

CORPORATE GOVERNANCE ALERT:
SEC PROPOSES RULES TO PROVIDE SHAREHOLDERS ACCESS
TO COMPANY PROXY STATEMENTS FOR DIRECTOR ELECTIONS

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The Securities and Exchange Commission today proposed new rules granting selected shareholders access to companies' annual proxy statements and giving those shareholders the ability to nominate up to three independent directors. A shareholder seeking to nominate independent directors 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. The proposal contains eligibility requirements, however, that are designed to prevent the use of the new proxy-access and nomination rules in connection with a change of control. The company's board would continue to nominate its own separate and complete slate of directors and could publicly oppose any shareholder nominees.

The text of the proposed rules is not yet publicly available. When the SEC makes available the proposed rules, we expect to distribute a more detailed memorandum. In the meantime, we have prepared this overview based on today's open meeting of the SEC Commissioners.

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 and state law permits shareholder nominations (Delaware law permits shareholder nominations). The purpose of the "triggering event" requirement is to limit the proxy-access and nomination authority to those circumstances where a significant portion of shareholders already has demonstrated dissatisfaction with the director nomination and election process. A "triggering event" would occur only if, within the last two years, either:

- a shareholder or group owning at least 1% of outstanding shares sponsors a resolution to open the nomination process and provide proxy-access, and a majority of shares voted at an annual meeting support this resolution; or
- the company receives "withhold" votes representing at least 35% of shares voted in an election for any director nominated by the company.¹

Director Nomination and Proxy-Access Process. Following the occurrence of a "triggering event," the SEC rules would permit specified shareholders to nominate up to three directors to the

¹ Commissioner Glassman suggested that a majority of outstanding shares (rather than votes cast) may be a better trigger with respect to approving resolutions and also said the SEC staff should consider increasing the 35% "withhold" vote threshold to 50%. In contrast, Commissioner Goldschmid suggested that the rules may be more effective if the SEC eliminates the requirement that a 1% shareholder sponsor the resolution. The Commissioners instructed the SEC staff to seek comment on these specific issues.

company's board² and would further require that the company include, in its proxy statement, the names of those nominees and additional shareholder-prepared disclosure, as well as proxy cards containing the names of the shareholder nominees. At today's open meeting, the SEC staff did not describe the scope of the permitted shareholder-prepared disclosure, nor how to resolve disagreements between the shareholders and the company with respect to this disclosure.

Eligible Shareholders and Nominees. The rules would only permit nominations and proxy-access for a shareholder or group that (i) has beneficially owned more than 5% of the company's voting securities for at least two years, (ii) intends to hold those securities through the date of the shareholder meeting and (iii) is eligible to, and has, filed a Schedule 13G evidencing that it is not seeking to change or influence "control" of the company. As a result, the proposed rules would not apply to a participant in a takeover contest. The shareholder or group also cannot have any agreement with the company regarding the nomination process.

Furthermore, shareholder nominees would be required to certify to the company that they are "independent" under applicable listing standards and do not otherwise have a conflict of interest that would interfere with their ability to serve the company's shareholders, as a whole. The directors also would have to certify that they have no financial relationships with, and are not affiliates or employees of, the nominating shareholders.

Effective Time. The proposed rules will be open for public comment for a period of sixty days from publication. As a result, the SEC almost certainly will not finalize the rules before the beginning of the 2004 proxy season. Under the proposals, any triggering event that occurs after January 1, 2004 would subject a company to the new nomination and proxy-access requirements – even if final rules are not approved prior to that date. Accordingly, the proposals will likely affect how companies and shareholders conduct their affairs during the 2004 proxy season.

Conclusions. The proposed rules represent a significant intrusion into substantive corporate law by the SEC.³ While the SEC has considered the adoption of similar rules on at least three previous occasions dating back to the 1940s, we believe the alternative, disclosure-based measures adopted by the SEC in the past to enhance board and management accountability are more consistent with the policies underpinning the federal securities laws. At the very least, the SEC would ideally have waited to assess the effects of the myriad new rules adopted in relation to the Sarbanes-Oxley Act as well as the new rules to be adopted by the NYSE and Nasdaq before taking any necessary additional action in this area.

² 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 larger beneficial ownership would be given priority.

³ The SEC staff, in a prior report, conceded that it needs to consider the scope of the SEC's authority under the federal securities laws to issue the proposed proxy-access rules, and we would expect that this issue will be addressed in the SEC's proposing release.

The companies that will initially be most vulnerable to the new rules are those that have been previously subject to shareholder dissatisfaction. This dissatisfaction may have been evidenced by either precatory shareholder proposals (e.g., redemption of rights plan, elimination of staggered board, etc.) that have obtained a majority vote at recent annual meetings or director "withhold" votes in amounts that are above or relatively close to the proposed 35% threshold. In the past, many companies have been prepared to offer only limited concessions to activist shareholders because an adverse vote on proposals sponsored by shareholders would often have no practical consequences. The prospect of a triggering event, in contrast to a mere precatory proposal, may pressure companies to make much more significant concessions to shareholder groups than such companies were previously willing to make. Many companies may be reluctant to risk management time and resources associated with a contested election or, if an election is successful, the adverse impact on board cohesiveness that may result from the introduction of one or more new directors who have not been selected by the nominating committee, including those who seek to further a separate agenda.

Companies should assess their vulnerability to a triggering event in order to prepare for the coming proxy season, including evaluating alternatives that address the concerns of institutional investors. These efforts should commence expeditiously because the SEC has proposed that any triggering event occurring on or after January 1, 2004 would subject a company to the nomination and access rules at its subsequent meeting.

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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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