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SEC PROPOSES RULES REGARDING STOCKHOLDER NOMINATION OF DIRECTORS

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

On October 14, 2003, the SEC, in response to recommendations from its Division of Corporation Finance, released extensive proposed rules that would require companies, under certain circumstances, to include in their proxy materials information regarding director nominees submitted by long-term, significant stockholders.

As proposed, the stockholder nomination procedure would be available to eligible stockholders no earlier than the 2005 proxy season. Comments on the proposed rules, which are discussed below, should be delivered to the SEC no later than December 22, 2003. *(Click here to link to the SEC's release regarding the proposed rules.)*

Companies To Which The Procedure Would Apply

The proposed stockholder nomination procedure would apply to all companies that are subject to the Exchange Act's proxy rules so long as (i) applicable state law does not prohibit stockholders from nominating candidates for director, and (ii) neither the company's charter nor its bylaws contain a valid provision prohibiting stockholder nominations of directors.

While not a part of the proposed rules, the SEC is considering, and is seeking comment on, whether the proposed rules should apply only to "accelerated filers," that is, companies subject to the accelerated filing deadlines for Forms 10-K and 10-Q. If the SEC adopts final rules incorporating this additional element, companies would be subject to the stockholder nomination procedure for any fiscal year during which they must file their 10-Ks and 10-Qs on an accelerated basis.

"Triggering Events"

The proposed stockholder nomination procedure would become operative only after the occurrence of one or both of the following "triggering events":

- at least one of the company's director nominees received "withhold" votes from more than 35% of the votes cast at a stockholders meeting held after January 1, 2004 (other than a "contested election" to which Exchange Act Rule 14a-12(c)

applies or an election to which the proposed stockholder nomination procedure applies); or

- a stockholder proposal submitted pursuant to Exchange Act Rule 14a-8 providing for a stockholder proxy access procedure (*i.e.,* a procedure similar to that provided for in the proposed rules) was (i) submitted for a vote at a stockholders meeting held after January 1, 2004 by a stockholder or group of stockholders holding more than 1% of the company's voting securities for a period of at least one year prior to the submission of the proposal (a "1% stockholder or group"), and (ii) received more than 50% of the votes cast on the proposal at the meeting.

Upon the occurrence of one or both of these events, the stockholder nomination procedure would remain available to any eligible stockholder or stockholder group (a "5% stockholder or group") for any stockholders meetings held during

- the remainder of the calendar year in which the triggering event or events occurred;
- the following calendar year; and
- the portion of the second following calendar year up to and including the annual meeting held during that calendar year.

While not a part of the SEC's proposed rules, the SEC is considering, and is seeking comment on, a third triggering event based upon a company's failure to implement a stockholder proposal (other than a stockholder nomination procedure proposal) that

- was submitted by a 1% stockholder or group; and
- received the approval of more than 50% of the votes cast on the proposal at a stockholders meeting held after January 1, 2004.

Under the proposed rules, companies would be required to notify stockholders, in their proxy statements, of any stockholder proposal that would, if approved by 50% or more of the votes cast, be a triggering event. Pending its adoption of final rules, the SEC recommends that companies provide this disclosure in their proxy statements voluntarily.

Notice Regarding Triggering Events

When a triggering event has occurred, the proposed rules would require a company to give stockholders notice of the event in the company's 10-K or 10-Q (or 10-KSB or 10-QSB, in the case of small business issuers). Specifically, companies would be required to disclose

- the stockholder vote with regard to the triggering event in its 10-Q (or 10-QSB) for the period in which the matter was submitted to a stockholder vote (or in its 10-K or 10-KSB if the matter was submitted to a stockholder vote in the fourth quarter of its fiscal year); and

- (i) that, as a result, the company would be subject to the stockholder nomination procedure, (ii) the period during which the company will be subject to the procedure, and (iii) the date by which a 5% stockholder or group must submit its nominations.

Eligible Stockholders

Upon the occurrence of one or both of the triggering events, a 5% stockholder or group would be eligible to submit a director nomination if such 5% stockholder or group:

- beneficially owns more than 5% of the company's voting securities and such securities have been held continuously for at least two years as of the date of the nomination;

- intends to own such securities through the date of the meeting at which the election for directors will be held;

- be eligible to report such beneficial ownership on Exchange Act Schedule 13G versus Schedule 13D (*i.e.,* the nominating stockholder has not, or in the case of a nominating group, no group member has, acquired the company's securities with the purpose or effect of changing or influencing control of the company); and

- has filed a Schedule 13G (or an amendment to a Schedule 13G) before or on the date of the submission of the nomination to the company, and such filing included a certification that the 5%

stockholder or group has held more than 5% of the company's voting securities for at least two years prior to such filing.

Nominee Requirements

A company would not be required to include a stockholder nominee in its proxy materials if the nominee's candidacy or, if elected, the nominee's board membership, would violate applicable state law, federal law, or the rules of a national securities exchange or association (*e.g.,* NYSE, Nasdaq, or AMEX) other than the independence requirements of such exchange or association.

Further, the proposed rules would prohibit the nomination of a candidate (and permit a company to exclude a nominee from its proxy materials) if the 5% stockholder or group has certain relationships with the nominee. Specifically, a nominee would be required to meet the following standards of independence from the nominating stockholder or, in the case of a nominating group, each member of the group:

- if the nominating stockholder or, in the case of a nominating group, any member of the group is an individual, the nominee is not the nominating stockholder, a member of the nominating group, or a member of the immediate family of the nominating stockholder or, in the case of a nominating group, any member of the group;

- if the nominating stockholder or, in the case of a nominating group, any member of the group is an entity, neither the nominee or any immediate family member of the nominee has been an employee of the nominating stockholder or, in the case of a nominating group, any member of the group during the then-current calendar year or previous calendar year;

- neither the nominee nor any immediate family member of the nominee has, during the year of the nomination or the previous calendar year, accepted any consulting, advisory or other compensatory fee from the nominating stockholder or, in the case of a nominating group, any member of the group;

- the nominee is not an executive officer, director or affiliate of the nominating stockholder or, in the case of a nominating group, any member of the group; and

- the nominee does not "control" the nominating stockholder or, in the case of a nominating group, any member of the group.

The proposed rules would also require the nominating stockholder or, in the case of a nominating group, each member of the group to represent to the company that:

- the nominee satisfies any applicable listing standards (*e.g.,* the listing standards of NYSE or Nasdaq) regarding director independence; and

- neither the nominee nor the nominating stockholder, or in the case of a nominating group, any member of the group, has an agreement with the company regarding the nomination of the nominee.

Number of Stockholder Nominees

Upon the occurrence of one or both of the triggering events, a company would be required to include the following number of stockholder nominees in its proxy materials:

- one nominee, if the company's board has 8 or fewer members;

- two nominees, if the company's board has between 9 and 19 members; and

- three nominees, if the company's board has 20 or more members.

The proposed rules would provide an additional standard for companies with classified or "staggered" boards of directors. Moreover, where the number of nominees submitted to a company exceeds the number of nominees the company is required to include in its proxy materials, the proposed rules would require the company to include in its proxy materials the nominee or nominees submitted by the 5% stockholder or group with the largest beneficial ownership of the company's voting securities, up to and including the number of nominees required to be included by the company.

Stockholder Notice of Intent

To have a nominee included in the company's proxy materials, the 5% stockholder or group would be required to notify the company of its

intent no later than 80 days before the date the company's proxy materials are to be mailed. This notice would be required to include, among other information and representations, representations regarding:

- the 5% stockholder or group's eligibility to use the stockholder nomination procedure;
- the nominee's eligibility to stand as a nominee and, if elected, to serve as a director; and
- the absence of prohibited relationships between the nominee and the 5% stockholder or group.

Under the proposed rules, the 5% stockholder or group would be required to file such notice with the SEC no later than two business days after providing the notice to the company.

Company Procedures Upon Receipt of Stockholder Notice

Upon receipt of notice from the 5% stockholder or group, a company may exclude a 5% stockholder or group's nominee from its proxy materials if the company determines that:

- the procedure is not applicable to the company;
- the 5% stockholder or group has not complied with the procedure's requirements;
- the nominee does not satisfy the requirements of the procedure;
- any representation of the 5% stockholder or group included in the notice delivered to the company is false in any material respect; and
- the company has received more nominees than it is required to include in its proxy materials and the 5% stockholder or group is not entitled to have its nominee included in such situation.

In such case, the company would be required to (i) promptly notify the 5% stockholder or group of its determination, but in no event less than 30 calendar days before the date of the company's proxy statement delivered in connection with the previous year's annual meeting, and (ii) include a statement regarding the determination in its proxy statement for the meeting for which the stockholder nominee was submitted.

Otherwise, if a company determines that it must include the stockholder nominee in its proxy materials, the proposed rules would require the company to:

- notify the 5% stockholder or group of its determination;
- include information regarding the nominee in its proxy statement (including the website address on which the 5% stockholder or group intends to solicit in favor of its nominee); and
- include the name of the nominee on the company's proxy card.

In addition, if a company includes a statement in its proxy statement supporting the company's nominees or opposing the 5% stockholder or group's nominee, other than a mere recommendation to vote in favor of or withhold votes from a specified candidate or candidates, the proposed rules would require that the 5% stockholder or group be given the opportunity to include a statement in the company's proxy statement in support of the 5% stockholder or group's nominee. Under the proposed rules, the supporting statement submitted by the 5% stockholder or group may not exceed 500 words and must be filed with the SEC on or about the date the company's proxy statement is mailed to stockholders.

Limited Exemptions from Proxy Solicitation Rules

Under current SEC rules, a stockholder's communication with more than 10 other stockholders either (i) in an effort to form a nominating group for purposes of the proposed stockholder nomination procedure, or (ii) in support of a particular director nominee, would be subject to the SEC's rules governing proxy solicitations and would require the filing and dissemination of a proxy statement.

The proposed rules would, however, provide limited exemptions for these activities. First, any solicitation in connection with the formation of a nominating group would be exempt from the SEC's proxy solicitation rules so long as:

- the total number of stockholders solicited is not more than 30; or
- each written communication includes no more than (i) a statement of the stockholder's intent to form a nominating group, (ii) the percentage of voting securities the stockholder beneficially owns (or the aggregate percentage owned by any

group to which the stockholder belongs), and (iii) the means by which the solicited stockholder can contact the soliciting stockholder.

As a further condition to the availability of this exemption, any material delivered to solicited stockholders would be required to be filed with the SEC no later than the date the material is first delivered to solicited stockholders.

Second, communications by or on behalf of a 5% stockholder or group in support of a nominee would be exempt from the SEC's proxy solicitation rules provided:

- the soliciting party does not seek the power to act as proxy for a stockholder and does not furnish or request a form of proxy, consent or other authorization;
- each written communication includes (i) the identity of the 5% stockholder or group and its interests, by stockholdings or otherwise, and (ii) a "prominent" legend advising solicited stockholders that the nominee is or will be included in the company's proxy statement, that stockholders should read the proxy statement, and that the proxy statement and other soliciting material will be available on the SEC's website free of charge; and
- any material delivered to solicited stockholders is filed by the 5% stockholder or group with the SEC no later than the date the material is first delivered to solicited stockholders and, at the same time, three copies of such material is filed with each exchange upon which any class of the company's securities is listed.

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NYSE REVISES PROPOSED CORPORATE GOVERNANCE RULES

By Richard P. Wolfe and Andrew D. Pilant

On October 8, 2003, the New York Stock Exchange filed with the SEC a second amendment to its proposed corporate governance rules. The amendment revises several of the NYSE's proposed rules filed with the SEC on April 4, 2003. *(Click here to link to a "marked" version of the revised proposals showing changes to the previously filed proposal).* The SEC is expected to issue an order approving the NYSE's revised corporate governance rules shortly. Significant changes from the previous rule proposals are summarized below.

Revisions to Director Independence Rules

"Look-back" Periods. The NYSE has shortened the "look-back" period from five years to three years for those relationships deemed to impair a director's independence (including affiliations with the company's auditors and interlocking compensation committee relationships). As amended in April, the proposed rules included a five-year transition period during which the look-back would only have applied to the time elapsed since the rule's effective date. As revised, each independence disqualification now has a one-year look-back for the first year following SEC approval, with the full three-year look-back period becoming effective after the end of that first year.

Employee Relationships and Direct Compensation. Previously, the proposed rules presumed that a director was not independent until five years after the director (or his or her immediate family member) no longer received more than $100,000 per year in direct compensation from the listed company. The board of directors could override the presumption if all independent directors determined that the compensatory relationship was not material. The NYSE has eliminated the presumption and split the provision into two bright-line tests that distinguish between employment relationships and direct compensation:

- any director employed by (or any director having an immediate family member who is an executive officer of) the listed company is not independent until three years following the termination of the relevant employment; and

- any director who receives (or whose immediate family member receives) more than $100,000 per year in direct compensation is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

Generally, direct compensation does not include director and committee fees, or pension or other forms of deferred compensation for prior service to the listed company. In addition, the NYSE has confirmed that an immediate family member's compensation should be considered only when the family member is an executive officer of the listed company.

Business Relationships. The NYSE has revised the bright-line rule relating to a director affiliated with another company that has a business relationship with the listed company. The amended rule provides that if (1) a director is an executive officer or employee (or has an immediate family member who is an executive officer) of another company, and (2) payments received from, or paid to, the listed company exceed the greater of $1 million or 2% *of such other company's consolidated gross revenues*, the director may not be deemed independent until three years after falling below such threshold. Previously, the proposed rule would have compared payments from the other company to the *listed company's* consolidated gross revenues as well. The revised rule's commentary notes that only the current employment of the director or immediate family member should be considered for the business relationship test.

The revised rule's commentary also states that listed companies must disclose charitable contributions made to any organization of which a director serves as an executive officer if such contributions exceed the greater of $1 million or 2% of the charitable organization's consolidated gross revenues. As a reminder, the NYSE points out that boards must consider the materiality of charitable contributions and similar relationships when assessing a director's independence.

Executive Sessions for Independent Directors

The rules continue to require that non-management directors meet in regularly scheduled executive sessions without management. The NYSE has added a recommendation that, to the extent any non-management directors are not independent, listed companies should at least once a year schedule an executive session involving only independent directors.

Independent Board Committees

Compensation Committee. Previously, the compensation committee was given the "sole authority" to determine the compensation of the company's chief executive officer. The NYSE has revised that provision to clarify that *all independent directors* may be involved in approving the CEO's compensation; the updated commentary also states that the entire board is not precluded from *discussing* CEO compensation.

Audit Committee. Audit committee standards have been restructured to adopt the Sarbanes-Oxley audit committee requirements (relating to independence standards and certain committee responsibilities) by direct reference to Rule 10A-3 under the Securities Exchange Act of 1934, rather than restating Rule 10A-3 or attempting to paraphrase it. Other audit committee requirements imposed by the NYSE (such as contents of the committee charter) were not significantly modified.

While the NYSE continues to require that at least one member of the audit committee have "accounting or related financial management expertise," the commentary clarifies that the board may presume that a person has such expertise if that person satisfies the definition of "audit committee financial expert" (defined in Item 401(h) of Regulation S-K of the Exchange Act).

Effective Dates

General Transition Period. Listed companies are required to be in compliance with the new NYSE corporate governance rules by the earlier of a company's first annual meeting after January 15, 2004 or October 31, 2004. Generally, companies with classified boards have an additional year to replace a director not scheduled to stand for election in 2004.

Initial Public Offerings (IPOs). A company listing in conjunction with its IPO will be required to phase in its independent nomination and compensation committees on the same schedule mandated by Rule 10A-3 for audit committees:

- one independent member at the time of listing;
- a majority of independent members within 90 days; and
- fully independent committees within one year.

These companies will also be required to have majority independent boards within 12 months after listing on the NYSE. The revised proposal clarifies that this schedule of compliance will also apply to companies emerging from bankruptcy or that have ceased to be controlled companies.

Transfers. Companies transferring to the NYSE from markets or exchanges that do not impose the same requirements will have 12 months (as opposed to 24 months in the prior proposal) to come into full compliance with the NYSE rules.

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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