

**CORPORATE GOVERNANCE ALERT:
PREPARING FOR THE SEC'S PROXY ACCESS PROPOSALS**

JANUARY 15, 2004

The Securities and Exchange Commission has yet to finalize its proposed director nomination and proxy access rules, but its proposals will nonetheless have an impact on the upcoming proxy season. The SEC has indicated that the results of shareholder voting at annual meetings in 2004 will affect whether the SEC's proxy-access requirements, if adopted, will apply to a particular company in its 2005 proxy statement. As a result, we expect that shareholder activists and large shareholders may seek to include shareholder proposals in company proxies during the coming months or may target vulnerable director nominees for "withhold" votes this year. This memorandum is designed to assist companies in preparing for the current proxy season in light of the proposed rules.¹

SUMMARY OF THE SEC'S PROPOSALS

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 proxy fight, 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.²

¹ For a memorandum summarizing the SEC's proposed rules in detail, as well as additional memoranda regarding corporate governance developments, please refer to our website, www.simpsonthacher.com.

² The SEC is considering whether to increase or decrease the 35% withhold threshold (and has received public comments supporting both an increase and a decrease). Withhold votes at an election being contested under

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.

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.

PREPARING FOR THE PROXY SEASON

1. Successful Shareholder Proposals Could Constitute a Trigger Event

The SEC is considering whether to include additional triggering events in its final rules, including, notably, 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. In recent years, many shareholder proposals calling for the redemption of rights plans or the elimination of staggered boards have received majority support. Accordingly, if the SEC expands its "triggering events" definition, a successful shareholder vote on these previously precatory proposals at the 2004 annual meeting would force a company to choose between (1) implementing the proposal and (2) becoming subject to the proxy-access process.

Accordingly, companies responding to requests from shareholder activists should consider the implications of their shareholders seeking a proposal that receives majority support. As a related matter, but no less important, the consequences of rejecting a proposal from a shareholder activist that meets the 1%, one-year test can be more far reaching than is presently the case as a result of their ability to trigger the proxy-access process pursuant to an "opt-in" vote.

2. Disclosure Issues in the 2004 Proxy Statement

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 also recommends that, until the rules are final, companies receiving a shareholder proposal that could result in a triggering event (i.e., from a 1%, one-year shareholder who identifies themselves as such) should follow the proposed rules by including the proposal and corresponding disclosure. We believe it would be in the best interest of most companies to follow the SEC's

Exchange Act Rule 14a-12(c) or being contested pursuant to the proxy-access rules would not constitute a triggering event. The SEC is also considering whether a board's failure to respond to a successful shareholder proposal made by a 1%, one-year shareholder should constitute a triggering event, as described in the text below.

recommendation and, further, we believe that companies should consider seeking a board recommendation against the proposal.

A company also may wish to consider whether it has the right to reject the shareholder proposal as untimely or otherwise failing to meet the SEC's requirements. Under the proposed rules, only "opt-in" proposals made by 1%, one-year shareholders must be included in the proxy. Also, the proposals must comply with Exchange Act Rule 14a-8 (e.g., delivery at least 120 days prior to the anniversary of the mailing of the prior year's proxy statement), even if made by 1%, one-year shareholders.

3. Evaluating the Vulnerability of Directors

Even if a company does not face a specific shareholder proposal regarding proxy-access, it will still confront the risk of a triggering event resulting from the receipt of 35% "withhold" votes for any director nominated by the board. It is also possible the SEC will adopt a threshold lower than 35%.

Companies with controversial directors, or with incumbents who have received a significant percentage of withhold votes should take great care in evaluating their nominees.³ A company may wish to consider, under very limited circumstances, not nominating directors who present a significant risk. In some circumstances, however, we would expect that a company's nominating committee would meet with such directors to discuss specific concerns and then take additional steps intended to reduce the likelihood of receiving withhold votes.

4. Evaluating and Improving Shareholder Relations

In light of the SEC's proposals, we expect that most companies will make special efforts this proxy season to become more attuned to shareholder sentiments, particularly concerning corporate governance and the board of directors. A company may wish to consider evaluating the sufficiency of its investor relations department and budget and/or engaging a proxy solicitor to evaluate shareholder views and those of voting advisory services (such as ISS) and to solicit individual shareholder votes.

³ Institutional Shareholder Services generally recommends that shareholders cast "withhold" votes for a director where the director:

- ignored a shareholder proposal that was approved by a majority of the votes cast for two consecutive years or ignored a shareholder proposal approved by a majority of the shares outstanding;
- is an inside director or affiliated outside director and sits on the audit, compensation, or nominating committee;
- is an inside director or affiliated outside director and the full board serves as the audit, compensation, or nominating committee or the company does not have one of these committees;
- is an audit committee member and the non-audit fees paid to the auditor are excessive (e.g., non-audit fees are significantly in excess of audit fees); or
- attended less than 75% of the board and committee meetings without a valid reason for the absences.

ISS's recommendations are followed, or at least considered as a factor, by many institutional investors.

A proxy solicitor should be particularly helpful in evaluating a company's risk profile. Obviously, those companies most vulnerable are those that have faced successful or nearly successful precatory shareholder proposals in the past, particularly regarding redemptions of rights plans or staggered boards. A proxy solicitor may, however, identify additional weaknesses or areas of concern based on other companies' experiences.

Regardless of whether a company is facing a specific shareholder proposal or has received significant numbers of withhold votes in the past, a proactive approach designed to address shareholder concerns in 2004 may be necessary to avoid turning the 2005 election process into a contested one.

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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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