

Client Alert

SEC Proposes New Rules Regarding Shareholder Proxy Access for Director Nominations

A. Introduction

On October 14, 2003, the Securities and Exchange Commission ("SEC") published for comment proposed amendments to the proxy rules under the Securities Exchange Act of 1934 (the "Exchange Act") that would, under certain circumstances, require companies to include in their proxy materials information about shareholder nominees for election as directors.¹ If adopted, the rules would represent a major change to the board election process of public companies.

B. Companies Subject To the Proposed Rule

The SEC's proposed Rule 14a-11 under the Exchange Act, which contains the basic requirements of the proposal, would apply to all companies that are subject to the Exchange Act's proxy rules. There are, however, several proposed exceptions. A company would not be subject to the proposed rules if:

- Applicable state law *prohibits* the company's security holders from nominating director candidates. Delaware and most other states currently have no such prohibition;
- Applicable state law permits a company to prohibit shareholder nominations through charter or by-law provisions, and the company has adopted those prohibitions; or
- The company is a foreign private issuer.

The SEC is also considering whether the proposed new rules should initially apply only to companies subject to accelerated deadlines for filing Exchange Act periodic reports²,

¹ Securities and Exchange Commission Release Nos. 34-48626; IC-26206; File No. S7-19-03. A copy of the release is available on the SEC website at www.sec.gov/rules/proposed/34-48626.htm.

² These "accelerated filers" are companies that, among other things, have a common equity public float of at least \$75 million.

given the disproportionate burden of regulation that the proposed procedures may impose on smaller companies.

C. Proposed Trigger Events for Nomination Procedure

The proposed rules would apply only to companies that have taken certain actions considered unresponsive to shareholder concerns. Under the proposed rules, either of the following two events would trigger potential application of the nomination procedure:

- At least one of the company's director nominees received "withhold" votes from more than 35% of the votes cast at an annual shareholder meeting held after January 1, 2004.³
- A shareholder proposal submitted under Exchange Act Rule 14a-8 providing that the company become subject to the shareholder nomination procedure of Rule 14a-11 (a "direct access" proposal) (i) has been submitted for a vote at an annual shareholder meeting held after January 1, 2004 by a shareholder or group of shareholders that beneficially owned more than 1% of the company's voting securities for at least one year, and (ii) has received more than 50% of the votes cast on the proposal.

The SEC is also considering whether to include a third trigger event that would be satisfied if a Rule 14a-8 shareholder proposal that is not a "direct access" proposal (i) was submitted for a vote at an annual shareholder meeting by a shareholder or group of shareholders that held more than 1% of the company's voting securities for at least one year, (ii) received more than 50% of the votes cast on the proposal, and (iii) was not implemented by the board of directors before the 120th day prior to the first anniversary of the date that the company mailed its proxy materials for that annual meeting.

Under the proposed rules, once a trigger event occurs, eligible shareholders can use the Rule 14a-11 nominating procedure for any annual or special meetings held during (i) the remainder of the calendar year in which the triggering event occurs, (ii) the calendar year following the calendar year in which the triggering event occurs, and (iii) the portion of the second calendar year following the calendar year in which the triggering event occurs, up to and including the annual meeting held that year.

³ This trigger event would not, however, apply in the case of a contested election to which Exchange Act Rule 14a-12 applies or an election to which the proposed shareholder nomination procedure in proposed Exchange Act Rule 14a-11 applies.

Since certain shareholder proposals included in a company's proxy statement may trigger the proposed shareholder nomination procedure requirements, the SEC has proposed an amendment to Exchange Act Rule 14a-5 that would require companies to advise shareholders of this fact in the proxy statement relating to the meeting in which such proposal will be presented. The SEC is also recommending that companies begin making these disclosures now, pending final action on the proposed rules.

In addition, a company would be required to provide notice of the occurrence of nominating procedure trigger events in its quarterly reports on Form 10-Q or annual reports on Form 10-K, depending on when the triggering events occur.

D. Proposed Shareholder Eligibility Standards

Under the proposed rules, a shareholder or group of shareholders would be eligible to submit a Rule 14a-11 nomination if the shareholder or group:

- Beneficially owns in the aggregate more than 5% of the company's securities that are eligible to vote for the election of directors at the next annual meeting (or, in lieu of an annual meeting, a special meeting) of shareholders, provided that the securities have been held continuously for at least two years;
- Intends to continue holding the securities through the date of the meeting;
- Is eligible to report beneficial ownership on Exchange Act Schedule 13G (passive or institutional investor) rather than Schedule 13D; and
- Has filed a Schedule 13G or amendment to Schedule 13G reporting its beneficial ownership as a passive or institutional investor on or before the date of the submission of the nomination to the company, which Schedule 13G must include a certification that the shareholder or group of shareholders has satisfied the 2-year 5% ownership requirement.

E. Requirements for Shareholder Nominees

The proposed rules would allow companies to exclude a shareholder nominee if the nominee's candidacy or election would violate: (i) controlling state law; (ii) federal law; or (iii) rules of a national securities exchange (other than rules relating to independence of directors). The SEC has proposed a separate requirement for independence pursuant to which the nominating shareholder or shareholders would be required to represent that the nominee meets the objective criteria for "independence" under any applicable national securities exchange or national securities association rules. Any aspect of such standards regarding independence that call for a subjective determination by the board or a board committee would not need to be satisfied.

The proposed rules also provide that a shareholder nominee must meet several specified standards of independence from the shareholder or shareholder group that has nominated him or her. These independence standards relate primarily to family relationships, employment and consulting relationships, service as a director or executive officer and other control relationships.

Limits on Nominees That Company Must Include. As proposed, a company would be required to include *one* shareholder nominee in its proxy materials if the total size of the board is eight or fewer directors, *two* shareholder nominees if the size of the board is greater than eight and less than twenty directors and *three* shareholder nominees if the size of the board is twenty or more directors. The proposed rules would work differently for "staggered" boards where a company has a director currently serving on its board who was elected as a shareholder nominee with a term extending past the date of a subsequent shareholder meeting. In that case, the number of shareholder director nominations otherwise permitted at the subsequent meeting would be reduced by the number of such directors who will continue to serve after the meeting. When more than one shareholder or group of shareholders is eligible to make a Rule 14a-11 board nomination, the company must accept the nomination for inclusion in the proxy statement from the largest-sized shareholder or shareholder group first, until all the required nominations have been made.

F. Notice to the Company and the SEC

A nominating shareholder or group of shareholders would be required to provide notice to the company of its intent to include its nominee in the company's proxy materials no later than 80 days before the anniversary of the date of the company's proxy statement for the previous year's annual meeting. The notice would be required to include various representations from the nominating shareholder or shareholder group as to compliance with applicable requirements of Rule 14a-11, including satisfaction of shareholder and nominee eligibility standards, as well as disclosure about the nominee that complies with applicable proxy disclosure rules.

In addition, the nominating shareholder or shareholder group would be required to file the same notice with the SEC no later than two business days after providing the notice to the company.

G. Required Action by Company After Receipt of Notice

The proposed rules would require the company to determine whether a nomination complies with the requirements of Rule 14a-11 and to provide notice of its determination to the nominating shareholder or shareholder group, generally at least 30

days before the anniversary of the date of the company's proxy statement for the previous year's annual meeting.

If the company finds that the requirements of Rule 14a-11 are satisfied, the company must include in its proxy statement information regarding the shareholder nominee, including the website address on which the nominating shareholder intends to solicit proxies in favor of the nominee. In addition, the company must include the name of the nominee on the proxy card accompanying the proxy statement. Under the proposed rules, proxy cards that include a shareholder nominee could not allow shareholders the option of voting for company nominees as a group, and must permit each candidate to be voted on separately.

The company may recommend that shareholders vote against shareholder nominees included on the proxy card and in favor of management nominees. All nominees must be presented impartially on the proxy card, except that shareholder nominees may be identified as such. The rules would permit a company to include in the proxy statement a statement supporting company nominees and/or opposing the shareholder nominees. If it chooses to do so, the company must afford the nominating shareholder the opportunity to include a supporting statement of its nominee not exceeding 500 words.

H. Certain Exemptions from Proxy Rules for Nominating Shareholder Solicitations

The proposed rules provide for a limited exemption from certain proxy rules to allow shareholders to communicate for the limited purpose of forming nominating groups without having to file and disseminate a proxy statement. The exemption would apply if:

- The total number of persons solicited is not more than 30; or
- The communication is limited to (i) a statement of intent to form a nominating group in order to nominate a director under the proposed rule, (ii) the percentage of securities beneficially owned by the soliciting shareholder or shareholder group, and (iii) the means by which shareholders may contact the soliciting party.

Under either option, any soliciting material given to shareholders must be filed with the SEC by the nominating shareholder under the company's Exchange Act file number, no later than the date the material is first given to shareholders.

The SEC is also proposing a limited exemption from certain proxy rules that would permit solicitations by nominating shareholders in support of a nominee placed on the company's proxy card if:

- The soliciting party does not seek, directly or indirectly, on its own or another's behalf, the power to act as proxy for a shareholder and does not request or act on behalf of a person who furnishes or requests a form of revocation, abstention, consent or authorization;
- The written communication includes (i) the identity of the nominating shareholder and a description of his or her direct or indirect interests, and (ii) a prominent legend advising shareholders that a shareholder nominee will be included in the company's proxy statement, and to read the proxy statement; and
- Any solicitation material provided to shareholders is filed with the SEC under the company's Exchange Act number no later than the date such material is first given to shareholders.

I. Related Amendments to Schedule 13G and Section 16

The proposed rules would clarify that a shareholder or shareholder group would not become ineligible to file a Schedule 13G solely as a result of presenting a nomination under Rule 14a-11.

The rules also provide that members of a shareholder group formed solely for the purpose of nominating a director under Rule 14a-11 would not have their shareholdings aggregated for purposes of determining if they are 10% shareholders required to file ownership reports under Section 16 of the Exchange Act. The SEC does not, however, intend that individual beneficial owners holding more than 10% of any class of equity securities be excluded from Section 16 coverage.

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The SEC's release includes a series of questions intended to focus public comments on specific aspects of the proposals, and in particular on whether they are necessary or appropriate to accomplish the SEC's stated objectives.

The SEC requests that comments on the proposed rules be received by December 22, 2003. Comments may be submitted electronically to rule-comments@sec.gov. All comment letters should refer to File No. S7-19-03 (in the subject line if sent electronically) and will be made publicly available by the SEC.

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding these proposals, please contact any of the following:

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