SIMPSON THACHER MEMORANDUM

The SEC's New Proxy Access Proposal: Thoughtful Reform to Promote Better Corporate Governance or Rushed Response to Political Pressure?

June 26, 2009

INTRODUCTION

The Securities and Exchange Commission, in its latest foray into the contentious issue of stockholder proxy access, released a proposed rule on June 10, 2009 that would generally require public companies to include stockholder nominees for director in company proxy materials so long as the stockholder is not seeking to change the control of the issuer or gain more than a limited number of seats on the board.[1] In the same release, the SEC also proposed an amendment to the stockholder proposal rules that would preclude companies from relying on the "election exclusion" to exclude from their proxy materials proposals to amend company governing documents regarding director nomination procedures or disclosures related to stockholder nominees.

In proposing these rules, the SEC noted the need for a democratized proxy process in the context of the "erosion of investor confidence" and heightened concerns about board accountability, particularly in light of the current economic crisis. The SEC cites a number of other policy arguments in favor of proxy access including the concern of foreign investors and the lack of director accountability creating a competitive issue for U.S. companies. The public comment process and media debates about these proposed rules will highlight sharply differing views about what, if any, changes to the proxy rules would further the best interests of stockholders and the national economy. The SEC also views proxy access as an effective way to remove impediments to stockholder participation in director nominations so that the proxy process better replicates the rights that a stockholder would have in person at an annual meeting.

These proposed rules facilitate stockholder access to a much greater degree than past SEC proposals. We expect the proposed rules to result in the submission of a record number of comment letters to the SEC prior to the August 17, 2009 comment submission deadline. Due to the complexity and importance of the issues involved,[2] we have serious reservations as to

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1 Proposed Rule: Facilitating Shareholder Director Nominations, Exchange Act Rel. No. 34-60089 (June 10, 2009), available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

2 The proposing release is 250 pages long and contains 384 footnotes and almost 500 questions for public comment.

whether the SEC will be in a position to adopt thoughtful and comprehensive reforms to the proxy rules in time for the 2010 proxy season.

BACKGROUND

The SEC's proposed rules are the latest episode in the continuing saga surrounding stockholder access to company proxy materials. In October 2003, the SEC proposed a proxy access rule that would have made access to company proxy materials available to stockholders upon the occurrence of certain issuer-related triggering events (the "2003 Proposal").[3] The 2003 Proposal would have required stockholders to satisfy certain eligibility requirements, including beneficially owning more than 5% of a company's stock for at least two years at the time of a director nomination. The 2003 Proposal made the requirement to permit stockholder nominations only applicable upon the occurrence of certain triggering events that were designed to reflect lack of board responsiveness to stockholder concerns.[4] After attracting approximately 17,000 letters to the SEC in support or opposition, the 2003 Proposal was abandoned in 2004 because the SEC Commissioners were unable to reach a consensus.

In July 2007, the SEC proposed two competing rules relating to stockholder proposals.[5] One rule (the "Exclusion Proposal") codified the SEC's historical interpretation that Rule 14a-8(i)(8) under the Securities Exchange Act of 1934 (the "Exchange Act") allows companies to exclude stockholder proposals that may result in contested director elections. The second rule (the "Access Proposal") would have required companies to include in their proxy materials stockholder proposals for bylaw amendments regarding director nomination procedures, provided that the stockholder making such a proposal beneficially owned more than 5% of the company's stock and had held the stock for at least one year. The SEC received approximately 34,000 letters supporting or opposing these proposed rules. In November 2007, the SEC adopted the Exclusion Proposal but, after the resignation of SEC Commissioner Roel C. Campos, then SEC Chairman Christopher Cox thought it unlikely that he could garner a majority vote to adopt the Access Proposal, but he promised to revisit the matter in the future.

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3 Proposed Rule: Security Holder Director Nominations, Exchange Act Rel. No. 48626 (Oct. 14, 2003), available at http://www.sec.gov/rules/proposed/34-48626.htm.

4 Under the 2003 Proposal, proxy access would have been available to eligible stockholders only after the occurrence of at least one of the following triggering events within the prior two years: (1) the receipt of withhold votes from more than 35% of the votes cast with respect to one or more directors; or (2) a stockholder proposal requesting proxy access receiving support from more than 50% of the votes cast after being submitted by a stockholder who held more than 1% of the company's voting securities for at least one year.

5 Proposed Rule: Shareholder Proposals Relating to the Election of Directors, Exchange Act Rel. No. 34-56161 (July 27, 2007), available at http://www.sec.gov/rules/proposed/2007/34-56161.pdf; Proposed Rule: Shareholder Proposals, Exchange Act Rel. No. 34-56160 (July 27, 2007), available at http://www.sec.gov/rules/proposed/2007/34-56160.pdf.

CURRENT PROPOSED RULES

Proposed Rule 14a-11

Proposed Rule 14a-11 under the Exchange Act would, under certain circumstances, require companies,[6] including registered investment companies, to include stockholder nominees for director in company proxy materials. Unlike the 2003 Proposal, the applicability of Rule 14a-11 would not be predicated on any triggering events designed to evidence lack of board responsiveness to stockholders.

Stockholders seeking to nominate directors under Rule 14a-11 would need to meet certain eligibility criteria regarding length and percentage of stock ownership. Specifically, the nominating stockholder or group would be required to have beneficially owned shares in a company for at least one year in an amount equal to at least:

- 1% of the company's securities for large accelerated filers and registered investment companies with net assets of $700 million or more;
- 3% of the company's securities for accelerated filers and registered investment companies with net assets of $75 million or more but less than $700 million; and
- 5% of the company's securities for non-accelerated filers and registered investment companies with net assets of less than $75 million.

As noted, Rule 14a-11 would not be available to a nominating stockholder or group of stockholders seeking to change control of a company or to gain more than a limited number of seats on a board of directors. The maximum number of nominees a company would be required to include in its proxy materials under Rule 14a-11 would be the greater of (a) one or (b) 25% of the board. A company with more than one eligible stockholder or group would be required to include up to the maximum number of permissible nominees on a first-come, first-served basis in the order in which it receives timely notice of nominations under Rule 14a-11.

Any nominating stockholder or group using Rule 14a-11 would be required to submit to the issuer and file with the SEC a Schedule 14N, which would be subject to liability for false or misleading statements pursuant to Rule 14a-9 of the Exchange Act and which would be required to contain specified information, including: (1) a representation that the nominee meets the *objective* criteria for independence from the company set forth in applicable rules of a national securities exchange or national securities association (if the company is subject to such rules); (2) a representation that neither the nominee nor the nominating stockholder or group has an agreement with the company regarding the nomination of the nominee; (3) a statement

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6 Rule 14a-11 would apply to companies subject to the federal proxy rules because they have a class of equity securities registered under Section 12 of the Exchange Act. The rule would not apply to issuers with only public debt or to foreign private issuers.

that the nominating stockholder or each member of the nominating group intends to own the requisite amount of securities through the date of the stockholder meeting; (4) disclosure regarding the nature and extent of the relationships between the nominating stockholder or group or the nominee and the company or any affiliate of the company;[7] and (5) other disclosures about the nominee and the nominating stockholder or group. In addition, a Schedule 14N could include an optional statement, not to exceed 500 words, to appear in the company's proxy statement in support of the stockholder nominee(s). An amendment to Schedule 14N would need to be filed promptly upon any material change in the facts disclosed in the initial Schedule 14N or in a prior amendment, and a final Schedule 14N amendment would be required to be filed within 10 days after the company's announcement of election results to state the stockholder or group's intention regarding continued ownership of the company's securities.

Proposed Amendment to Rule 14a-8(i)(8)

Rule 14a-8 under the Exchange Act provides that a company must include a stockholder's proposal and supporting statement in its proxy materials if the stockholder satisfies certain eligibility and procedural requirements and the proposal is not excludable on specified substantive grounds. Rule 14a-8(i)(8), commonly referred to as the "election exclusion," provides one such substantive basis for excluding stockholder proposals that relate to a director nomination or election, or a procedure for such nomination or election. This provision permits the exclusion of any proposal to establish a procedure that may result in a contested board election. The SEC's proposed change to Rule 14a-8(i)(8) would, under certain circumstances, require a company to include in its proxy materials a stockholder proposal that would amend, or that would request an amendment to, the company's governing documents regarding nomination procedures or disclosures related to stockholder nominations, provided that the proposal does not conflict with proposed Rule 14a-11.[8]

DISCUSSION

Proposed Rule 14a-11 would institute more dramatic changes than previous proxy access rules proposed by the SEC. The 2003 Proposal would have required a company to include stockholder director nominees only after a triggering event indicating a potential lack of responsiveness by that company to stockholder concerns. The current proposed rule has no triggering event requirement and would instead compel the inclusion in company proxy materials of any qualifying director nominee proffered by an eligible stockholder or group.

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7 Unlike the 2003 Proposal, Rule 14a-11 would not require a nominee to be independent from the nominating stockholder or group.

8 If the SEC adopts this amendment, companies would still be able to exclude stockholder proposals on the basis of any of the procedural requirements or other substantive bases for exclusion under Rule 14a-8.

Additionally, the 2003 Proposal set the minimum stock ownership threshold at 5% with a minimum holding period of two years, whereas the current proposed rule features a tiered beneficial ownership threshold that starts as low as 1% for large accelerated filers and requires only a one-year holding period. As proposed, any number of stockholders can form a group and aggregate their holdings to satisfy the Rule 14a-11 ownership threshold.

One of the most significant issues relating to Rule 14a-11 is the degree to which a company's governing documents may override the proposed proxy access rule. Although the proposed rule does not permit companies to opt out of Rule 14a-11,[9] the SEC has asked whether company governing documents should be permitted to prohibit or limit the inclusion of stockholder director nominees in company proxy materials. In that connection, the release asks whether Rule 14a-11 should provide that a company's governing documents may render the rule inapplicable to a company only if the stockholders have approved a provision addressing the inclusion of stockholder nominees in company proxy materials, as contrasted to the board implementing such a provision without stockholder approval.

Supporters of the SEC's latest version of proxy access see it as a healthy way to give stockholders additional influence over nominations to the board of directors and an effective mechanism to inject fresh ideas into the boardroom and improve board effectiveness. Opponents fear that the proposed rules risk turning every corporate election into a costly and disruptive contest and discouraging qualified director candidates from appearing on a company's slate of nominees. Many argue that proxy access will damage the board cohesiveness necessary for effective oversight and that it will actually exacerbate the short-term management focus which the SEC is attempting to discourage and which many observers blame for the current economic ills. The opponents worry that the flip-side of rosy visions of robust stockholder democracy is selfishly empowered special-interest stockholders pursuing narrow agendas that destroy overall long-term enterprise value. Finally, opponents question whether the accountability of boards—rather than easy money or lax regulations—can be fairly linked to the current financial crisis as the SEC implies.

A dizzying array of unresolved questions surrounds proposed Rule 14a-11, including, but not limited to, the nearly 500 questions posed by the SEC in the proposing release. For example, the rule does not provide for how the Rule 14a-11 process would apply in the case of traditional proxy contests and what would happen if a traditional proxy contest emerged after a stockholder-nominated director was included in company proxy materials. The proposing release also fails to discuss how economic incentives that nominating stockholders or groups may have through derivative securities would be taken into account. For example, Rule 14a-11

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[9] The SEC states that Rule 14a-11 will not be applicable to those companies whose governing documents do not permit stockholder nominations (whether pursuant to proxy access or otherwise). Other than for registered investment companies, this is less significant than it first appears because there is no practical or legal ability to eliminate the ability of stockholders to nominate directors.

appears to permit a nomination by a nominating stockholder or group that had entirely hedged its financial exposure to the company or that would even profit from decreases in the company's stock price. Other issues relating to the proposed rule include the interrelationship of the notice requirements with the company's own advance-notice requirements for director nominations, the application of the rule to directors elected by class and the consequences if a stockholder fails to hold the required amount of shares through the annual meeting.

CONCLUSION

Due to the complexity of the issues involved, we do not believe that the SEC will be able to adopt any form of direct proxy access in a thoughtful manner in time for the 2010 proxy season. As an alternative, a more realistic and measured approach might be to first amend Rule 14a-8(i)(8) as proposed and assess its effects during the 2010 proxy season. The SEC should utilize its resources in a comprehensive and deliberate manner to gather empirical data and perspectives based on the experiences of participants in the proxy process following the amendment of Rule 14a-8(i)(8) in order to develop an approach to access that helps further its objectives without undermining efficient and effective governance of the companies it regulates. In the meantime, companies and their stockholders could privately correct the deficiencies in the proxy process that the SEC has identified (similar to the organic market movement to majority rather than plurality voting for director elections that is taking place, particularly among large-cap companies, in the absence of SEC action[10]). Modifications to the established structure for corporate elections must be carefully calibrated to promote better corporate governance and enhanced participation for all stockholders. Hasty changes adopted for the sake of immediate "reform" in uncertain times could paradoxically result in unintended consequences that diminish the general welfare of stockholders and other corporate constituencies that the proposed rules seek to benefit. In fact, they may exacerbate the problems that the SEC's proposed rules are seeking to remedy.

This memorandum is for general information 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 our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

10 In footnote 69 of the proposing release, the SEC cites a Corporate Library report indicating that, as of December 2008, 49.5% of S&P 500 companies had adopted majority voting in director elections and another 18.4% had retained a plurality standard but adopted a policy requiring the resignation of a director not receiving majority support.

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