested by the nominating shareholder, a statement by the nominating shareholder in support of the nominee or nominees that does not exceed 500 words. In addition, both the company and the nominating shareholder would be able to solicit proxies in favor of their nominees outside of the proxy statement, provided that such solicitations were made within the parameters of the applicable proxy rules.

If, after receiving notice of a shareholder's intent to have a nominee included in the proxy statement, the company determines that it is permitted to, and wishes to, exclude a shareholder nominee, the company must follow the procedure for exclusion described in the Release. The procedure, which is similar to the procedure used to determine whether other shareholder proposals must be included, is outline in the following table.

Deadline	Action Required
Within 14 days of receipt of the nominating shareholder's Schedule 14N	Notify the nominating shareholder of the company's determination not to include a nominee, including an explanation of the company's basis for exclusion.
Within 14 days of receipt of the company's notice of exclusion described above	The nominating shareholder must respond to the company and correct any eligibility or procedural deficiencies identified by filing an amendment to its Schedule 14N. Neither the composition of a nominating shareholder group nor a shareholder nominee could be changed to correct a deficiency.
At least 80 days before the company files its definitive proxy materials with the SEC	If the company determines that it still may exclude a shareholder nominee, the company must provide notice of the basis for its determination to the SEC and provide a copy to the nominating shareholder. The burden of proof for establishing that a shareholder nominee was properly excluded falls on the company.
Within 14 days of the company's notice to the SEC described above	The nominating shareholder may submit a response to the company's notice to the SEC. The SEC's staff may, at its discretion, issue a no-action letter to the company and the nominating shareholder stating whether it views the exclusion as proper.
At least 30 days before the company files its definitive proxy materials with the SEC	The company must provide notice to the nominating shareholder as to whether it will include or exclude the nominee.

Additional Considerations for Nominating Shareholders

The proposed rule provides that a nominating shareholder will not become an "affiliate" of the company under the Securities Act solely as a result of acting as a nominating shareholder. In addition, should a nominating shareholder's nominee be elected to the board, the nominating shareholder will not become an "affiliate" of the company as long as he or she does not have an agreement or relationship with the director. The Release recognizes the possibility that shareholders who successfully nominate and place a director on a corporate board may be deemed to be members of the board themselves under the so-called "deputization theory" for purposes of Section 16(b) of the Exchange Act and thus could face short-swing profit liability for their trades in the company's securities. The Release suggests that the SEC may propose standards to avoid this result.

A nominating shareholder or group of shareholders must also consider whether they have formed a group that is required to file beneficial ownership reports under Exchange Act Section 13(d)(3) and Rule 13d-5(b)(1). Any group of persons that is directly or indirectly the beneficial owner of more than 5% of a class of equity securities of a reporting company must file a Schedule 13D with the SEC. However, a passive investor that owns between

5% and 20% of a class of equity securities and did not acquire the securities with the purpose or effect of changing or influencing control of the company may file its beneficial ownership report on a Schedule 13G. The SEC states in the Release that a nominating shareholder or group of shareholders would not lose its eligibility to file as a passive investor on Schedule 13G solely as a result of the nomination and/or election of a director under Rule 14a-11.

Election-Related Shareholder Proposals

In addition to proposed Rule 14a-11, the SEC has also proposed to amend Exchange Act Rule 14a-8 to allow shareholder proposals relating to the procedures for election of directors to be included in a company's proxy statement. Currently, a company may exclude from the proxy statement shareholder proposals that "relate to an election." Under the proposed amendment, revised Rule 14a-8(i)(8) would not restrict the types of amendments that a shareholder could propose to a company's governing documents to address the company's provisions regarding nomination procedures or disclosures related to shareholder nominations. Any such proposals that conflict with proposed Rule 14a-11 or state law could be excluded by the company. The SEC notes in the Release that a shareholder could propose amendments that would establish procedures for nominating directors and disclosures related to such

nominations that require different ownership thresholds, holding periods or other qualifications or representations than those in proposed Rule 14a-11. The SEC has not clearly articulated the ways in which a proposal could be deemed to conflict with Rule 14a-11, but, by way of example, it stated that a proposal that would preclude director nominations by shareholders who would qualify under proposed Rule 14a-11 from being included in the company's proxy materials would be properly excluded under new Rule 14a-8.

Issues with the Proposal

The SEC's proposal has intensified the ongoing debate between management groups and shareholder activists as to proxy access. We anticipate that the following issues will be among those raised in comment letters that are submitted in response to the SEC's proposal.

Absence of Control Intention: Schedule 14N requires nominating shareholders to certify that their shares are not held for the purpose or effect of changing control of the company. A company may exclude a shareholder nominee if it believes that this certification is false or misleading in any material respect. Because control intentions are inherently subjective and highly fact-specific, this rule could set the stage for disputes between the company and the nominating shareholder if the company has reason to question the truthfulness of the certification. Several issues may arise:

- How can the company meaningfully investigate and determine the truthfulness of the certification?
- In assessing the accuracy of the certification, may the company consider the behavior of the nominating shareholder with respect to other companies, including a shareholder's history of trying to acquire or influence control of other companies?
- Other issues may arise over the meaning of the term "control" itself. For this purpose, does "control" include efforts to change the policies of the company, for example, with respect to matters such as foreign expansion, capital investment or cost-cutting? Or should "control" be defined more conventionally to include only the acquisition of a majority of a company's voting securities or the ability to elect a majority of the board of directors?
- What issues arise if a shareholder's certification in this regard was accurate when made but the shareholder subsequently determines it wants to effect a change of control?
- If a shareholder's certification as to control is found to be inaccurate after its director nominee has been elected, what are the consequences? May the director nominated by such

shareholder be removed from the board, even though the director has been elected by the shareholders?

Independence Determination: Nominating shareholders must represent that a nominee is "independent" consistent with the objective standards of the applicable national securities exchange, but need not represent that the nominee meets any subjective test of independence. Both the NYSE and the Nasdaq have two-part independence tests for directors that include a set of objective or "bright line" disqualifying criteria as well as a broad, subjective standard. The objective disqualifying criteria include relationships between the issuer and the director or members of the director's family, such as employment and certain consulting agreements. The subjective criteria require the board to determine that an independent director has no "material relationship" with the issuer or that a director has no relationship that would "interfere with the exercise of independent judgment" in carrying out his or her duties as a director.

- Why should the independence standard be lower for shareholder nominees?
- Does the nominating shareholder have enough information to determine that a nominee is objectively independent from the company? Traditionally, independence determinations are made by the board of directors after receiving a completed questionnaire from the prospective director detailing his or her business and personal affiliations. It does not appear that the SEC contemplates a similar process for shareholder nominees, with the result that the burden of establishing the nominee's independence will fall on the nominating shareholder.
- What if, due to insufficient available information, a nominee whom the nominating shareholder has represented to be objectively independent is subsequently found not to meet the objective independence test?
- What if an objectively independent nominee is elected to the board and then is determined by the board or relevant committee not to be independent under any subjective independence test imposed by the rules of the applicable exchange?
- If a company has more stringent independence requirements than those imposed by the listing standards applicable to the company, should the company's requirements or the listing standards apply?

Intent to Hold Securities Through Date of Annual Meeting: Nominating shareholders must represent on Schedule 14A that they intend to hold their shares through the date of the meeting for the election of directors.

- What remedy exists if shareholders fail to hold on to their shares? Removal of nominee from the ballot, or, if elected, from the board?

Desirable Qualifications: A key factor for nominating committees in selecting a nominee for board election is whether the nominee possesses a particular expertise that is necessary for the board to function effectively, such as finance, accounting, manufacturing or M&A.

- One possible concern with the SEC's proposal may be that the overall expertise and effectiveness of a board of directors may suffer if the shareholder nominee defeats an incumbent candidate that has special expertise that is desirable for the board as a whole. For example, what if the shareholder nominee defeats a candidate who has served for years with distinction as chair of the Audit Committee or who has M&A expertise that greatly assists management with an ongoing acquisition program?
- The SEC apparently believes that a shareholder's right to nominate a director overrides these considerations, and, as a matter of shareholder democracy, the SEC may be right. But if the SEC's proposal is adopted in its current form, nominating committees may be well-advised to anticipate the ensuing consequences if a shareholder nominee displaces a valuable board member who happens to be up for re-election when the shareholder nominee is placed on the ballot.

SEC Review: Is the SEC equipped to respond timely to the potentially high number of disputes between companies and nominating shareholders? Fact-intensive matters such as the accuracy of certifications as to control intentions may be difficult for the SEC to resolve. If the SEC does not issue a no-action letter as to a dispute over an event of exclusion, is the company's position final or may the shareholder pursue other remedies, such as injunctive relief?

Race to Nominate Directors: The Release states that the proposed nominees of the first nominating shareholder to nominate the maximum number of directors will be included in the proxy materials and all additional shareholder nominees will be excluded. As a result, meritorious nominees may not be included because they were submitted a day after other nominees.

- Is this approach desirable if the objective is to maximize the qualifications of corporate board members? The Release (question E.10) asks for comment on this issue and proposes other possible criteria for selecting the shareholders' nominees to be included in the company's proxy materials, including the amount of shares held or how long shares have been held. (The

Release even suggests that a random drawing is a possibility.)

- The Release also asks whether it may be desirable for the company's proxy statement to include the nominations of more than one shareholder group. This alternative would increase the choices available to the shareholders but would complicate the presentation of director nominees on company proxy cards.

Shareholder Liability: A nominating shareholder may be liable for any false or misleading statements in information provided to the company.

- What is the consequence for a nominating shareholder who includes materially false information or materially false representations on Schedule 14N under the proposed Rule 14a-9(c)? For example, suppose that a nominating shareholder falsely claims that he or she does not intend to seek control of the issuer.
- What flexibility does the board have to fashion its own remedies? For example, may a board of directors adopt a bylaw stating that it may remove any director whom it believes was elected based on a false shareholder declaration?
- The Release states that a company has no liability for statements made by a nominating shareholder that are including in its proxy statement unless the company knows or has "reason to know" that the statement is false or misleading. Does the use of a "reason to know" standard imply a due diligence responsibility on the part of the company?

Variable Size Board: The SEC proposal does not address situations where the company's governing documents provide for a range for the number of directors on the board rather than a fixed number of board seats. This could enable the current board to adjust the size of the board in order to reduce the number of permitted shareholder nominees, which could be done simply by not filling vacancies as they arise and then reducing the size of the board before the election.

Company Disclosures Regarding the Shareholder Nominee: It is reasonable to assume that a company will perform a basic background investigation regarding a shareholder nominee. Suppose that the investigation reveals information that the company believes is material to the qualifications of a shareholder nominee to serve on the board, but such information is not necessarily required to be disclosed under the SEC's specific disclosure items applicable to director nominees. Examples could include a judicial finding of securities fraud just over five years before the filing date or a dismissal from a CEO or CFO position in which the nominee's former employer alleged that the nominee

misappropriated company assets or engaged in other questionable conduct. A company might reasonably conclude that these and similar facts are relevant to the fitness of a nominee to serve as a director and should be brought to the attention of its shareholders. A company also might conclude, depending on the facts, that it would face liability if it did not disclose such information because it has “reason to know” that the information provided by the shareholder is false or misleading.

- Does the company have an affirmative obligation to include such information in its proxy statement?
- May the company elect to do so?
- Does the shareholder nominee have the right to review the additional disclosure beforehand and to contest or supplement

new disclosures that the company proposes to include?

- How will these disclosure disputes be resolved? The SEC’s review procedures outlined in the Release seem to be limited to disputes over whether a nominee must be included in the proxy statement and do not appear to cover the content of proxy statement disclosure.

The SEC’s deadline for submitting comments on the proposed new rules is August 17, 2009. Please let us know if we may assist you in the preparation of a comment letter.

If you have any questions about the matters discussed in this client briefing, please contact:

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