

Client Advisory

October 2003

SEC Proposes Rules to Enhance Shareholder Access to Companies' Proxy Materials

The Securities and Exchange Commission has proposed and issued for comment rules that would enhance the ability of shareholders of a public company (including registered investment companies) to nominate candidates for directorships. In general, proposed Rule 14a-11 would, in certain circumstances, require companies subject to the SEC's proxy rules and whose shareholders have a state law right to nominate a candidate or candidates for election as director to include in their proxy materials the names and certain other information regarding shareholder nominees for election as director. The proposing release (Release Nos. 34-48626; IC 26206) is available on the SEC's Web site at <http://www.sec.gov/rules/proposed/34-48626.htm>.

I. The Mechanics of the Proposed Rules

Triggering Events. The proposed rules contemplate a nomination procedure that becomes operative only after the occurrence of one or both of the following triggering events:

- When 35% or more of votes cast at a shareholders' meeting with respect to one or more director nominees are "withhold" votes; or
- The filing of a demand for proxy access by a shareholder, or group of shareholders, who have owned at least one percent of the outstanding voting shares for at least one year as of the date the demand is submitted, and the subsequent approval of the demand by a majority of the votes cast at a meeting.

The Commission intends that this trigger mechanism be operational for the 2004 proxy season.

Notice and Additional Disclosure Requirements. Once triggered, the nomination procedure would remain operative during the two calendar years following the triggering event, up to and including the annual meeting (or special meeting in lieu of an annual meeting) held during the second calendar year. The proposed rules also provide for disclosures in a company's 10-Q, 10-QSB, 10-K or 10-KSB filings to inform shareholders of the occurrence of one or both of the triggering events, and the Staff "recommends" that, even before all rule amendments are adopted, a company identify in its 2004 proxy statement any proposal that would (because it is presented by "qualified shareholder(s)"), constitute a nominating process triggering event under the proposed rule amendments.

Nominating shareholders would be required to give the company notice of their intent to require that the company include the shareholder 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. The nominating shareholders would also be required to file such notice with the SEC no later than two business days after providing notice to the company.

Eligibility of Nominating Shareholders. To be eligible to submit a nomination under proposed Rule 14a-11, nominating shareholders would be required to:

- Own more than 5% of the company's securities that are eligible to vote, and have held such securities continuously for two years as of the date of nomination;
- Intend to continue to own those securities through the date of the next annual meeting (or special meeting in lieu of an annual meeting);
- Be eligible to report beneficial ownership on Schedule 13G, rather than Schedule 13D; and
- Have filed a Schedule 13G or an amendment to Schedule 13G reporting their beneficial ownership before or on the date of the submission of the nomination to the company.

The Number of Shareholder Nominees. The number of shareholder nominees would vary depending on the size of the company's board of directors. Companies with eight or fewer directors would be required to include information concerning one nominee. Those companies with between nine and 19 directors would be required to include information concerning two nominees, and companies with boards of 20 or more directors would be required to include information concerning three nominees.

Companies with classified or "staggered" boards of directors would not be required to include more shareholder nominees than could result in the total number of directors serving on the board that were elected as shareholder 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 directors is between nine and 19, and three if the number of directors is 20 or more.

Eligibility of Shareholder Nominees. The proposed rules provide that shareholder nominees would have to demonstrate independence from nominating shareholders to be eligible candidates for inclusion in the proxy materials. Moreover, nominating shareholders would have to represent that the shareholder nominee satisfies the applicable objective securities market criteria regarding director independence, and that neither the nominee nor the nominating shareholder has a direct or indirect agreement with the company regarding the nomination of the shareholder nominee.

The Company's Determination. Once a company received notice from a nominating shareholder, the company would determine whether the nominating shareholders complied with all aspects of the nomination procedure, including whether the notice given by the nominating shareholder or nominating shareholder group contains false representations and whether the nominee is sufficiently independent and free of conflicts of interest. If the company determined that the nominating shareholders did not sufficiently comply with proposed Rule 14a-11, the company would not be required to include the shareholder nominee(s) in the company's proxy materials. The company would then have to provide written notice to the nominating shareholders of its determination and also include such notice in its proxy statement.

The Impact on a Company's Proxy and Group Voting. If a company determined that it must include a shareholder nominee in its proxy materials, it would be required to advise the nominating shareholders of this determination and state, in its notice, whether the company intends to include in its proxy statement a disclosure opposing the shareholder nominee. If the company intended to include a statement in opposition to the shareholder nominee(s), the nominating shareholders would also be allowed to include a statement of no more than 500 words supporting the shareholder nominee(s). The company would still be required, pursuant to Rule 14a-4, to present nominees in an impartial manner on the proxy card.

In an effort to facilitate voting for shareholder nominees, the proposed rules would not permit a company to provide the option of voting for or withholding authority to vote for company nominees as a group when a shareholder nominee is included in the proxy, but would require that each candidate be voted on separately.

Pre- and Post-Proxy Statement Solicitations. Proposed Rule 14a-11 would permit shareholders to form groups that would aggregate their shares in order to meet the minimum ownership threshold of more than 5% to nominate a director candidate. In order to facilitate communications between shareholders in an effort to form nominating shareholder groups, the SEC has proposed that such communications would not run afoul of the proxy solicitation rules found in Exchange Act Rules 14a-3 to 14a-6(o), 14a-8, and 14a-10 to 14a-15, provided that:

- The total number of persons solicited does not exceed 30; or
- Each written communication includes no more than:
 - A statement of the shareholder’s intent to form a nominating shareholder group in order to nominate a director under the proposed rule;
 - The percentage of shares that the shareholder beneficially owns or the aggregate percentage of shares owned by any group to which the shareholder belongs; and
 - The means by which shareholders may contact the soliciting party; and
- Any soliciting material published, sent or given to shareholders is filed with the SEC by the nominating shareholder or nominating shareholder group, no later than the date the material is first published, sent or given to shareholders.

If the company is required to place a shareholder nominee on the company’s proxy card, under proposed Rule 14a-11, solicitations by or on behalf of a nominating shareholder or nominating shareholder group in support of such nominee would not be subject to the proxy solicitation rules found in Exchange Act Rules 14a-3 to 14a-6(o), 14a-8, and 14a-10 to 14a-15, provided that:

- The soliciting party does not seek the power to act as proxy for a shareholder and does not furnish or otherwise request a form of revocation, abstention, consent or authorization;
- Each written communication includes:
 - The identity of the nominating shareholder or nominating shareholder group and a description of his or her direct or indirect interests, by security holdings or otherwise;
 - A prominent legend advising shareholders that a shareholder nominee is or will be included in the company’s proxy statement and that the shareholder should read the company’s proxy statement; and
- Any soliciting material published, sent or given to shareholders is filed with the SEC by the nominating shareholder or nominating shareholder group, no later than the date the material is first published, sent or given to shareholders. The nominating shareholder or nominating shareholder group would also be required to submit three copies of the materials to each national securities exchange upon which any class of securities of the company is listed and registered.

II. Major Areas in Which the SEC is Soliciting Comment

The SEC is soliciting public comment on a number of alternatives to its proposal that could affect the scope and impact of proposed Rule 14a-11, in particular:

- Whether the nomination procedure should apply only to companies that are subject to accelerated deadlines for filing period reports, i.e., “accelerated filers” having a market capitalization of \$75 million or more. The SEC notes that implementing the proposed rules in this fashion could avoid the disproportionate burdens that the proposed nomination procedure may impose on smaller companies.
- Whether the SEC should include a third triggering event premised upon a company’s not implementing a shareholder proposal pursuant to Rule 14a-8, be it mandatory or precatory, other than a direct proxy access shareholder proposal, that receives support from more than 50% of the votes cast. The SEC

suggests that both Rule 14a-8 and proposed Rule 14a-11 are premised upon the existence of evidence regarding the ineffectiveness of, or shareholder dissatisfaction with, a particular company's proxy process. It is this common element that seems to drive the SEC's request for comment as it tries to determine whether a nomination procedure trigger that would apply to all shareholder proposals could more effectively improve a company's proxy process.

- Whether the nomination procedure triggering event related to a direct access shareholder proposal should be limited to situations where more than a 1% shareholder or group of shareholders submits the proposal.
- Whether a 5% beneficial ownership threshold for determining the eligibility of nominating shareholders is appropriate.
- Whether it is appropriate for the company to make the determination regarding the basis on which a nominee would not be included in the company's proxy statement, and if not, who should make such a determination, and by what means should a company's determination be subject to review.

III. Questions Raised by Proposed Rule 14a-11

The SEC's proposal raises many issues and questions not dealt with in the release including questions concerning the operation of proposed Rule 14a-11 and the proposed rule's interplay with existing SEC proxy rules and state corporate law.

How will the nomination procedure work for a "controlled company"?

The proposed governance rules of both the New York Stock Exchange and NASDAQ provide exceptions (primarily to the Board committee independence requirements) for so-called controlled corporations. Where a single shareholder or group of related shareholders owns in excess of 50% of the voting shares of a public company (usually in the context of a two-class capitalization) should there not be an exception, on practical grounds, to the application of the proxy proposals? Should the Staff not consider whether such an exception would make sense at an even lower threshold of "control," such as 35% or 40%? The proposal does not address this issue.

How will proposed Rule 14a-11 impact Rule 14a-8?

In footnote 74 to the release, the SEC indicates that the Staff intends to take the position that a proposal, submitted by a holder of 1% of a company's stock for over one year, for access to the company proxy is no longer (i.e., even before the adoption of new rules) excludable under Rule 14a-8(i)(8). That rule currently provides that a company may exclude a Rule 14a-8 proposal if the proposal relates to an election for membership on the company's board of directors. The SEC is proposing an amendment to Rule 14a-8(i)(8) that would, if adopted, codify this new position. However, the footnote also indicates that prior Staff advice permitting the exclusion of similar proposals will remain in effect. This position is bound to cause confusion.

Will proposed Rule 14a-11 inadvertently encourage proxy contests?

While the proposed rules are clear that access to the company's proxy under Rule 14a-11 would only be available where the nominating shareholder or nominating shareholder group was not seeking control of the company, the release does not address the issue of what happens when a shareholder or group of shareholders, independent of the nominating shareholder or nominating shareholder group, initiates a proxy contest to wrest governing power from the corporation's incumbent board of directors. Such an independent effort may become more attractive if (a) the inclusion of shareholder nominees on the company's proxy card weakens shareholders' loyalty to the incumbent board and generates enthusiasm for a shift in board control, and (b) the number of board seats the insurgent group must wrest from the existing board, given the presence of shareholder nominees, is reduced. It will be interesting to see if comments are directed to the Staff on this issue and if the SEC addresses this issue in its final rules.

How will proposed Rule 14a-11 impact state law?

The proposed rules require that shareholders have an existing, applicable state law right to nominate a candidate or candidates for election as director before the nomination procedure ever becomes operable. If proposed Rule 14a-11 is adopted, will there be a “race to the bottom” among the states to eliminate, or substantially limit, shareholders’ rights to nominate a candidate or candidates for election as director, thus forestalling the application of Rule 14a-11?

We Can Help

Katten Muchin Zavis Rosenman is available to discuss proposed Rule 14a-11 and its potential implications. If you have concerns regarding the proposed rules, we encourage you to submit written comments to the SEC and are available to assist you in this regard. The 60-day public comment period ends December 22, 2003. Please direct questions regarding issues discussed in this Client Advisory to the Co-Chairs of Katten Muchin Zavis Rosenman’s Securities Practice:

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