SEC Proposes Rule Relating to Stockholder Nominations of Directors

Executive Summary

On October 8, 2003 the SEC proposed new rules which, if adopted, would require public companies to include in their proxy material stockholder nominees for election as director under certain defined circumstances. This development follows closely behind the proposal of the SEC on August 6, 2003 of rules requiring expanded disclosure regarding the director nomination process and specific disclosure of procedures by which stockholders may communicate with directors.

The proposed rules would permit a stockholder or group of stockholders holding in excess of 5% for at least two years to include between one and three director nominees in company proxy material in the event of the occurrence of certain specified trigger events. In summary, a trigger is deemed to occur when (i) at least one of the director nominees of the company receives "withhold" votes from more than 35% of the votes cast (other than in the case of a contested election or an election in which a stockholder nominee is included in company proxy material pursuant to the proposed rules) or (ii) a stockholder or group of stockholders holding in excess of 1% proposes that the company be subject to the proposed stockholder nomination process, which proposal receives more than 50% of the votes cast.

The proposal contains eligibility requirements that are designed to prevent the use of the new proxy-access and nomination rules by stockholders who are seeking control of a board of directors. The board of directors would continue to nominate its own separate and complete slate of directors and could include a statement in its proxy materials in opposition to any stockholder nominee.

The October proposal would create a new Rule 14a-11 and would amend a number of existing rules, schedules and forms. The 60-day comment period for the October proposal ends on December 22, 2003. The SEC in its lengthy proposed release has solicited comments on a number of questions. We note that at least one SEC commissioner has openly questioned whether or not the SEC has authority to adopt Rule 14a-11 and the related amendments under the 1934 Act.

What is the intended purpose of the proposed rules?

The proposed rules are intended to create a mechanism for nominees of significant long-term stockholders (or groups of stockholders) to be included in company proxy materials where there are indications that the director nomination process may be ineffective or that the security holders are dissatisfied with that process. This stands in contrast to current practice, which requires stockholders who desire to propose director nominees to undertake their own expensive proxy solicitation process or to simply propose a director nominee at the meeting at which the company has already typically secured proxies for enough votes to ensure the election of its slate of directors.

To what companies would proposed Rule 14a-11 apply?

The proposed rule would apply to all companies subject to the proxy rules of the SEC, but only where stockholders would have an existing, applicable state law right to nominate candidates for election as director. The SEC indicated in its release that it is considering applying the proposed new rules only to public companies that meet certain market capitalization and other criteria. Foreign private issuers would not be subject to the proposed new rules.

What are the relevant triggering events?

The proposed rules would not apply until one of two triggering events has taken place. A triggering event would be deemed to have occurred when:

- At least one of the director nominees of the company (for whom the company solicited proxies) received "withhold" votes from more than 35% of the votes cast at an annual meeting of security holders held after January 1, 2004 at which directors were elected, provided this does not apply in the case of a contested election or an election to which the proposed security holder nomination procedure in proposed Rule 14a-11 applied; or

- A stockholder proposal pursuant to Rule 14a-8 requesting application of the proposed new director nomination procedures was submitted for a vote of stockholders at an annual meeting held after January 1, 2004 by a stockholder (or group of stockholders) that held more than 1% of the securities entitled to vote on the proposal for a year or more, and the proposal received more than 50% of the votes cast on that proposal (abstentions and broker non-votes are not included in the calculation).

In the event of the occurrence of a triggering event, the proposed nomination procedure rules would become operative and remain in effect through the remainder of that calendar year and all of the following calendar year, plus the period up to and including the next annual (or special) meeting of stockholders.

When would a company be required to give notice of the occurrence of a triggering event?

A company would be required to make stockholders aware when a nomination procedure triggering event has occurred. In particular, a company would be required to give notice of:

- The occurrence of a security holder vote with regard to either of the nomination procedure triggering events in its next Form 10-Q or Form 10-K; and

- Information disclosing that the company would be subject to the security holder nomination procedure as a result of such vote, if applicable.

What security holders would be eligible to submit nominees?

To be eligible to submit a nomination, a stockholder or group of stockholders would be required to:

- Beneficially own individually or in the aggregate more than 5% of the securities that are eligible to vote for the election of directors at the next meeting, with each of such securities having been held continuously for at least two years from the date of nomination;

- Intend to continue to own those securities through the date of that meeting;

- Not have an intent to change or influence control of the company. In particular, this provision would require the nominating stockholder to be eligible to report beneficial ownership on Schedule 13G rather than Schedule 13D in reliance on Rule 13d-1(b) or (c); and

- Have filed a Schedule 13G or an amendment thereto reporting beneficial ownership as a passive or institutional investor (or group) on such schedule before or on the date of the submission of the nomination to the company, which Schedule must include a certification that the stockholder or group has held more than 5% of the subject securities for at least two years.

What are the qualifications for security holder nominees for director?

Any director candidate nominated by a stockholder or group of stockholders under the proposed new rule must meet certain qualifications, which include:

- The nominee must satisfy the independence criteria of either the New York Stock Exchange or NASDAQ, as applicable; and

- The nominee must have no specified relationships with the nominating stockholder or group of stockholders (for example, the nominee cannot be an executive officer, director, employee or affiliate of, or receive consulting or advisory fees from, the nominating stockholder).

What notice must by provided to the company by the nominating stockholders?

The stockholder must provide notice to the company of its intent to require the company to include any nominee in the company proxy materials and provide certain information about each such candidate for inclusion in the proxy materials. As a general rule, this notice to the company must be no later than 80 days before the date that the company mailed its proxy materials for the annual meeting in the prior year. Other information must also be included in the notice, including without limitation representations with respect to beneficial ownership, the qualifications of the nominee (including whether the nominee meets certain independence criteria) and the absence of disqualifying relationships.

How many nominees would the company be required to include?

The company is not required to include in its proxy materials information with respect to more than one nominee where the board is 8 or fewer, two nominees if the board is greater than 8 but less than 20 and three nominees if the board is 20 or more. In the event the company has a staggered board, and the company has one or more directors currently serving on the board who were elected as a stockholder nominee pursuant to the proposed new rule, and the terms of those directors extends beyond the date of the meeting, such continuing stockholder-nominated directors are counted towards such respective maximum number of director nominees.

What if there are multiple nominators?

If there is more than one stockholder or group otherwise permitted to nominate a director, the company is required to include in its proxy materials only information with respect to the nominee or nominees of the stockholder or group of stockholders with the largest two-year beneficial ownership.

Would nominating security holders run afoul of rules governing solicitation of proxies?

The proxy rules would be amended to make certain rules not applicable to solicitations in connection with the formation of a nominating security holder group pursuant to Rule 14a-11, provided that the number of persons solicited is not more than 30 or each written communication is limited to specified information.

Would nominating security holder groups be subject to Exchange Act Section 16 as an aggregated 10 percent holder?

A group formed solely for the purpose of nominating a director or directors and soliciting in connection with the nomination would not be aggregated together under Section 16. Section 16 would be amended accordingly under the proposed rules.

What types of statements in support or against nominee would be allowed/required?

If the company intends to include a statement supporting its nominees and/or opposing the nominee of any stockholder, it must advise the stockholder that such stockholder may submit a statement of no more than 500 words supporting its nominee. A mere recommendation by the company to vote for, or withhold votes from, specified candidates does not constitute an opposing or supporting statement permitting a nominating stockholder to include this 500 word supporting statement.

Would the new rule apply to proxy contests?

No.

What disclosures would be required by the August proposal?

The proposed rules would require the following additional nominating process disclosures (the first two of which arguably just rephrase the existing requirements of Item 7(d)(2) of Schedule 14A):

- Whether the nominating committee has a policy with regard to the consideration of any director candidates recommended by stockholders and, if it does, a description of the material elements of that policy and a statement as to whether the committee will consider candidates recommended by stockholders;

- If the nominating committee will consider candidates recommended by stockholders, a description of the procedures to be followed by stockholders in submitting such recommendations;

- A description of any specific, minimum qualifications that the nominating committee believes must be met by a nominee, any specific qualities or skills that the nominating committee believes are necessary for one or more of the directors to possess and any specific standards for the overall structure and composition of the board;

- A description of the process of the committee for identifying and evaluating nominees (including nominees recommended by stockholders) and any differences in the manner in which the nominating committee evaluates nominees for director based on whether a nominee is recommended by a stockholder;

- Disclosure of who proposed each nominee approved by the nominating committee for inclusion on the company proxy card, except when the nominee is an executive officer or a director standing for reelection; and

- If the company pays a fee to any third party to identify or assist the company in identifying or evaluating potential nominees, disclosure of the function performed by the third party.

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