

Client Alert

A report
for clients
and friends
of the firm October 2003

SEC Proposes Rules to Require Shareholder Access to a Company's Proxy Statement to Nominate Candidates for Election as Directors

On October 8, 2003, the Securities and Exchange Commission authorized rule proposals, which were presaged by the recommendations in the SEC staff's July 15, 2003 report, *Review of the Proxy Process Regarding the Nomination and Election of Directors*.¹ The proposed rules would require that companies include in their proxy statements the names and certain other information about shareholder nominees for election as directors, if applicable state law permits shareholder nominations of candidates for election as directors and one or more specified "trigger" events has occurred that evidence shareholder dissatisfaction with the effectiveness of a company's proxy process. *See* Securities Exchange Act of 1934 Rel. No. 48626 (October 14, 2003) ("Rel. 34-48626").

The comment period on these proposals will expire on or about December 21, 2003. The proposals are exceedingly complex. Rel. 34-48626 is almost 100 pages long; contains 238 footnotes; asks literally hundreds of questions about the proposals; leaves open numerous important issues; and suggests a number of alternative proposals, some of which are

discussed below. Accordingly, this alert can only summarize the highlights of the proposals.

Although a comment period of 60 days from publication in the Federal Register is longer than the comment periods the SEC has permitted with respect to many of its recent rule proposals, there is no statutorily mandated date for these rules to become effective. Given their complexity and the importance of the questions raised, the comment period spanning the holiday season may not be sufficient for informed comment. However, the SEC appears bound and determined to act on these proposals by the end of 2003.

Companies That Would Be Subject to the Rules

All companies subject to the SEC's proxy rules would be covered by the proposed rules.² Thus, SEC reporting companies that do not have equity securities registered under the Exchange Act and foreign private issuers would not be covered.

State Law Condition

Most states permit shareholders to nominate candidates for election as directors. However, to nominate candidates a shareholder would have to comply with any applicable requirements in the company's certificate of incorporation or by-laws; nominate a candidate from the floor of the meeting; or commence a proxy contest using the shareholder's own proxy statement.

Even if a shareholder were to comply with the existing shareholder nomination requirements of state law, Federal law, SRO standards and a company's cer-

¹ Available at <http://www.sec.gov/news/studies/proxyreport.pdf>.

² However, the SEC is considering applying the proposed rules only to "accelerated filers" and certain registered investment companies. "Accelerated filers" are companies with a "public float" of \$75 million or more that have been SEC reporting companies for at least 12 months and have filed at least one annual report with the SEC and are not "small business issuers". This alert does not address the special rules that would be applicable to registered investment companies.

tificate of incorporation or by-laws, boards of directors seldom, if ever, propose shareholder nominees.

Nominations from the floor of a shareholders meeting have little chance of success, since, generally, only a plurality is needed to elect directors and most shareholders will have given their votes to the company by proxy.

Proxy contests, including those using the SEC's "short slate" rules under Rule 14a-4(d), are too expensive and cumbersome for most shareholders, particularly those not seeking control of the company, to use as a means of nominating candidates for election as director.

Thus, the SEC is seeking a more effective means to permit shareholder nominations. Proposed Rule 14a-11 and the related proposals are the result of that search. However, under these proposals, nominations could not violate state or federal law or general, objective requirements for "independence" of directors under applicable stock exchange or Nasdaq listing standards ("SRO standards"). (Subjective independence requirements and special requirements for audit committee members would not have to be satisfied.)

"Trigger" Events

Events which, in the SEC's view, would evidence shareholder dissatisfaction with a company's proxy process and trigger the shareholder nomination rule are:

- At least one of the company's directors received "withhold" votes from more than 35% of the votes cast at a meeting of shareholders held after January 1, 2004; or
- A shareholder proposal that the company become subject to the shareholder nomination rule (a "direct access proposal") submitted under Rule 14a-8 after January 1, 2004, by a shareholder or group of shareholders (an "eligible shareholder") beneficially owning for more than one year at least one percent of the shares entitled to vote at the meeting (the "one/one trigger") received more than 50% of the votes cast on the proposal.³

The SEC has asked for comments on, but has not formally proposed, a third trigger event. That event would be that any shareholder proposal other than a "direct access proposal" submitted by an eligible shareholder pursuant to Rule 14a-8 that received more than 50% of the votes cast was not "implemented" by the board directors by the 120th day prior to the mailing of the proxy statement for the subject meeting. Should such a trigger be adopted, it could significantly increase resistance to shareholder proposals.

A trigger event would remain operative for the remainder of the fiscal year in which it occurred and essentially for the next two calendar years.

Notice of Potential Trigger Events

Under proposed amendments to Rule 14a-5, the company would be required to disclose a potential trigger event in its proxy statement under which a trigger event could occur. Since there is a potential for 35% of the vote to be withheld from a director in any election held after January 1, 2004, this proposal could require disclosure in every subject company's proxy statement. The SEC recommends such disclosure, pending action on the proposals and, in a thinly veiled threat, stated in Rel. 34-48626: "[c]ompanies also should consider whether failure to make such identification has any implications under Exchange Act Rule 14a-9." The SEC made the same suggestion and the same veiled threat with respect to the possible third trigger event discussed above, even though it has not formally proposed to adopt that trigger.

Notice that a "Trigger Event" Has Occurred

Companies would be required to disclose that a trigger event has occurred in their next 10-Q, 10-QSB, 10-K or 10-KSB, including the vote with respect to the trigger event and that, as a result, the company would be subject to the shareholder nomination rules during the applicable periods.

Who May Nominate Candidates for Election as Directors?-Proposed Eligibility Standards

The SEC does not intend its shareholder nomination rule to become a vehicle or persons seeking control of a company or for single interest shareholder representatives to advance their interests. Therefore, the SEC has proposed eligibility requirements for shareholders wishing to avail themselves of the rules (an "Eligible Nominating Person") to nominate eligible persons for election as directors (an "Eligible Nominee"). Those eligibility requirements are:

- The Eligible Nominating Person would be required to have beneficially own more than 5% of the outstanding shares eligible to vote at the meeting for at least two years;
- The Eligible Nominating Person would be required to hold those shares through the meeting;
- The Eligible Nominating Person would be required to be eligible to file reports of beneficial ownership pursuant to either Rule 13d-1(b) [certain institutional investors] or Rule 13d-1(c) [certain passive investors]; and

³ Pending action on the proposed rules, the SEC staff will interpret the Rule 14a-8 exceptions as not applying to such proposals.

- The Eligible Nominating Person must have filed a schedule 13G reporting its beneficial ownership of such shares.⁴

Permitted Solicitation to Form a Shareholder Group

The SEC has proposed limited exemptions from its proxy solicitation rules and beneficial ownership reporting rules to permit solicitations to form shareholder groups for purposes of nominating candidates for election as directors pursuant to the proposed rules, and/or to be eligible to submit a "direct access proposal."

Who May Be Nominated by a Shareholder as a Candidate for Election as a Director?

As mentioned above the SEC does not intend its proposals to assist persons seeking control of a company or single interest shareholder representatives to advance their interests. Thus, it has proposed the following eligibility requirements for Eligible Nominees:

- If the nominating shareholder or any member of the nominating shareholder group is a natural person, the nominee is not the nominating shareholder, a member of the nominating shareholder group, or a member of the immediate family of the nominating shareholder or any member of the nominating shareholder group;
- If the nominating shareholder or any member of the nominating shareholder group is an entity, neither the nominee nor any immediate family member of the nominee has been an employee of the nominating shareholder or any member of the nominating shareholder group during the then current calendar year nor during the immediately preceding calendar year;
- Neither the nominee nor any immediate family member of the nominee has, during the year of the nomination or the immediately preceding calendar year, accepted directly or indirectly any consulting, advisory, or other compensatory fee from the nominating shareholder or any member of the group of nominating shareholders or any affiliate of the holder or member, provided that compensatory fees would not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the holder or member (provided that the compensation is not contingent in any way on continued service);
- The nominee is not an executive officer, director (or person fulfilling similar functions) of the nominating security holder or any member of the nominating shareholder group, or of an affiliate of the nominating shareholder

or any member of the nominating shareholder group; and

- The nominee does not control the nominating shareholder or any member of the nominating shareholder group.

In addition:

- The nominee will be required to satisfy any applicable SRO standards regarding director independence, except that, where a standard regarding independence that requires a subjective determination by the board or a group (such as the "independent" directors) or committee of the board (for example, requiring that the board of directors or any group or committee of the board of directors make a determination regarding the existence of factors material to a determination of a nominee's independence), that element of SRO independence standard would not have to be satisfied; and
- Neither the nominee nor the nominating shareholder (or any member of the nominating security shareholder group, if applicable) has a direct or indirect agreement with the company regarding the nomination of the nominee.

Number of Directors That Could Be Nominated

The number of directors that could be nominated under the proposals would vary depending upon the size of the company's board of directors.

Under the proposals, an Eligible Nominating Person could nominate one director, if the company's board of directors has up to eight members. If a company has between nine and 19 directors, an Eligible Nominating Person could nominate a maximum of two directors. If a company has 20 or more directors, an Eligible Nominating Person could nominate a maximum of three directors. There are special provisions applicable to companies with "staggered" or "classified" boards of directors.

If there are multiple nominations in excess of the permitted number, the cutoff will be determined by the amount of shares beneficially owned by an Eligible Nominating Person, with a nomination by the Eligible Nominating Person with the greater beneficial ownership prevailing.

Required Form of Notice to Company of a Shareholder Nomination

An Eligible Nominating Person nominating a candidate pursuant to the proposed rule would be required to notify the

⁴ Under the proposals, the Eligible Nominating Person would not be subject to the reporting or shortswing profit provisions of Section 16 of the Exchange Act. Also, the SEC has stated that the judicial "director by deputation" theory should not apply to a shareholder nominee who is elected. Of course, application of that theory is up to the Federal courts not the SEC.

company of the nomination. The form of notice would be required to include the following:

- A representation that the Eligible Nominating Person is eligible to submit a nominee under the security holder nomination procedure;
- A statement that, to the knowledge of the Eligible Nominating Person, the candidate's nomination or service on the board, if elected, would not violate controlling state law, federal law, or SRO listing standards (other than certain standards relating to independence);
- Representations regarding the absence of a prohibited relationship between the nominee and the Eligible Nominating Person;
- A representation that neither the nominee nor Eligible Nominating Person has a direct or indirect agreement with the company regarding the nomination of the nominee;
- A copy of the Eligible Nominating Person's filed Exchange Act Schedule 13G indicating ownership of more than 5% of the appropriate class of the company's securities;
- A representation that the Eligible Nominating Person was eligible to report its security ownership on Exchange Act Schedule 13G in reliance on Exchange Act Rule 13d-1(b) or (c);
- A representation that more than 5% of the appropriate class of the company's securities, as reflected in the Exchange Act Schedule 13G of the Eligible Nominating Person, has been held continuously for at least two years and that the Eligible Nominating Person intends to continue to own those securities through the date of the subject election of directors;
- A statement from the nominee that the nominee consents to be named in the company's proxy statement and to serve on the board if elected, for inclusion in the company's proxy statement;
- Disclosure about the nominee complying with the requirements of Item 7(a), (b) and (c) of Exchange Act Schedule 14A, for inclusion in the company's proxy statement; and
- Any of the following information with regard to each Eligible Nominating Person that is not included in the Exchange Act Schedule 13G, for inclusion in the company's proxy statement:
 - Name and business address;
 - Present principal occupation or employment and the name, principal business and address of any corpora-

tion or other organization in which such employment is carried on;

- The amount of each class of securities of the company that the individual owns beneficially, directly or indirectly, determined in accordance with Exchange Act Rule 13d-3;
- Whether or not, during the past ten years, the individual has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, the dates, the nature of the conviction, the name or other disposition of the case; and whether the individual has been involved in any other legal proceeding during the past five years, as specified in Item 401(f) of Regulation S-K; and
- The methods by which the Eligible Nominating Person may solicit security holders, including any website address on which the nominating security holder or nominating security holder group may publish soliciting materials.

The notice would be required to be provided to the company at least 80 days prior to the date the company furnished its proxy statement for its last annual meeting to its shareholders.⁵ The notice would be required to be filed with the SEC within two business days of being submitted to the company.

Company Procedures Upon Receiving Notice of a Nomination

Upon receiving a notice of a nomination, a company would be required to include information concerning the nomination in its proxy statement and on its proxy card, unless it determines that the nomination does not comply with the shareholder nomination rules.

Required Company Proxy Statement Disclosure

The company would be required to include information about the nomination in its proxy statement, including the website address of the Eligible Nominating Person soliciting in support of the shareholder nominee.

If the company includes a statement in opposition to a shareholder nominee, other than a mere recommendation not to vote for the nominee, the company must notify the Eligible Nominating Person and provide the Eligible Nominating Person with an opportunity to include a statement of up to 500 words in support of the nominee in the company's proxy statement. The Eligible Nominating Person would have 10 business days from the date of the company's notice to provide this statement. The statement would be proxy soliciting material and would be required

⁵ If the company did not hold an annual meeting during its last fiscal year or if the company move the date of the subject annual meeting more than 30 days from the date of its last annual meeting, than the notice must be submitted within a reasonable time before the meeting. The company would be required to disclose this "reasonable time" in a Form 8-K filed with the SEC.

to be filed with the SEC by the Eligible Nominating Person.

Inclusion of a shareholder nominee in the company's proxy statement would not require the company to file its proxy statement in preliminary form.

If the company determines not to include the shareholder nominee in its proxy statement and on its proxy card, the company must notify the Eligible Nominating Person least 30 days before mailing its proxy statement and give its reasons for excluding the nominee. The reasons must be those permitted under the proposed rules, which are:

- The company is not subject to the shareholder nomination rules;
- The Eligible Nominating Person has not complied with the applicable procedures;
- The nominee is not eligible under the rules;
- Any representation in the request is false in any material respect; or
- The company has received more than the permitted number of nominations and can exclude the nomination in question under the shareholder nomination rules.

The company would be required to describe its determination to exclude the shareholder nomination and the reasons for that determination in its proxy statement.

Proposals Affecting the Form of Proxy Card

The Eligible Nominee's name would be required to be included on the company's proxy card. In addition, the company would not be permitted to provide on its proxy card for voting for the company's nominees as a group. Each nominee would have to be listed separately.

Liability Issues

Nominating shareholders will be subject to the antifraud provisions of Rule 14a-9 with respect to the information they supply to the company for inclusion in its proxy statement. The company will not be responsible for this information and it will not be automatically incorporated by reference in the company's Securities Act registration statements or Exchange Act filings.

Of course, the SEC retains the ability to enforce the shareholder nomination rules.

Permitted Solicitation by Shareholders in Support of Their Nominee(s)

The SEC has proposed limited exemptions from its proxy rules to permit shareholders to solicit support for their candidates nominated pursuant to the proposed rules. (A company could solicit in opposition to the shareholders' candidates in accordance with the SEC's existing proxy rules.) Any such solicitations would be subject to the antifraud provisions of Rule 14a-9.

Filing Requirements With Respect to Support Solicitations

If shareholders solicit support for their candidates they would be required to file a notice with the SEC with regard to their candidate support solicitations within two business days of the solicitation. The proposed rules do not address the consequences of a failure to file the required notice or a late filing.

Vote Required to Elect a Director Nominated in Accordance With the Proposals

The vote required to elect a director will continue to be governed by state law and the company's governing instruments, including provisions for cumulative voting.

Related Proposed Disclosure Rules

On August 14 2003, the SEC proposed related rules that would require disclosure, in addition to that required by its existing rules, about:

- The nominating committee process under a company's governing documents and practices, including consideration of candidates recommended by shareholders⁶; factual and
- The process by which shareholders may communicate with directors.⁷

See Rel 34-48301.

Proposed Effective Dates

The SEC has proposed a two stage effectiveness schedule for the shareholder nomination rules. The "trigger" events rules would become effective on January 1, 2004. The remaining rule would become effective in 2005. Thus, the first shareholder nominations could not take place until the 2005 proxy season.

The related disclosure rule presumably could be acted upon at the same time as the shareholder nomination rules or could be acted upon separately. The comment period for

⁶ The New York Stock Exchange and the Nasdaq Stock Market have proposed listing standards which would require that their listed companies have nominating/corporate governance committees comprised of independent directors. See Rel. Nos 34-47672 (April 17, 2003) and 47516 (March 17, 2003)

⁷ The NYSE has proposed to require its listed companies to disclose a method by which interested parties may communicate directly with the presiding independent director or non-management directors as a group. See Rel. 34-47672 (April 11, 2003).

these proposed rules has expired and, if adopted, they are expected to be in effect for the 2004 proxy season.

Some of the Other Open Issues

The open issues not covered by specific rule proposals but which are the subject of questions in Re. 34- 48626 include:

- How disputes will be handled? Will they be handled administratively by the SEC in a manner similar to the procedures under the SEC's existing shareholder proposal rule, Rule 14a-8, or in judicial proceedings? For example, disputes could arise if the company and shareholder or group disagree as to whether the shareholder or group is eligible to submit an "access proposal"; whether a shareholder or group is eligible to nominate a candidate; whether a candidate is eligible; or whether a "trigger event" has occurred. The proposed rules do not provide means for resolving any of these types of disputes. (However, the SEC could take a position and proceed against perceived violations of the rules administratively or civilly.); and
- How will renominations of shareholder nominees be dealt with?

Conclusion

Given the strong support of the proposals by SEC Chairman Donaldson and the apparent support of the other four SEC Commissioners, it is likely that some form of shareholder nomination requirement will be adopted. The comment period expires in December and it is all together possible that the SEC could act on them before the end of the year. The SEC intends that the rules would be in effect as of January 1, 2004, as to "trigger" events. If the SEC acts within this time frame, trigger events that occur in 2004 would permit shareholder nominations in 2005. However, there may be legal challenges to any final rules that could delay their taking effect; prohibit their taking effect; or cause them to be modified.

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