

CORPORATE GOVERNANCE ALERT

SEC PROPOSES RULES FOR COMMENT REGARDING SECURITY HOLDER DIRECTOR NOMINATIONS



On October 14, 2003, the Securities and Exchange Commission (SEC) proposed rules for comment that, if adopted, will require companies to include in their proxy materials security holder nominees for election as director. These proposed rules would create a mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to be included in company proxy materials where security holders are permitted under state law to nominate directors and where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process. In addition, the proposed rules would establish the filing requirements under the Securities Exchange Act of 1934 (the Exchange Act) for nominating security holders. The comment period for the proposed rules ends on December 22, 2003.

APPLICATION OF THE PROPOSED RULES

Proposed Exchange Act Rule 14a-11 would apply to all companies (i) that are subject to the Exchange Act proxy rules, including investment companies registered under Section 8 of the Investment Company Act, and (ii) whose security holders have an existing, applicable state law right to nominate a candidate for election as a director.

In addition, the SEC is considering, and seeks comment on, whether proposed Exchange Act Rule 14a-11 should apply only to those companies that are subject to accelerated deadlines for filing Exchange Act periodic reports and investment companies registered under Section 8 of the Investment Company Act. Accelerated filers would be subject to the new security holder nomination procedure for any fiscal year in which they must file all of their periodic reports on an accelerated basis. Thus, the security holder nomination procedure would apply to a company after it first meets the following conditions as of the end of its fiscal year:

- the company's common equity public float was \$75 million or more as of the last business day of its most recently completed second fiscal quarter

- the company has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months
- the company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act
- the company is not eligible to use Exchange Act Forms 10-QSB and 10-KSB.

By limiting this procedure to accelerated filers, the SEC seeks to avoid the disproportionate burdens of regulation that the proposed procedure may impose on smaller companies and to gain experience with the proposed rule in an initial stage while retaining the flexibility to expand the rule's application to all companies.

NOMINATION PROCEDURE TRIGGERING EVENTS

The security holder nomination procedure would be triggered by the occurrence of one or both of the following events.

- *"Withhold" Votes.* At least one of the company's nominees for the board of directors for whom the company solicited proxies received "withhold" votes from more than 35 percent of the votes cast at an annual meeting of security holders held after January 1, 2004, at which directors were elected (excluding contested elections and elections to which the proposed security holder nomination procedure applies).
- *"Direct Access."* A security holder proposal submitted pursuant to Exchange Act Rule 14a-8 providing that the company become subject to the security holder nomination procedure (i) was submitted for a vote of security holders at an annual meeting of security holders after January 1, 2004, by a security holder or group of security holders that held more than 1 percent of the company's securities entitled to vote on the proposal for one year as of the date the proposal was submitted and provided evidence of such holding to the company, and (ii) that "direct access" proposal received more than 50 percent of the votes cast on that proposal at that meeting.

In addition, the SEC is considering, and seeks comment on, whether it should include a third nomination procedure triggering event, which it refers to as a "non-implementation" trigger. The non-implementation trigger would occur when —

- a security holder proposal submitted pursuant to Exchange Act Rule 14a-8, other than a direct access security holder proposal, was submitted for a vote of security holders at an annual meeting by a security holder or group of security holders that held more than 1 percent of the company's securities entitled to vote on the proposal for one year and provided evidence of such holdings to the company
- the security holder proposal received more than 50 percent of the votes cast on that proposal
- the board of directors of the company failed to implement the proposal by the 120th day prior to the date that the company mailed its proxy materials for the annual meeting.

The non-implementation trigger would apply to all security holder proposals, whether mandatory or precatory. The SEC noted that any new rule implementing the non-implementation trigger would also have to provide guidance to companies and security holders regarding the determination of whether any given proposal has been implemented.

The SEC has also proposed an amendment to Exchange Act Rule 14a-5 that would require a company to identify in its proxy materials any proposal that would, if adopted, be a nominating process triggering event. Pending final action on that proposal, the SEC recommends that companies make such an identification and should also consider whether failure to make such an identification has any implication under Exchange Act Rule 14a-9 (false or misleading statements).

DISCLOSURE OF THE OCCURRENCE OF A TRIGGERING EVENT

The security holder nomination procedure proposed by the SEC would require additional disclosures in a company's Exchange Act Form 10-Q, 10-QSB, 10-K or 10-KSB to apprise security holders when a nomination procedure triggering event has occurred. The proposed procedure consists of the following:

- each company would be required to disclose the security holder vote regarding any nomination procedure triggering event in its quarterly report for the period in which the matter was submitted to a vote of security holders or, where the nomination procedure triggering event occurred during the fourth quarter of the fiscal year, on Exchange Act Form 10-K or 10-KSB
- each company would be required to include in that Exchange Act report information disclosing that it would be subject to the security holder nomination procedure as a result of such vote, if applicable.

ELIGIBILITY OF THE NOMINATING SECURITY HOLDER OR GROUP

Proposed Exchange Act Rule 14a-11 requires that a security holder or group of security holders meet the following criteria in order to avail itself of the nomination procedure:

- beneficially own, either individually or in the aggregate, more than 5 percent of the company's securities that are eligible to vote for the election of directors at the next annual meeting of security holders (or special meeting, as the case may be), with each of the securities used for the purposes of calculating that ownership having been held continuously for at least two years as of the date of the nomination
- intend to continue to own those securities through the date of that annual or special meeting
- be eligible, as to the security holder or each member of the security holder group, to report beneficial ownership on Exchange Act Schedule 13G (rather than Exchange Act Schedule 13D) in reliance on Exchange Act Rule 13d-1(b) or (c)
- have filed an Exchange Act Schedule 13G or an amendment to such schedule reporting their 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 security holder or security holder group has held more than 5 percent of the subject securities for at least two years.

ELIGIBILITY OF THE NOMINEE

A company would not be required to include a security holder nominee in its proxy materials if the nominee's candidacy or, if elected, board membership, would violate controlling state law, federal law or rules of a national securities exchange or national securities association (other than rules governing the independence of directors). The notice to the company by the nominating security holder would be required to include a representation that the nominee's candidacy, or, if elected, board membership, would not violate any of the specified provisions.

In addition, each person that is a security holder nominee would be required to meet the following standards of independence from the security holder or each member of the security holder group that has nominated such person:

- if the nominating security holder or any member of the nominating security holder group is a natural person, the nominee is not the nominating security holder, a member of the nominating security holder group or a member of the immediate family of the nominating security holder or any member of the nominating security holder group
- if the nominating security holder or any member of the nominating security holder group is an entity, neither the nominee nor any immediate family member of the nominee has been an employee of the nominating security holder or any member of the nominating security holder 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 security holder or any member of the group of nominating security holders or any affiliate of any such 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 such holder or any such member (provided that such 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 security holder group, or an affiliate of the nominating security holder or any such member of the nominating security holder group
- the nominee does not control the nominating security holder or any member of the nominating security holder group (or in the case of a holder or member that is a fund, an interested person of such holder or any such member as defined in Section 2(a)(19) of the Investment Company Act).

Each nominating security holder or each member of the group of nominating security holders would be required to represent to the company that (i) the nominee satisfies the applicable standards of a national securities exchange or national securities association regarding director independence, if any, except that where a rule imposes a standard regarding independence that requires a subjective determination by the board or a group or committee of the board, this element standard would not have to be satisfied; and (ii) neither the nominee nor the nominating security holder (or any member of the group) has a direct or indirect agreement with the company regarding the nomination of the nominee.

Under proposed Exchange Act Rule 14a-11, a nominating security holder will not be deemed an “affiliate” under the Securities Act of 1933 or the Exchange Act solely as a result of nominating a director or soliciting for the election of such a director nominee or against a company nominee pursuant to the security holder nomination procedure.

PROPOSED LIMITATION ON NUMBER OF NOMINEES

The SEC proposes the following limitation on the number of nominees by the security holder or group:

Number of Board Members	Number of Nominees
Up to 8	1
More than 8, less than 20	2
20 or more	3

Where a company has a director currently serving on the board who was elected as a security holder nominee and the term of that director extends past the date of the meeting of security holders for which the company is soliciting proxies, the company would not be required to include on its proxy card more security holder nominees than could result in the total number of directors serving on the board that were elected as security holder nominees being greater than the total number of nominees permitted by proposed Rule 14a-11, as reflected in the diagram above.

In the event that more than one security holder or group of security holders would be eligible to nominate a person or persons to a company’s board of directors, the company would be required to include in its proxy materials only the nominee or nominees of the security holder or group of security holders with the largest beneficial ownership (as reported on Exchange Act Schedule 13G) at the time of the delivery of the nominating security holder’s notice of intent to nominate a director.

The SEC emphasizes that it does not intend for the security holder nomination procedure to be available for any security holder or security holder group that is seeking control of the company. Rather, the SEC intends that the existing procedures for contested election of directors continue to fulfill that purpose.

PROCEDURE WITH RESPECT TO NOTICES BY THE NOMINATING SECURITY HOLDER

The nominating security holder or group would be required to provide notice to the company of its intent to require that the company include the security holder’s nominee in the company’s proxy card no later than 80 days before the date the company mails its proxy materials for the annual meeting. Such notice would include representations and statements concerning the criteria set forth in the proposed rules as well as evidence of the required level of ownership. Such notice would also be filed with the SEC (excluding the already-filed Exchange Act Schedule 13G). The

SEC views such a notice as a soliciting material of the nominating security holder or group, subject to the provisions of Exchange Act Rule 14a-9.

Upon receipt of a nominee pursuant to proposed Rule 14a-11, a company would determine whether the nominating security holder or group has complied with proposed Rule 14a-11 and whether the nominee satisfies each of the requirements of the proposed procedure. A company may determine it is not required to include a nominee from a nominating security holder or group in its proxy materials if it determines any of the following:

- the security holder nomination procedure in proposed Exchange Act Rule 14a-11 is not applicable to the company
- the nominating security holder or group has not complied with the requirements of the procedure
- the nominee does not meet the requirements of the procedure
- any representation required to be included in the notice to the company is false in any material respect
- the company has received more nominees than it is required to include by proposed Exchange Act Rule 14a-11 and the nominating security holder or group is not entitled to have its nominee included in that situation.

Unless a company determines that it is not required to include the nominee in its proxy materials, the company would be required to include information regarding the nominee in its proxy statement, including the Web site address on which the nominating security holder or group intends to solicit in favor of its nominee, and the name of the nominee on the company's proxy card that is included in the proxy materials.

Provided that the company complies with Exchange Act Rule 14a-9, the company would be able to include statements in the proxy statement supporting the company's nominees and/or opposing the nominating security holder or group nominee or nominees. If the company determines to include any such statements in its proxy statement, other than a mere recommendation to vote in favor of or withhold votes from specified candidates, then the company would be required to permit the nominating security holder or group to include in the company's proxy statement a statement of support, not to exceed 500 words, for the security holder nominee or nominees.

A company would be permitted to identify any security holder nominee as such and recommend that security holders vote against, or withhold votes from, those nominees and in favor of the management nominees. In addition, where a security holder nominee is included on a proxy card, the proposed rules would not permit a company to provide security holders the option of voting for or withholding the authority to vote for the company nominees as a group.

If a company determines it is not required to include a nominee in its proxy materials, it would be required to notify promptly the nominating security holder or group in writing of its determination, but not later than 30 calendar days before the date of the company's proxy statement released to security holders in connection with the previous year's annual meeting.

LIABILITY FOR STATEMENTS

Under the proposed rules, a nominating security holder or group would be liable for any false or misleading statements included in the notice provided to the company. A company would not be liable for the contents of the security holder's proposal or supporting statement that is included in the company's proxy materials. In addition, any information that is provided to the company in the nominating security holder's notice and then included in the company's proxy materials would not be incorporated by reference into any filing under the Securities Act or the Exchange Act unless the company determines to incorporate that information by reference specifically into that filing. Then, to the extent the company incorporates that information by reference, the SEC would consider the company's disclosure of that information as the company's own statement for the purposes of the antifraud and civil liability provisions of the Securities Act and Exchange Act.

RELATED RULE CHANGES

Schedule 13G. In light of proposed Exchange Act Rule 14a-11, the SEC proposes to amend Exchange Act Schedule 13G in two respects. First, it proposes to add an instruction to the description of the first and second categories of persons who may report their ownership on Exchange Act Schedule 13G to provide that a beneficial owner who acquires or holds a company's securities in connection with a nomination, soliciting activities or election of a nominee under proposed Exchange Act Rule 14a-11 should not be deemed to have a purpose or effect of changing or influencing control of the company solely by virtue of making the nomination or engaging in such activities. Second, the SEC would require that the security holder or group certify that they have owned the required amount of securities (more than 5 percent) for the minimum period of two years required by Exchange Act Rule 14a-11.

Exchange Act Section 16. Because the SEC believes that a group formed solely for the purpose of nominating a director pursuant to Exchange Act Rule 14a-11, soliciting in connection with the election of that nominee or having that nominee elected as director should not be viewed as being aggregated together for the purposes of Exchange Act Section 16, the SEC proposes to amend the rule that defines who is a 10 percent owner for the purposes of Section 16 to exclude an Exchange Act Rule 14a-11 nominating security holder group. Although the members of such a group would still be subject to the general condition of the rule that they not have the purpose or effect of changing or influencing control of the issuer, they would not be deemed to have a control purpose or effect solely by virtue of group membership.

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Our lawyers are monitoring these proposed rules and will keep you apprised of any developments that arise from the requirements imposed under such rules and from regulatory activity of the SEC. To access previous Corporate Governance Alerts, please visit our Web site at <http://www.akingump.com/publication.cfm>.

CONTACT INFORMATION

If you have any questions or would like to learn more about this topic, please contact the partner who normally represents you, or:

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