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SEC PROPOSES DISCLOSURE REGARDING NOMINATING COMMITTEES AND SHAREHOLDER COMMUNICATIONS WITH DIRECTORS

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

On August 8, 2003, the SEC, in response to recommendations from its Division of Corporation Finance, released proposed rules that would require enhanced disclosure regarding the operation of board nominating committees and new disclosure regarding the means, if any, by which shareholders can communicate with directors. *(Click here to link to the text of the report containing the Division of Corporation Finance's recommendations.)*

Comments on the proposed rules, which are summarized below, should be delivered to the SEC no later than September 15, 2003. *(Click here to link to the SEC's release regarding the proposed rules.)*

Nominating Committees

The proposed rules would expand current proxy statement requirements to require disclosure of the following:

- whether the company has a nominating or similar committee and, if not, (i) the "specific 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, (i) a description of the material terms of the charter, and (ii) where the charter is available (*e.g.,* the company's website);
- 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], any instance

[1] The New York Stock Exchange's proposed rules would require NYSE-listed companies to have independent nominating committees, whereas the Nasdaq Stock Market's proposed rules would permit, in lieu of an independent nominating committee, the nomination of directors by a majority of the company's independent directors. The NYSE and Nasdaq's proposed rules, which have been submitted to the SEC for public comment and final approval, will become effective upon adoption by the SEC.

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during the last 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 and, if so, (i) a description of the material aspects of the policy, and (ii) if the committee will consider candidates recommended by shareholders, the procedures for shareholders to follow in submitting recommendations;

- a description of any specific (i) qualifications the nominating committee believes a nominee must possess, (ii) qualities or skills the committee believes one or more of the company's directors should possess, and (iii) standards of the committee for the overall structure and composition of the company's board;

- 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;

- the source of each nominee (other than nominees who are executive officers or incumbent directors of the company) approved by the nominating committee for inclusion on the company's proxy card;

- 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 decides not to nominate a candidate recommended by a shareholder or group of shareholders that

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[2] Under the SEC's proposed rules, non-listed issuers would be required to 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.

have owned greater than 3% of the company's outstanding stock for at least one year, (i) the name(s) of the shareholder(s) who made the recommendation, and (ii) the "specific reasons" for the committee's decision not to nominate the candidate.

Shareholder Communication with Directors

In addition, the proposed rules would require the following disclosures in proxy statements where action is to be taken with respect to the election of directors:

- whether the company provides a process by which shareholders can communicate with the company's directors and, if not, the "specific basis" for the board's opinion that is appropriate for the company not to have such a process; and

- if the company does have such a process, (i) a description of the process, (ii) the names of the directors to whom shareholders can send communications, (iii) if communications are not sent directly to directors, a description of the process for determining which communications will be relayed to directors, including the department or group responsible for making such determination; and (iv) a description of any material action taken by the board in response to communications from shareholders.

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SEC STAFF RESPONDS TO FREQUENTLY-ASKED QUESTIONS REGARDING AUDITOR INDEPENDENCE

By Amos J. Oelking, III

On August 13, 2003, the Office of the Chief Accountant of the SEC provided responses to 35 frequently-asked questions regarding the application of the SEC's auditor independence rules. *(Click here to link to the Office of the Chief Accountant's responses.)*

The SEC's auditor independence rules, which became effective May 6, 2003, seek to enhance the independence of outside auditors and require additional disclosure to investors about the services provided by outside auditors. *(Click here to link to our E*Zine regarding the SEC's auditor independence rules.)*

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SEC APPROVES FINAL RULES REGARDING RESEARCH ANALYST CONFLICTS OF INTEREST

By Richard P. Wolfe and James E.A. Slaton

On July 29, 2003, the Securities and Exchange Commission gave final approval to rule change proposals of the New York Stock Exchange ("NYSE") and National Association of Securities Dealers, Inc. ("NASD" and, together with NYSE, the "SROs") addressing research analyst conflicts of interest. The rules as adopted reflected a third round of amendments filed by the SROs on the same day. *(Click here to link to the full text of the SEC's release.)*

The amended rules are intended to (i) improve the objectivity of research and provide investors with more reliable information by imposing additional safeguards, and (ii) fulfill the requirements of the Sarbanes-Oxley Act of 2002. The proposals were originally filed in October 2002 and amended in December 2002 and May 2003. This article compares key provisions of the rules as amended and adopted to the rules as initially proposed by the SROs.

Because the final NYSE and NASD rules deal with the same issues, they are summarized together.

Pitch Meetings

The amended rules prohibit research analysts from participating in "pitches" or other communications for the purpose of soliciting investment banking business.

The initial proposal merely prohibited an analyst from issuing research reports or making public appearances concerning a company if the analyst engaged in any communication with the company in "furtherance of obtaining investment banking business" prior to the time the company entered into a letter of intent or other written agreement that designated the analyst's firm as underwriter of the company's initial public offering.

Approval of Research Analyst Compensation

The adopted amendments clarify provisions of the originally proposed rule requiring that analyst compensation be determined by a committee that does not include investment banking personnel.

First, the amendments limit the applicability of this rule to the lead analyst primarily responsible for a report and clarify that the function of the compensation committee is merely to "review and approve," not to determine, analyst compensation.

Second, the amendments include a new rule prohibiting investment banking personnel from *evaluating* the compensation of any research analyst, including both lead and junior analysts.

Public Appearances

The initial proposals required analysts to decline subsequent appearances with media outlets, including print media, that edited out required analyst disclosures concerning their conflicts of interest unless media assurances were given that future disclosures would not be edited out.

Under the amended rules, an analyst may continue appearances with such media outlets so long as the analyst makes the required disclosures to the media outlet in good faith. Analysts are required, however, to make a record of the appearance and the disclosures to the media outlet.

Pre-Approval of Analyst Personal Trading

The original proposals would have extended the existing analyst personal trading restrictions to include individuals with supervisory roles, such as supervisory analysts or the director of research. The final rules are less restrictive and merely require a member's legal or compliance personnel to pre-approve all securities transactions of persons who supervise research analysts or who have direct influence or control with respect to the preparation of research reports, to the extent the transactions involve securities of subject companies covered by their research analysts.

Exception to Analyst Trading Restriction

The final rules exclude from analyst personal trading restrictions "blind trust" accounts controlled by a person other than the research analyst or members of his household, where none of such persons knows of the account's investments or transactions. This point was not addressed in the original proposals.

Termination of Coverage

In response to requests for clarification of the initial rule proposal requirement that member firms publish notice of "withdrawal" of research coverage, the rules as amended and adopted require notice upon the "termination" of research coverage. Additionally, the requirement in the initial proposal that the notice be made "in the same manner" as when research coverage was first initiated has been clarified.

Disclosure of Compensation

As amended and adopted, the rules reflect modifications to the existing SRO requirement that compensation for investment banking services received from subject companies be disclosed. The amended rules require a member firm to disclose in research reports whether it, any of its affiliates, or its research analysts received *any* compensation from an issuer that is the subject of a research report or public appearance. This requirement was not included in the initial proposal.

The proposed "real-time" disclosure of non-investment banking compensation, which was criticized by commenters as being unduly burdensome, was modified to require only periodic disclosure in certain circumstances.

Additionally, the final rules limit certain compensation disclosure requirements to cases where the analyst or member knows or has reason to know of the compensation. The original proposals required disclosure without a knowledge qualification.

Also added by the amendments is a requirement that disclosure be made if the subject issuer is, or has been during the previous year, a client of the member broker or dealer and, if so, the types of services provided to the issuer. Under previous SRO rules, disclosure would only be required if the subject issuer is an *investment banking* client of the member firm.

The disclosure requirements are subject to an exemption to the extent disclosure would reveal material non-public information regarding specific potential future investment banking transactions of the subject issuer.

Retaliation

The rules as adopted would prohibit retaliation (or threatened retaliation) by a member broker or dealer against any research analyst employed by that broker or dealer or its affiliates as a result of an unfavorable research report or public appearance. This issue was not addressed in the original proposal.

Prepublication Review

The rules as amended extend the prohibition in the existing SRO rules on the prepublication review and approval of research reports by investment banking personnel to any non-research personnel associated with the broker or dealer, except legal and compliance staff. Additionally, communications between research and non-research personnel regarding the content of a report (*e.g.*, results of fact checking) must be intermediated through the firm's legal or compliance department.

Quiet Periods

In the case of IPOs only, the final rules, as did the proposed rules, impose a 25-day "quiet period" (*e.g.*, prohibition against publishing or otherwise distributing research reports) on members of the underwriting syndicate and dealers who are not managers or co-managers of the offering. Previously existing SRO rules imposed quiet periods — for 40 calendar days following an IPO and 10 calendar days following a secondary offering — on underwriting managers and co-managers, but not on other members of the underwriting syndicate or selling group.

The original proposal would have prohibited a member that has acted as a manager or co-manager of *any* securities offering from distributing a research report or making a public appearance — a "booster shot" — concerning any subject company 15 days prior to and after the expiration, waiver, or termination of a lock-up agreement that restricts the sale of securities held by the company or its shareholders after the completion of a securities offering.

After consideration of commenters' concerns, the SROs modified their proposals by exempting secondary offerings of "actively traded" securities from the rule prohibiting "booster shot" research reports, because such offerings are already exempted by SEC Rule 139 from the "quiet period."

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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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