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SEC ISSUES FINAL DISCLOSURE RULES REGARDING NOMINATING COMMITTEES AND SHAREHOLDER COMMUNICATIONS WITH DIRECTORS

By Richard P. Wolfe and Amos J. Oelking, III

On November 24, 2003, the SEC released its final rules requiring enhanced proxy statement disclosures regarding board nominating committees and new proxy statement disclosures regarding the means, if any, by which shareholders can communicate with directors. ([Click here to link to the full text of the SEC's final rules release.](#))

The final rules, which were adopted substantially as proposed, are discussed below. ([Click here to link to our E*Zine regarding the SEC's proposed disclosure rules.](#))

Disclosures Regarding Nominating Committees

The SEC's final rules expand current proxy statement disclosure requirements with the goal of assisting shareholders in understanding the director nomination process. Specifically, the final rules require proxy statement disclosure of the following:

- whether the company has a nominating or similar committee and, if not, (i) the basis for the board's opinion that it is appropriate for the company not to have such a committee, and (ii) the names of the directors who participate in the consideration of director nominees;
- whether the nominating committee has a written charter and, if so, disclosure of whether the charter is available on the company's website;
 - if the charter is available on the company's website, the proxy statement should include the company's website address; and
 - if the charter is not available on the company's website, the proxy statement should include the charter as an appendix "at least" once every three years; as to years for which the charter is not required to be included as an appendix, the proxy statements for such years should identify the prior proxy statement in which the charter was included in satisfaction of this requirement;

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- the SEC's proposed rules would have required a description of the "material terms" of the charter; at the suggestion of commenters, the SEC did not include this requirement in the final rules and adopted instead the above disclosure requirement regarding the availability of the written charter;
- if the company's securities are listed on an exchange or quotation system (e.g., NYSE or Nasdaq) that has independence requirements for nominating committee members,¹ whether the members of the nominating committee are "independent" under such requirements (the proposed rules would have required companies to disclose "any instance" during the preceding fiscal year where a nominating committee member was not independent);
- if the company is not a listed issuer, whether each of the nominating committee members is independent and the definition of independence used in making such determination;²
- whether the company's nominating committee has a policy regarding consideration of director candidates recommended by shareholders;
 - if the committee has such a policy, the company's proxy statement should include a description of the material aspects of the policy, including whether the committee will consider candidates recommended by shareholders; and
 - if the committee does not have such a policy, the basis for the board's opinion that it is appropriate for the company not to have such a policy;

¹ The New York Stock Exchange's rules require NYSE-listed companies to have independent nominating committees, whereas the Nasdaq Stock Market's rules permit, in lieu of an independent nominating committee, the nomination of directors by a majority of the company's independent directors. NYSE and Nasdaq companies are required to comply with these rules, which were approved by the SEC on November 4, 2003, by the earlier of (i) their first annual shareholders' meeting after January 15, 2004, or (ii) October 31, 2004.

² Under the SEC's final rules, non-listed issuers are required to (i) use an independence definition adopted by a national securities exchange registered pursuant to Section 6(a) of the Securities Exchange Act of 1934 (e.g., NYSE) or a national securities association registered pursuant to Section 15A(a) of the Exchange Act (e.g., Nasdaq) that has been approved by the SEC; and (ii) apply the independence standards of the same exchange or association for purposes of the audit committee disclosure required by Item 7(d)(3)(iv) of Exchange Act Schedule 14A.

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- if the committee will consider candidates recommended by shareholders, the procedures for shareholders to follow in submitting recommendations;
- a description of any specific minimum qualifications the nominating committee believes a nominee must possess, and specific qualities or skills the committee believes one or more of the company's directors should possess (the final rules do not include the SEC's proposed requirement that companies disclose "any specific standards for the overall structure and composition" of their boards of directors);
- a description of the nominating committee's process for identifying and evaluating nominees, including shareholder nominees, and any differences in the evaluation process for shareholder nominees versus nominees of the nominating committee;
- with regard to nominees (other than executive officers or incumbent directors) approved by the nominating committee for inclusion on the company's proxy card, which category or categories of persons or entities recommended such nominees ("security holder," "non-management director," "chief executive officer," "other executive officer," "third-party search firm," or other specified source) and the name of any person or entity that caused a particular candidate to be recommended (the proposed rules would have required identification, by name, of the source of each director nominee);
- if the company pays a fee to any third party for assistance in identifying and evaluating potential nominees, a description of the function performed by such third party; and
- if the nominating committee received, by a date not later than the 120th calendar day before the date of the company's proxy statement for the previous year's annual shareholders' meeting,³ a candidate recommended by a shareholder or group of shareholders that have owned greater than 5% of the company's outstanding stock for at least one year (the proposed rules provided for an ownership threshold of 3%), (i) the name of the candidate, (ii) the shareholder

³ Therefore, if a company's proxy statement for its 2003 annual shareholders' meeting was dated May 15, 2003, the relevant deadline for the 2004 proxy statement would be January 16, 2004. However, the instructions to the final rules provide that where a company has changed its meeting date by more than 30 days from the previous year's meeting date, the shareholder or shareholder group must have made its recommendation a "reasonable time" before the company begins to print and mail its proxy materials.

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or shareholder group that made the recommendation, and (iii) whether the committee chose to nominate the candidate.

Under the final rules, companies are not required to make these disclosures without the written consent of both the recommending shareholder or shareholder group and the candidate and proof of the required ownership and holding period, and are not obligated to request such materials if the recommending shareholder or shareholder group does not provide them.

The proposed rules would have required companies to disclose the specific reasons for not nominating a shareholder-recommended candidate; the SEC's final rules do not include this requirement, but do permit companies to make such disclosure voluntarily. Moreover, the final rules expand on the proposed rules to require identification of the recommended candidate in addition to identification of the recommending shareholder or shareholder group.

Form 10-K/10-Q Reporting Obligation

In its release regarding the proposed rules, the SEC did not propose, but did request comment on, a requirement that companies disclose in their periodic reports material changes in their procedures by which shareholders can submit director nominees. In response to comments received, the SEC's final rules require, in the event of a material change in the procedures for shareholders to submit director nominees, that such change be reported in the company's Form 10-K or 10-Q (or Form 10-KSB or 10-QSB in the case of a small business issuer) for the period in which the change occurs. The instructions to the final rules provide that where a company that did not previously have in place procedures for shareholders to submit director nominees adopts such procedures, such adoption constitutes a "material change" triggering the reporting obligation.

Disclosures Regarding Shareholder Communications with Directors

In addition to the enhanced nominating committee disclosures, the final rules require new disclosures regarding shareholder communications with board members. The intent of these rules is to improve shareholders' understanding of the board operations of companies in which they invest. Specifically, the final rules require the following proxy statement disclosures:

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- whether the company's board provides a process by which shareholders can send communications to the company's directors and, if not, the basis for the board's opinion that is appropriate for the company not to have such a process;
- if the company does have such a process, (i) a description of the process, including, if the company so permits, how shareholders can send communications to individual directors (versus the board as a whole), and (ii) if shareholder communications are not sent directly to directors, a description of the company's process for determining which communications will be relayed to directors; and
- a description of the company's policy, if any, regarding director attendance at annual shareholders' meetings, and disclosure of the number of directors who attended the prior year's annual meeting.

In lieu of providing these disclosures in its proxy statement, the final rules provide that a company may include such information on its website so long as its website address is included in its proxy statement. In addition, a company need not disclose its process for collecting and organizing shareholder communications so long as the process has been approved by a majority of the company's independent directors.

The SEC's proposed rules would have required companies to identify, by name, the directors to whom shareholders could send communications; the final rules permit, but do not require, companies to disclose the names of directors to whom communications can be sent. The final rules also do not include the SEC's proposed requirements that companies (i) identify the department or group responsible for determining which communications are forwarded to directors, and (ii) describe any material action taken in response to communications from shareholders.

Compliance Dates

Companies must comply with the enhanced nominating committee disclosure rules and new shareholder/director communication disclosure rules in their proxy and information statements delivered on or after January 1, 2004. Accordingly, companies will be required to include the new disclosures in their proxy statement for their 2004 annual meeting.

Likewise, companies must comply with the reporting obligation regarding material changes in their procedures for shareholder recommendations of directors in their first Form 10-Q or 10-K (or Form

10-QSB or 10-KSB in the case of small business issuers) for the first reporting period ending after January 1, 2004. Thus, companies with “calendar year” fiscal years will be required to comply with the reporting obligation beginning with their Form 10-Q (or Form 10-QSB) for the fiscal quarter ending March 31, 2004.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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