

**CORPORATE GOVERNANCE ALERT:
SEC PROPOSES RULES GRANTING LARGE LONG-TERM SHAREHOLDERS
ACCESS TO THE COMPANY'S PROXY STATEMENT FOR DIRECTOR NOMINEES**

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The Securities and Exchange Commission has proposed new rules granting large, long-term shareholders access to companies' annual proxy statements for the purpose of nominating up to three independent directors to a company's board.¹ Although the proposed rules are not yet final, they will have a significant impact on the upcoming proxy season as the final rules may contain features that are triggered by shareholder votes in 2004.

EXECUTIVE SUMMARY

Under the SEC's proposed proxy access rules, certain shareholders and groups would be able to use a company's annual proxy statement to solicit votes for their own independent director nominees. A shareholder or group seeking to make such a nomination would no longer be required to wage a separate, expensive proxy fight under the proposed rules, but instead could use the company's machinery and funds to support its campaign in limited, non-control circumstances.

The proxy access process would be applicable to a company only after the occurrence of a "triggering event" that evidences shareholder dissatisfaction with the nomination process or board nominees. Under the proposals, a "triggering event" would exist if, at any time during the last two years (but after January 1, 2004), either:

- a majority of votes cast at a shareholders meeting support a proposal that the company "opt in" to the proxy-access process, but only if such proposal is submitted by a shareholder or group that beneficially owns more than 1% of the company's voting securities for at least one year (as of the date of submission); or
- any of the company's director nominees receives "withhold" votes from more than 35% of votes cast at a shareholders meeting.

Following the occurrence of a "triggering event," a shareholder or group that has owned 5% of a company's voting securities for at least two years could require a company to place between one and three of its nominees, depending on the size of the board in the company's proxy materials. The proposals contain shareholder and nominee eligibility requirements designed to prevent the use of the proxy-access process in connection with a change of control or to nominate affiliated persons.

¹ See SEC Release No. 34-48626 (October 23, 2003). The SEC also recently adopted final rules mandating additional disclosure regarding the director nomination process. We discuss these rules in a separate memorandum, which is available through our website, www.simpsonthacher.com.

The SEC has not yet adopted these proposals, but its proposing release states that the occurrence of a "triggering event" during the 2004 proxy season will result in the opening of the proxy to shareholders in the 2005 proxy season (assuming final rules are adopted). Accordingly, these proposed rules may have significant effects in 2004, even before they become final.

BACKGROUND

Under the SEC's existing proxy rules, any person who wishes to solicit proxies for a registered company must comply with Section 14(a) of the Exchange Act and the SEC's rules promulgated thereunder. In particular, solicitations generally may be made only after delivering to shareholders a definitive proxy statement that has been filed with the SEC and made available for SEC review and comment. With respect to solicitations for director elections, companies solicit proxies for their board nominees by mailing an annual proxy statement.

Shareholders who wish to propose alternative nominees must engage in a competing proxy contest and prepare and mail a proxy statement that conforms to the SEC's rules. This process can be expensive and is rarely successful, principally because shareholder nominees have to compete with the corporation-financed soliciting material. The board's nominees, on the other hand, do not bear the costs of their own candidacy.

As a result of the prohibitive costs of engaging in a separate proxy contest and the low likelihood of success, most director elections are uncontested. Shareholders generally are given the choice of voting "for" each individual candidate, or withholding a vote for such candidate, but the number of candidates is nearly always the same as the number of open seats. This means that a nominee will be elected regardless of a high number – even a majority -- of votes withheld. The SEC refers to this director election process as a "rubber stamp" of the board's nominees.²

NEW SEC RULES REGARDING PROXY ACCESS

Overview of New Rule

The SEC's proposed rules would, under limited circumstances, permit shareholders and groups that have beneficially owned at least 5% of a company's voting securities for more than two years to nominate up to three directors and include disclosure regarding those nominees in the company's annual proxy statement. The proposal contains three significant limitations. First, proxy-access would only be available if a specified "triggering event" has occurred. Second, nominations would only be permitted if the company's state of incorporation and charter do not prohibit shareholder nominations.³ Third, the rules contain eligibility requirements designed to prevent the use of the proposed rules in connection with a change of control or the nomination of affiliated persons.

² See SEC Release No. 34-48626 (October 23, 2003).

³ Delaware law permits shareholder nominations.

Contrary Federal or State Law and Charter Restrictions

The proposed rules will not apply to a company if applicable state law prohibits the company's shareholders from nominating a candidate for election as a director. Similarly, if state law permits a company to prohibit shareholder nominations through provisions in companies' articles of incorporation or bylaws, the proposed procedure would not be applicable to a company that has validly included such a provision.⁴

The SEC also proposes that the proxy-access rules would not apply if a nominee's candidacy or board membership would violate controlling state or federal law or the rules of a national securities exchange or national securities association applicable to the company (other than rules regarding director independence).

Triggering Events

The proposed rules conferring proxy-access and nomination authority would only be effective with respect to a company if a "triggering event" has occurred. The purpose of the "triggering event" requirement is to limit the proxy-access and nomination authority to those circumstances where shareholders have previously demonstrated dissatisfaction with the election process. Prior to the occurrence of a triggering event, no shareholder would have the right to include soliciting materials in the proxy statement.

A "triggering event" exists if, at any time during the last two years (but after January 1, 2004), either:

- any of the company's nominees for the board for whom the company solicited proxies receives "withhold" votes from more than 35% of votes cast at any meeting of shareholders at which directors were elected;⁵ or
- a shareholder proposal that the company open the nomination process and provide proxy-access has been duly submitted by a shareholder or group that held more than 1% of the securities entitled to vote on that proposal for at least one year (as of the date of submission) and the proposal receives a majority of the votes cast on that proposal.

The SEC is considering whether to include additional triggering events in its final rules (e.g., the board's failure to implement a non-binding shareholder resolution submitted by a 1%, one-year shareholder or group that wins a majority of votes cast at a shareholder meeting) and whether the

⁴ This exception is discussed in the proposing release from the SEC, but is not explicitly contained in the text of the proposed rules.

⁵ Withhold votes at an election being contested under Exchange Act Rule 14a-12(c) or being contested pursuant to the proxy-access and nomination rules will not constitute a triggering event. The SEC's proposed rules do not clarify how to calculate withhold votes in an election featuring cumulative voting. For example, the rules do not clearly provide whether shareholders could aggregate their allotted votes as multiple "withhold" votes against a single, targeted director.

35% withhold threshold should be higher or lower. A company would be required to disclose the occurrence of a triggering event in its next quarterly or annual report.

Process of Making a Nomination

Overview. Following the occurrence of a "triggering event," the proposals rules would permit large, long-term shareholders to nominate up to three directors to the company's board and would further require that the company include, in any proxy statement for the election of directors, the names of those nominees and additional shareholder-prepared disclosure, as well as proxy cards containing the names of the shareholder nominees.

Eligible Shareholders. The rules would only permit nominations by, and proxy-access for, a shareholder or group that meets the following criteria:

- The shareholder or each group member has beneficially owned more than 5% of the company's voting securities continuously for at least two years. The company must rely on the beneficial ownership reported by the shareholder or group on its Schedule 13G⁶, unless it has reason to believe that the information is inaccurate.
- The shareholder or each group member intends to hold its qualifying securities through the date of the shareholder meeting.
- The shareholder or group is eligible to, and has, filed a Schedule 13G, evidencing that it is not seeking to change or influence "control" of the company.⁷ The Schedule 13G must set forth information demonstrating compliance with the beneficial ownership thresholds and periods described above. As a result of this Schedule 13G requirement, the SEC has ensured that the proxy-access process could not be used by a participant in a takeover contest (who would be required to file a Schedule 13D instead of a Schedule 13G).

Eligible Nominees. Shareholder nominees must meet certain standards of independence from the nominating security holder or group, including the following criteria:

⁶ Schedule 13G plays an important role under the proposed rules in determining the eligibility of shareholders to make nominations. A Schedule 13G filed in connection with the formation of a group to nominate a director under the proxy-access rules would require a special form of certification regarding the percentage of securities held and the time period for such holding.

Schedule 13G, however, is not used to report beneficial ownership in open-end investment companies. As a result, if the subject company is an open-end investment company, the SEC's proposed rules generally would use a different procedure for reporting information as set forth in Proposed Exchange Act Rule 14a-11(c)(11).

⁷ The SEC proposals would amend the instructions to Rule 13d-1 to provide that "a beneficial owner who acquires or holds a registrant's securities in connection with a nomination under [the proxy-access rules] will not be deemed to have a purpose or effect of changing or influencing the control of the registrant solely by virtue of acquiring or holding the securities in connection with a director nomination pursuant to [the proxy-access rules], a solicitation for the election of that director nominee and/or against a registrant nominee, or the election of that director nominee."

- if any nominating holder or group member is a natural person, then the nominee cannot be (i) the nominating holder, (ii) a member of the nominating group, or (iii) a member of the immediate family⁸ of the nominating holder or any group member;
- if any nominating holder or group member is an entity, then neither the nominee or any immediate family member of the nominee may have been employee of any nominating holder or group member during the then-current calendar year, nor during the immediately preceding calendar year (if any nominating holder or group member is an entity);
- neither the nominee nor any immediate family member of the nominee may have accepted during the then-current calendar year or during the immediately preceding calendar year, directly or indirectly, any consulting, advisory, or other compensatory fee from any nominating holder or group member or any affiliate thereof⁹;
- the nominee may not be an executive officer or director (or person performing similar functions) of any nominating holder or group member, nor of an affiliate thereof;
- the nominee may not control any nominating holder or group member (or, with respect to investment companies, any "interested person" of such nominating holder or group);
- the nominee must meet the objective listing criteria for "independence" applicable to the company¹⁰ (or, with respect to investment companies, the nominee must not meet the definition of "interested person"); and
- neither the nominee nor any nominating holder or group member may have any direct or indirect agreement with the company regarding the nomination of the nominee.

Forming a Group. The SEC sought to encourage groups of institutional shareholders to collaborate to reach the 5% nominating threshold. Accordingly, the SEC's rules prohibiting solicitations outside of the process mandated by Section 14(a) of the Exchange Act would not apply to solicitations to form a nominating shareholder group so long as:

- the number of persons solicited does not exceed 30;
- any written communications used in such solicitation include nothing more than:
 - a statement of intent to form a nominating group under the proxy-access rules;

⁸ "Immediate family" includes any person related to the nominee by blood, marriage, or adoption, not more remote than first cousin.

⁹ Compensatory fees do not include receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with any nominating holder or group member so long as the compensation is not contingent on continued service.

¹⁰ The "independence" test does not include any higher standard applicable only to audit committee members.

- the percentage of securities beneficially owned by the soliciting holder(s); and
- contact information.
- any soliciting material published, sent or given to shareholders must be filed with the SEC, on Schedule 14A, under the company's file number no later than the date the material is first published, sent or given to shareholders.

Formation of a group for purposes of the proxy-access rules will not result in a group under the "beneficial ownership" definition in Exchange Act Rule 16a-1. As noted, the making of nominations and solicitations under the proxy-access rules will not alone be deemed to have a "purpose or effect of changing or influencing the control" of the company under Rule 13d-1.

Nomination Procedures. If, following the occurrence of a "triggering event," a shareholder wishes to nominate a candidate for the board and have proxy-access, it must provide notice to the company of its intention at least 80 days before the anniversary of the date on which the company mailed its proxy materials for its prior year's annual meeting. If the company did not hold an annual meeting during the prior year, or if the date of the meeting has changed more than 30 days from the prior year, then the nominating shareholder must provide notice a reasonable time before the company mails its proxy materials.¹¹

This notice delivered by the shareholder must include a copy of the nominating holder or group's Schedule 13G, as well as significant representations to the company. These representations include, among other representations, that (1) the nominating group and the nominee each satisfy the detailed criteria described above under "Eligible Shareholders" and "Eligible Nominees", respectively, and (2) to the knowledge of each nominating holder or group member, the nominee's candidacy and board membership would not violate applicable law or applicable listing standards.

The information provided to the company in its notice of intent also must include the disclosure described below under "Required Disclosure". The nominating holder or group also must file with the SEC, as Rule 14a-6 "solicitation" material, a copy of these representations and disclosure within two business days after delivery to the company.

Number of Nominees. Shareholders could nominate only one director to a board with eight or fewer members; two to a board with between nine and nineteen directors; and three to a board with twenty or more members. If multiple shareholders or groups seek to nominate more directors than are permitted under the rules, then the shareholders or groups with the largest two-year beneficial ownership would be given priority.

The SEC proposed a slightly different method for calculating the number of permitted nominations for a company with a classified or staggered board of directors, although the maximum number of shareholder-nominated directors would not vary. If a company has a director (or directors) serving on its board who was elected as a shareholder nominee and the term of that director extends past the date of the upcoming shareholders meeting, then the company would not be

¹¹ If a company moves the date of its meeting by more than 30 days, it must provide disclosure on Form 8-K.

required to include more shareholder nominees than could result in the total number of shareholder-nominated directors being greater than the applicable maximum number if the board was not staggered.

Required Disclosure. The rules would require the company to include the following disclosure in its proxy statement regarding the shareholder nominee:

- the name of the nominee (both in the proxy statement and the proxy card);
- a statement from the nominee consenting (i) to be named in the proxy and proxy card and (ii) to serve on the board if elected;
- tabular disclosure regarding the nominee that is substantially similar to the information required of other director nominees under the current proxy rules, including (i) the nominee's biographical data, business experience and involvement in certain legal proceedings, (ii) transactions and relationships between the nominee, on the one hand, and the company or management, on the other hand, (iii) historical company stock trading information and (iv) any material proceedings to which the nominee or its associates is a party that are adverse to the company;
- the name of the nominating shareholder or group and additional biographical data (including involvement in certain legal proceedings) and beneficial ownership data for the shareholder or group¹²;
- the methods by which the nominating shareholder or group may solicit proxies, including (at the option of the shareholder or group) any web site address on which the soliciting materials may be published.

In addition to including this information in the proxy statement, the company would be restricted from providing a means for shareholders to vote for or against directors as a group, or slate, because such a mechanism could prejudice shareholder nominees.

Additional Required Disclosure. If the company includes any statement in its proxy statement supporting the board's nominees and/or opposing the nominees of the shareholder or group, then the shareholder or group may include a statement of support for its nominee not to exceed 500 words.

Liability for Required Disclosure; Incorporation by Reference. The rules would provide that the company is not responsible for any information provided by a nominating holder or group. The required disclosure also will not be deemed incorporated by reference into any other SEC filings, unless specifically identified.

¹² This disclosure is required for not only the shareholder or group, but also each general partner of any partnership, each member of any syndicate or group and each person controlling any such partner or member. If the nominating shareholder is a corporation, then this disclosure must address each executive officer and director of the corporation and its controlling persons (and each executive officer and director of such controlling person).

Solicitations by the Nominating Shareholder or Group in Favor of its Nominee. A nominating holder or group may solicit in support of its nominee without complying with most of the otherwise applicable proxy solicitation rules (other than, most importantly, Rule 14a-9 regarding false or misleading statements) so long as it complies with the following procedures:

- the holder and group may not seek the power to act as proxy for any shareholder and may not furnish or request revocations, abstentions, consents or authorizations;
- the holder and group's written communications must identify the holder and/or group and describe their direct or indirect interests, by security holdings or otherwise;
- the holder and group's written communications must include a detailed securities law legend;
- any soliciting material published, sent or given to shareholders must be filed with the SEC, on Schedule 14A, under the company's file number no later than the date the material is first published, sent or given to shareholders.

Rejecting Nominations. If a company receives a nomination from a shareholder pursuant to the proxy-access rules, but concludes that it is not required to include that nominee (i.e., because either the nominating group or nominee does not meeting the standards set forth in the proposed rules), then the company must disclose such determination in its next proxy statement. The disclosure must include a detailed analysis of the specific basis for excluding the nominee. The company also must provide prompt notice to the nominating shareholder or group regarding its conclusions.

Responding to a Shareholder Proposal on the Nomination Process and Proxy-Access

The SEC's proposed rules would require a company receiving a shareholder resolution that could result in the occurrence of a "triggering event" to include disclosure in its proxy that the vote on the proposal may determine whether the company will be subject to the proxy-access and director nomination procedures. The SEC has recommended that, until the rules are final, companies receiving a shareholder proposal that could result in a triggering event (i.e., from 1%, one-year shareholders who identify themselves as such) should follow the proposed rules by including the proposal and corresponding disclosure.¹³

Additional Issues

The SEC's proposed rules attempt to clarify that some of the relationships created by the nomination process and proxy-access do not, alone, create an "affiliate" status between the nominating shareholder and the company. In particular, the SEC notes that so long as a shareholder does not have a separate agreement with a successful director nominee, the fact that the director was

¹³ For additional information regarding how to respond to the SEC's proposed rules during the 2004 proxy season, as well as additional memoranda regarding recent corporate governance developments, please refer to our website, www.simpsonthacher.com.

nominated by such shareholder will not create "affiliate" status for purposes of the Securities Act or Exchange Act.

EFFECTIVE DATE; APPLICABILITY

The proposed proxy-access rules are not effective for the 2004 proxy season. Any triggering event that occurs after January 1, 2004, however, would subject a company to the new nomination and proxy-access requirements in 2005 – even if final rules are not approved prior to the occurrence of the triggering event. Accordingly, the SEC's proposals already are having an effect on how companies and shareholders conduct their affairs during the 2004 proxy season.

These proposed rules would apply to all companies that are subject to the SEC's proxy rules, including small business issuers. Foreign private issuers, foreign governments, issuers of only American Depositary Receipts and companies with only non-voting securities outstanding are not subject to the proxy rules. The SEC has asked for comment as to whether the proxy-access rules should apply only to "accelerated filers" or other large issuers.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, www.simpsonthacher.com.

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