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SEC Proposes Rules to Increase Shareholder Access to Company Proxy Materials for Director Nominations

In an effort to enhance the ability of shareholders to participate in the proxy process for the nomination and election of directors, the SEC has proposed rules that would, under certain circumstances, require companies to include in their proxy materials security holder nominees for election as director.

Proposed Rule 14a-11 and related rule changes 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 there are indications that the company has been unresponsive to security holder concerns as they relate to the proxy process;
- enable security holders to engage in limited solicitations to form nominating security holder groups and engage in solicitations in support of their nominees without disseminating a proxy statement;
- make clear that passive investors and institutional investors who are eligible to report their beneficial ownership on Schedule 13G will not be deemed ineligible solely by submitting a nomination or engaging in other activities under the proposed rule; and
- permit security holders to form nominating security holder groups that hold in the aggregate more than 10% of the company's equity securities and to successfully use the nomination procedure to elect a director without triggering Section 16 reporting obligations.

The proposed rule and related rule changes, which are subject to a 60-day comment period, are discussed below in greater detail.

Summary of Proposed Rule

To Which Companies Would the Proposed Rule Apply?

The proposed rule would apply to all companies that are subject to the proxy rules, including registered investment companies ("funds"). Because foreign private issuers are not subject to the proxy rules, the proposed rule would not apply to them.

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A company would be subject to the security holder nomination procedure only where the company's security holders have an existing, applicable state law right to nominate a candidate or candidates for election as a director. If state law permits companies incorporated in that state to prohibit security holder nominations through provisions in companies' articles of incorporation or bylaws, the proposed procedure would not be available to security holders of a company that had validly included such a provision in its governing instruments.

The SEC is considering whether the proposed rule should apply only to those companies that are subject to accelerated deadlines for filing periodic reports, and registered investment companies. Companies that fall within the definition of "accelerated filer" in Rule 12b-2 would be subject to the security holder nomination procedure for any fiscal year in which they must file all of their periodic reports on an accelerated basis.

What Events Must Occur Before a Company Would be Required to Include a Security Holder Nominee in Its Proxy Materials?

In order to focus the impact of the proposed security holder nomination procedure on those companies where there are criteria showing that the proxy process may be ineffective, the nomination procedure would become operative for a company only after the occurrence of one or both of the following nomination procedure triggering events:

- 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% of the votes cast at an annual meeting of security holders held after January 1, 2004 (provided, that this event may not occur in the case of a contested election to which Rule 14a-12(c) applies or an election to which the proposed security holder nomination procedure applies); or

- (a) a security holder proposal submitted pursuant to Rule 14a-8 providing that the company become subject to the proposed security holder nomination procedure was submitted for a vote of security holders at an annual meeting of security holders held after January 1, 2004 by a security holder or group of security holders that held more than 1% 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;[1] and (b) that "direct access" proposal received more than 50% of the votes cast on that proposal at that meeting (calculated in accordance with Rule 14a-8; only votes for and against would be included in the calculation).

The SEC is considering as an additional element of the proposed rule whether the proposed rule should include a third triggering event where:

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[1] The SEC staff intends to take the position that a "direct access" proposal is not excludable under Rule 14a-8(i)(8), and a proposed amendment to Rule 14a-8(i)(8) would make clear that a company may not rely on the exclusion permitted by that paragraph to exclude a "direct access" proposal. Furthermore, the SEC proposes an instruction to Rule 14a-8(i)(11) to specify that, where a company receives more than one "direct access" proposal, the company would not be permitted by that rule to exclude a "direct access" proposal submitted by a holder of more than 1% of the company's securities that duplicates a previously submitted proposal by a holder of less than 1%.

- a security holder proposal submitted pursuant to 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% 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% of the votes cast on that proposal; and

- 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.

Any such trigger would apply to all security holder proposals, regardless of whether a proposal requires board action (a "mandatory" proposal) or requests board action (a "precatory" proposal).

The SEC staff recognizes that were this trigger to be adopted, guidance would have to be provided with respect to determinations of whether a security holder proposal had in fact been implemented.

Once a triggering event occurs, the proposed security holder nomination procedure would remain operative for any annual meetings or special meetings held during:

- the remainder of the calendar year in which the triggering event occurs;

- the calendar year following the calendar year in which the triggering event occurs; and

- the portion of the second calendar year following the calendar year in which the triggering event occurs, up to and including the annual meeting (or special meeting in lieu of an annual meeting) held during that calendar year.

The SEC's intention is that the procedure would remain available for the two annual meetings following the occurrence of a triggering event.

In order to facilitate an informed security holder vote with regard to security holder proposals that could trigger the security holder nomination procedure, the SEC has proposed an amendment to Rule 14a-5 that would require the company, where a security holder proposal is submitted by a more than 1% security holder who has held securities for at least one year, to advise security holders of this fact in the proxy statement relating to the meeting at which the security holder proposal will be presented. The SEC recommends that, pending final action on that proposal, companies make such an identification. In addition, the SEC suggests that companies should consider whether failure to make such an identification has any implications under Rule 14a-9.

What Notice Must a Subject Company Give Regarding the Occurrence of an Event that Triggers the Operation of the Proposed Rule?

As a means of providing notice that a nomination procedure triggering event has occurred, the proposed procedure would require the following additional disclosures:

- each company would be required to disclose the security holder vote with regard to either of the nomination procedure triggering events in its quarterly report on Form 10-Q or 10-QSB 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, in its Form 10-K or 10-KSB;[2] and

- each company would be required to include in that Form 10-Q, 10-QSB, 10-K or 10-KSB information disclosing that it would be subject to the proposed security holder nomination procedure as a result of such vote, if applicable.

Which Security Holders or Security Holder Groups May Submit a Nominee that the Company Would Be Required to Include in Its Proxy Materials?

To be eligible to submit a nomination in accordance with the proposed rule, a security holder or group of security holders would be required to:

- beneficially own, either individually or 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 of security holders (or, in lieu of such an annual meeting, a special meeting of security holders), with each of the securities used for 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 Schedule 13G, rather than Schedule 13D, in reliance on Rule 13d-1(b) (passive investor) or (c) (institutional investor); and

- have filed a Schedule 13G or an amendment to Schedule 13G 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% of the subject securities for at least two years.

What Are the Requriements for the Person Whom the Eligible Security Holder or Security Holder Group May Nominate?

Consistency with Applicable Law and Rules

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[2] Because funds do not file quarterly reports on Form 10-Q, the disclosure would be included on Form N-CSR, which funds file semi-annually. In addition, the proposed rule would require disclosure in Form N-CSR regarding each matter submitted to a vote of security holders similar to that currently required by Item 4 of Part II of Form 10-Q, and delete as duplicative Item 77C of Form N-SAR, which currently requires similar disclosure.

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 of a national securities exchange or national securities association that set forth requirements regarding the independence of directors).

Rather than making compliance with independence standards a part of this requirement, the SEC has proposed a separate requirement regarding independence standards. Pursuant to that separate requirement, a nominating security holder or nominating security holder group would be required to represent that the nominee meets the objective criteria for "independence" in any applicable national securities exchange or national securities association rules. For this purpose, the nominee would be required to meet the definition of "independence" that is generally applicable to directors of the company and not any particular definition of independence applicable to members of the audit committee of the company's board of directors. To the extent a rule imposes a standard regarding independence that requires a subjective determination by the board or a group or committee of the board (for example, requiring that the board of directors or any group or committee of the board of directors make a determination regarding the existence of factors material to a determination of a nominee's independence), this element of an independence standard would not have to be satisfied.[3]

Prohibited Relationships with Nominating Security Holder or Group

In response to concerns that a security holder nomination procedure creates the potential for "special interest" or "single issue" directors that would advance the interests of the nominating security holder over the interests of security holders as a group, the proposed rule would require that each security holder nominee meet the following standards regarding the nominee's independence from the security holder or each member of the security holder group that has submitted such nominee:

- 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 (for these purposes, "immediate family" would be defined in a manner that is consistent with the definition of "family member" that requires disclosure under Item 401(d) of Regulation S-K);

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[3] In the case of a fund, a nominating security holder or group would be required to represent that its nominee is not an "interested person" of the fund as defined in Section 2(a)(19) of the Investment Company Act, rather than independent under the listing standards of a national securities exchange or national securities association. This "interested person" test also would apply to nominees by a security holder or security holder group for election to the board of directors of a business development company.

- 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 of an affiliate of the nominating security holder or any such member of the nominating security holder group; and

- the nominee does not control the nominating security holder or any member of the nominating security holder group.[4]

Prohibited Relationships with the Company

As a means of addressing concerns regarding the effect of a nomination procedure on a company's compliance with requirements that certain of its directors be "independent" and concerns regarding the use of the process by nominating security holders that were acting merely as a surrogate for the company, the proposed rule would require that each nominating security holder or each member of the group of nominating security holders represent to the company (in the nominating security holder or group's notice to the company required by the proposed rule) that:

- the nominee submitted under the proposed rule by that nominating security holder or group of nominating security holders 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 (for example, requiring that the board of directors or any group or committee of the board of directors make a determination regarding the existence of factors material to a determination of a nominee's independence), this element of an independence standard would not have to be satisfied;[5] and

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[4] 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.

[5] In the case of a fund, a nominating security holder or group would be required to represent that its nominee is not an "interested person" of the fund, as defined under the Investment Company Act.

- neither the nominee nor the nominating security holder (or any member of the nominating security holder group, if applicable) has a direct or indirect agreement with the company regarding the nomination of the nominee.

In order to address the concern that the use of the proposed security holder nomination procedure, by itself, may be deemed to establish a relationship between the nominating security holder or nominating security holder group and the company that would result in that holder or group being deemed an "affiliate" of the company for purposes of the federal securities laws, the proposed rule would include an instruction making clear that a nominating security holder will not be deemed an "affiliate" of the company under the Securities Act 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. In addition, where a security holder nominee is elected, and the nominating security holder or nominating security holder group does not have an agreement or relationship with that director, otherwise than relating to the nomination, the nominating security holder or nominating security holder group would not be deemed an affiliate solely by virtue of having nominated that director under the proposed rule.

How Many Security Holder Nominations Must the Company Include in Its Proxy Materials?

Under the proposed rule, a company would be required to include in its proxy materials:

- one security holder nominee if the total number of members of the board of directors is eight or fewer,

- two security holder nominees if the number of members of the board of directors is greater than eight and less than 20, and

- three security holder nominees if the number of members of the board of directors is 20 or more.

The proposed rule would have a separate standard for companies with classified or "staggered" boards of directors. Where a company has a director (or directors) currently serving on its board of directors 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 one if the total number of members of the board of directors is eight or fewer, two if the number of members of the board of directors is greater than eight and less than 20 and three if the number of members of the board of directors is 20 or more.

In situations where 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 pursuant to the proposed rule, the company would be required to include in its proxy materials the nominee or nominees of the security holder or security holder group with the largest beneficial ownership (as reported on Schedule 13G) at the time of the delivery of the nominating security holder's notice of intent to nominate a director pursuant to the proposed rule, up to and including the total number required to be included by the company.

In its proposing release, the SEC states that it does not intend the security holder nomination procedure to be available for any security holder or security holder group that is seeking control of a company. The existing procedures regarding contested elections of directors are intended to continue to fulfill that purpose.

What Notice Must the Nominating Security Holder or Nominating Security Holder Group Provide to the Company and File with the SEC?

The proposed rule provides that, to have a nominee included in the company's proxy materials, the nominating security holder or nominating security holder group must provide notice to the company of its intent to require that the company include that security holder's nominee on the company's proxy card no later than 80 days before the date that the company mails its proxy materials for the annual meeting. As is currently required in Rule 14a-8, this date would be calculated by determining the release date disclosed in the previous year's proxy statement, increasing the year by one, and counting back the required number of calendar days. If the company did not hold an annual meeting during the prior year, or if the date of the meeting has changed more than 30 days from the prior year, then the nominating security holder or group would be required to provide notice a reasonable time before the company mails its proxy materials for the current year, as specified in a Form 8-K filed pursuant to proposed Item 13.[6]

This notice would be required to include:

- a representation that the nominating security holder is eligible to submit a nominee under the proposed security holder nomination procedure;

- a statement that, to the knowledge of the nominating security holder or group, the candidate's nomination or service on the board, if elected, would not violate controlling state law, federal law, or listing standards (other than a standard relating to independence);

- a representation that the nominee meets the objective criteria for independence from the company that are set forth in applicable rules of a national securities exchange or national securities association;[7]

- representations regarding the absence of a prohibited relationship between the nominee and the nominating security holder or nominating security holder group;

- a representation that neither the nominee nor the nominating security holder (or any member of the nominating security holder group, if applicable) has a direct or indirect agreement with the company regarding the nomination of the nominee;

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[6] Although funds generally are not required to file on Form 8-K, the SEC proposes to require them to file on Form 8-K for this limited purpose.

[7] In the case of a fund, a nominating security holder or group would be required to represent that its nominee is not an "interested person" of the fund, as defined under the Investment Company Act.

- a copy of the nominating security holder's or nominating security holder group's filed Schedule 13G indicating ownership of more than 5% of the appropriate class of the company's securities;[8]

- a representation that the nominating security holder or each member of the nominating security holder group was eligible to report its security ownership on Schedule 13G in reliance on Rule 13d-1(b) or (c);[9]

- a representation that more than 5% of the appropriate class of the company's securities, as reflected in the Schedule 13G of the nominating security holder or nominating security holder group, have been held continuously for at least two years and that the nominating security holder or nominating security holder group intends to continue to own those securities through the date of the subject election of directors;[10]

- a statement from the nominee that the nominee consents to be named in the company's proxy statement and to serve on the board if elected, for inclusion in the company's proxy statement;

- disclosure about the nominee complying with the requirements of Item 7(a), (b) and (c) and, for investment companies, Item 22(b) of Schedule 14A, for inclusion in the company's proxy statement;

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[8] In the case of a fund, in lieu of the Schedule 13G, the nominating security holder or group would be required to include the following information, similar to certain information that would otherwise be required on Schedule 13G, as part of the notice to the fund of the security holder's intent to place its nominee on the company's proxy card:

- the percentage of each class of securities of the fund that the individual owns beneficially, directly or indirectly, and the number of shares as to which the person has:
  - sole power to vote or to direct the vote;
  - shared power to vote or to direct the vote;
  - sole power to dispose or to direct the disposition of such shares; and
  - shared power to dispose or to direct the disposition of such shares; and
- a certification, signed by each person on whose behalf the notice is filed or his or her authorized representative, that the securities have been held continuously for at least three years.

[9] This requirement would not apply in the case of a company that is a mutual fund.

[10] For companies that are mutual funds, this representation would be modified to reflect the fact that security holders of funds are not required to file on Schedule 13G.

- any of the following information with regard to each nominating security holder or member of a nominating security holder group that is not included in the Schedule 13G, for inclusion in the company's proxy statement:[11]
    - name and business address;
    - present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment is carried on;
    - the amount of each class of securities of the company that the individual owns beneficially, directly or indirectly, determined in accordance with Rule 13d-3; and
    - whether or not, during the past ten years, the individual has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, the dates, the nature of the conviction, the name or other disposition of the case; and whether the individual has been involved in any other legal proceeding during the past five years, as specified in Item 401(f) of Regulation S-K; and
- The methods by which the nominating security holder or nominating security holder group may solicit security holders, including any website address on which the nominating security holder or nominating security holder group may publish soliciting materials.

The nominating security holder or the nominating security holder group would be required to file the notice described above, excluding the already-filed Schedule 13G, with the SEC. This notice would be viewed as soliciting material of the nominating security holder or nominating security holder group, in that much of the information included in the notice would ultimately be disseminated to security holders in the company's proxy statement. Accordingly, the notice as filed with the SEC would be subject to the anti-fraud provisions of Rule 14a-9. The SEC contemplates that this solicitation would be made in accordance with the exemption set out in the proposed rule. The notice would be filed with the SEC in the following manner:

- the filing would include a cover page in the form set forth in Schedule 14A, as proposed to be amended, with the appropriate box on the cover page marked;
- the filing would be made under the company's file number; and
- the nominating security holder or nominating security holder group would be required to make the filing no later than two business days after providing the notice to the company.

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[11] Where the nominating security holder is an entity rather than an individual, the required disclosure would be provided with regard to the control persons of the entity. For example, if the nominating security holder is a corporation, the required information must be given with respect to each executive officer and director of the corporation, each person controlling the corporation, and each executive officer and director of any corporation or other person ultimately in control of the corporation.

What Must the Company Do After It Receives a Notice From a Nominating Security Holder or a Nominating Security Holder Group Under the Proposed Rule?

A company that receives a notice from a nominating security holder or nominating security holder group would need to determine whether the nominating security holder or nominating security holder group has complied with the proposed rule and whether the nominee satisfies each of the requirements of the proposed procedure. Unless a company determines that it is not required to include a nominee in its proxy materials, the company would be required to include information regarding the security holder nominee in the company's proxy statement that it sends to its security holders, including the website address on which the nominating security holder or nominating security holder group intends to solicit in favor of its nominee, and include the name of the nominee on the company's proxy card. The proposed procedure specifies the information regarding that nominee that the company must include in its proxy materials.

If the company includes any statement in its proxy materials supporting company nominees and/or opposing the nominating security holder or nominating security holder group nominee or nominees, other than a mere recommendation to vote in favor of or withhold votes from specified candidates, the proposed rule would provide the nominating security holder or nominating security holder group with the opportunity to include in the company's proxy statement a statement of support for the security holder nominee or nominees, of a length not to exceed 500 words.[12] Should the company choose not to make any statement in its proxy statement supporting company nominees and/or opposing the security holder nominee or nominees, other than the mere recommendation described above, the company would not be required to include in its proxy statement the nominating security holder's supporting statement. In either case, both the company and the nominating security holder or nominating security holder group would be able to solicit in favor of their nominees outside the proxy statement, for example on a designated website, provided that such solicitations were made within the parameters of the applicable proxy rules.

With regard to the company's proxy card, similar to the current practice with regard to security holder proposals submitted pursuant to Rule 14a-8, the company could identify any security holder nominees as such and recommend that security holders vote against, or withhold votes from, those nominees and in favor of the management nominees on the form of proxy. The company must otherwise present the nominees in an impartial manner in accordance with Rule 14a-4. Under the current rules, a company may provide security holders with the option to vote for or withhold authority to vote for the company's nominees as a group, provided that security holders also are given a means to withhold authority for specific nominees. Because the SEC believes that grouping the company's nominees may make it easier to vote for all of the company's nominees than to vote for the security holder nominees in addition to some of the company nominees, the proposed rules would not permit a company to provide security holders the option of voting for or withholding authority to vote for the company nominees as a group, but would instead require that each candidate be voted on separately.

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[12] Under the proposed rules, inclusion of a security holder nominee in the company's proxy materials would not require the company to file a preliminary proxy statement provided that the company was otherwise qualified to file in definitive form. In this regard, the proposed rules make clear that inclusion of a security holder nominee would not be deemed a solicitation in opposition.

A company may determine that it is not required to include a nominee from a nominating security holder or nominating security holder group in its proxy materials if it determines any of the following:

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

The company would be required to notify the nominating security holder or nominating security holder group, in writing, of its determination whether or not to include the security holder nominee. The company would have to provide this notice promptly, but in no case less 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 and, where the company did not hold an annual meeting in the previous year, or if the date of this year's annual meeting has been changed by more than 30 days from the date of the previous year's meeting, then the notice must be provided a reasonable time before the company mails its proxy materials for the current year. If the company determines that it is entitled to exclude the nominee, the notice must include the following information regarding the company's determination:

- a description of the determination made by the company's board of directors, including an affirmative statement of its determination not to include that specific nominee;
- a discussion of the specific requirement or requirements of the proposed rule that the company's board of directors has determined permit the company not to include that specific nominee; and
- a discussion of the specific basis for the belief of the company's board of directors that the company is permitted to not include that specific nominee.

The company would be required to include in its proxy statement for the meeting for which the nominee was submitted a statement that it has made such a determination as well as disclosure of the information relating to that determination that the company included in the notice to the nominating security holder.

If the company determines that it must include the security holder nominee, it would be required to advise the nominating security holder or nominating security holder group of this determination and state whether the company intends to include in its proxy statement disclosure opposing the security holder nominee and/or supporting company nominees. If the company intends to include such a statement, it must advise the nominating security holder or nominating security

holder group that it may submit a statement of not more than 500 words supporting the security holder nominee(s). The company also must advise the nominating security holder or nominating security holder group of the date by which this statement must be provided to the company, which could not be less than 10 business days from the date of the company's notice to the security holder. The nominating security holder or nominating security holder group's supporting statement would be viewed as soliciting material and would therefore be required to be filed as such by the nominating security holder in accordance with the proposed rules, on or about the date that the company's proxy statement is first released to security holders.

How Would the Liability Provisions in the Federal Securities Laws Apply to Statements Made by the Company and the Nominating Security Holder or Nominating Security Holder Group?

The SEC intends that the nominating security holder or nominating security holder group be liable for any false or misleading statements included in the notice provided to the company by the nominating security holder or nominating security holder group. The proposed rule contains express language, modeled on Rule 14a-8(l)(2), providing that the company would not be responsible for that disclosure.

The security holder nomination procedure would provide that any information that is provided to the company in the notice from the nominating security holder or nominating security holder group (and, as required, filed with the SEC by the nominating security holder or nominating security holder group) 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. However, to the extent the company does so incorporate that information by reference, the SEC would consider the company's disclosure of that information as the company's own statement for purposes of the antifraud and civil liability provisions of the Securities Act or the Exchange Act, as applicable.

How Do the Other Exchange Act Proxy Rules Apply to Solicitations By the Nominating Security Holder or Nominating Security Holder Group?

Security holders would be permitted to form groups that would aggregate their securities in order to meet the minimum ownership threshold of more than 5% to nominate a director candidate under the proposed rule. In an effort to facilitate communications among security holders seeking to form nominating security holder groups, the proposed rule would provide a limited exemption from certain of the proxy rules in order to enable security holders to communicate for this limited purpose without filing and disseminating a proxy statement.

Rules 14a-3 to 14a-6(o), 14a-8, and 14a-10 to 14a-15 would not apply to any solicitation by or on behalf of any security holder in connection with the formation of a nominating security holder group, provided that:

- the total number of persons solicited is not more than 30; or
- each written communication includes no more than:
  - a statement of the security holder's intent to form a nominating security holder group in order to nominate a director under the proposed rule;

  - the percentage of securities that the security holder beneficially owns or the aggregate percentage owned by any group to which the security holder belongs; and

  - the means by which security holders may contact the soliciting party; and

- any soliciting material published, sent or given to security holders in accordance with this paragraph is filed with the SEC by the nominating security holder, under the company's file number, no later than the date the material is first published, sent or given to security holders. The soliciting material would be required to include a cover page in the form set forth in Schedule 14A, with the appropriate box on the cover page marked.

In addition, in order to ease restrictions under existing proxy rules that would limit the ability of a nominating security holder or nominating security holder group to solicit proxies in favor of its nominees for director, the SEC has proposed a new exemption to the proxy rules providing that solicitations by or on behalf of a nominating security holder or nominating security holder group in support of a nominee placed on the company's proxy card in accordance with the proposed rule, would not be subject to Rules 14a-3 to 14a-6(o), 14a-8, and 14a-10 to 14a-15, provided that:

- the soliciting party does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form or revocation, abstention, consent or authorization;

- each written communication includes:

  - the identity of the nominating security holder or nominating security holder group and a description of his or her direct or indirect interests, by security holdings or otherwise; and

  - a prominent legend in clear, plain language advising security holders that a security holder nominee is or will be included in the company's proxy statement and to read the company's proxy statement when it becomes available because it includes important information. The legend also must explain to security holders that they can find the proxy statement, other soliciting material and any other relevant documents, at no charge on the SEC's website; and

- any soliciting material published, sent or given to security holders in accordance with this paragraph must be filed by the nominating security holder or nominating security holder group with the SEC, under the company's file number no later than the date the material is first published, sent or given to security holders. Three copies of the material would at the same time be filed with, or mailed for filing to, each national securities exchange upon which any class of securities of the company is listed and registered. The soliciting material would be required to include a cover page in the form set forth in Schedule 14A, with the appropriate box on the cover page marked.

Related Rule Changes

Beneficial Ownership Reporting Requirements

The SEC has proposed adding an instruction to the description of passive investors and institutional investors who may report their ownership on Schedule 13G to make clear 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 the proposed rule should not be deemed to have a purpose or effect of changing or influencing the control of the company solely by virtue of making the nomination or engaging in such activities. Any activity other than those provided for under the proposed rule would make these instructions inapplicable.

To enable the functioning of the proposed security holder nomination procedure, the SEC also proposes to amend Schedule 13G to require that the security holder or group certify that they have owned at least the required more than 5% amount of the securities for the minimum time period of two years required in the proposed rule. A security holder or group of security holders that previously had filed a Schedule 13G would be required to amend that Schedule to provide the required certification to make a nomination under the proposed rule. Upon termination of the nominating security holder group, the group would file a final amendment to the Schedule 13G disclosing termination of the group and, therefore, the group's filing obligation on Schedule 13G. As is currently the case in determining that a group has been formed and a group filing is therefore required, the group would be required to file as such only so long as the security holders comprising that group continue to have an agreement to act together for the purpose of acquiring, holding, voting or disposing of the company's equity securities.

Section 16 Reporting Requirements and Liability

To address the concern that using the proposed security holder nomination procedure will subject eligible security holder groups to Section 16, a proposed amendment to Rule 16a-1(a)(1), the rule that defines who is a 10% owner for Section 16 purposes, would exclude a nominating security holder group from the definition. These groups would remain subject to the general condition of the rule that they not have the purpose or effect of changing or influencing control of the issuer, but a note to Rule 16a-1(a)(1) would provide that members of nominating security holder groups would not be deemed to have a control purpose or effect solely by virtue of group membership. Security holders whose individual ownership exceeds 10% and are not otherwise excluded under the current rule would not be excluded by the proposed change.

Some security holders, particularly institutions and other entities, may be concerned that successful use of the proposed nomination procedure to elect a director may result in the nominating person also being deemed a director under the "deputization" theory developed by courts in Section 16(b) short-swing profit recovery cases. Under this theory it is possible for a person to be deemed a director subject to Section 16, even though the issuer has not formally elected or otherwise named that person a director. The judicial decisions in which this theory was applied do not establish precise standards for determining when "deputization" may exist. However, the express purpose of Section 16(b) is to prevent the unfair use of information by insiders through their relationships to the issuer. Accordingly, one factor that courts may consider in determining if Section 16(b) liability applies is whether, by virtue of the "deputization" relationship, the "deputizing" entity's transactions in issuer securities may benefit from the deputized director's access to inside information. The proposed rule includes standards for establishing the independence of the nominee from the nominating security

holder, or members of the nominating security holder group, as applicable. Given these independence standards, the SEC indicated its view that the "deputization" theory, whereby the beneficial ownership of a security holder or group is imputed to a "deputized" director (and director status imputed to the security holder or group), should not apply.

*   *   *

The proposed rule was developed following a special report prepared by the SEC's Division of Corporation Finance in the wake of recent corporate governance scandals. This same report was also the genesis of the SEC's August 2003 proposal to enhance disclosure regarding the director nomination process and to facilitate communications by shareholders with the board of directors. The two proposals, taken together, represent significant changes to the director nomination and proxy solicitation process.

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This memorandum is not intended to provide or constitute legal advice, and no legal or business decision should be based on its contents.

Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (see below). In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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