Staff Report:
Review of the Proxy Process Regarding the Nomination and Election of Directors

Division of Corporation Finance
July 15, 2003

This is a report of the Division of Corporation Finance. The statements in this report are those of the staff and are not statements of the Securities and Exchange Commission.

I. INTRODUCTION

Earlier this year, the American Federation of State, County and Municipal Employees Pension Plan requested that the Commission review the Division of Corporation Finance's no-action position in letters issued to six companies. The AFSCME Employees Pension Plan had submitted a shareholder proposal to those companies that would have required the companies to include in their proxy materials the nominee of any shareholder or group of shareholders beneficially owning 3% or more of the companies' outstanding common stock. The Division allowed the companies to exclude the proposals under Securities Exchange Act of 1934 Rule 14a-8(i)(8) because the proposals "relate[d] to an election for membership on the company's board of directors or analogous governing body."[1] The Commission let stand, rather than review, the determination of the Division.

Although the Commission determined not to review the Division's position, on April 14, 2003, the Commission issued Press Release No. 2003-46, announcing that it had directed the Division to formulate possible changes in the proxy rules and regulations and their interpretations regarding procedures for the election of corporate directors. As we discuss

[1] Exchange Act Rule 14a-8(i)(8).

below, increased shareholder participation in the processes related to elections has been a topic of interest and debate over the past 60 years. In particular, shareholder access to a company's proxy materials has been addressed previously by the Commission, outside commenters and shareholder advocates. This staff report summarizes prior Commission action and discusses alternatives for increasing shareholder participation in the proxy process regarding the nomination and election of directors and otherwise improving the proxy process in this area. Finally, the discussion of each alternative closes with a list of questions that are among those that the Commission could consider or submit for public comment if it were to propose that alternative.[2]

II. BACKGROUND

A. Prior Commission Action

The Commission first addressed the issue of shareholder access to a company's proxy materials for the nomination of directors as early as 1942, when it requested that the staff review the proxy rules and submit to the Commission recommended changes.[3] The Commission solicited comments on the staff proposals, including a proposal to revise the proxy rules to provide that ". . . minority stockholders be given an opportunity to use the management's proxy material in support of their own nominees for directorships."[4] According to testimony of Chairman Ganson Purcell before the House Committee on Interstate and Foreign Commerce, the staff had proposed that "stockholders be permitted to use the management's proxy statement to canvass stockholders generally for the election of their own nominees for directorships, as well as for the nominees of the management."[5] Under the proposal, a company would not have been required to include more than twice as many candidates on the proxy as director positions to be filled.[6] The Commission did not adopt rules to provide this access.[7]

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2 As is evidenced in the attached Summary of Comments, commenters provided their views on a number of topics that are related to director elections that are not addressed specifically in the body of this staff report. These topics include amending New York Stock Exchange Rule 452, which allows brokers to vote shares where the beneficial owner has not provided voting instructions 10 days prior to a scheduled meeting, and evaluating the impact of proxy advisory services on institutional investor voting. The Division has considered these issues in developing its recommendations and will address such issues, as appropriate, if the Commission directs the Division to draft proposed rules based on the Division's recommendations.

3 *See Securit[ies] and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce,* 78th Cong., 1st Sess., at 17-19 (1943) (testimony of Chairman Ganson Purcell).

4 Release No. 34-3347 (December 18, 1942).

5 *Securit[ies] and Exchange Commission Proxy Rules: Hearings, supra* note 3, at 19.

6 *Id.*, at 157.

7 The Commission did not provide an explanation for its determination, stating simply that, "a number of the suggestions proposed by the staff were not adopted," including the suggestion related to shareholder access to the company's proxy material. Release No. 34-3347 (December 18, 1942).

In 1977, the Commission again focused on shareholder access to a company's proxy materials regarding the nomination and election of directors during its broad review of shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally. In anticipation of public hearings held in September of 1977, the Commission, without formally proposing rule changes, requested comment on a number of issues, including whether "… shareholders [should] have access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors."[8] In addition to this overarching question, many of the other issues raised in the releases relating to the 1977 review remain issues that the Commission will have to address if it proposes to provide shareholder access to company proxy materials.

After the 1977 hearings, the Commission proposed and adopted amendments to the proxy rules. These amendments did not relate directly to shareholder access to a company's proxy materials regarding the nomination and election of directors. The Commission, however, did adopt a requirement that companies state whether they have a nominating committee and, if so, whether the nominating committee will consider shareholder recommendations. Although the Commission stated its intent to address "some of the more complex questions which have been raised in this proceeding relating to corporate governance and the means by which corporations can best account to shareholders and the public" and determine "what further action, if any, is appropriate with respect to shareholder communications and shareholder participation in the corporate electoral process generally," the Commission did not take further action on shareholder access to company proxy materials.[9] According to a 1980 staff report to the Senate, the staff concluded that, due to the emerging concept of nominating committees, the Commission should not propose and adopt a shareholder access rule at that time.[10] The staff report recommended,

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[8] Release No. 34-13482 (April 28, 1977), in which the Commission also asked:

a) what criteria should be applied to nominating shareholders;
b) what disclosures should be required of nominating shareholders;
c) whether shareholder nominations are permissible under state law; and
d) whether a meaningful distinction can be drawn between control and non-control nominations.

See also Release No. 34-13901 (August 29, 1977), in which the Commission published the final schedule of issues to be considered at the hearings, which included:

a) whether shareholders should have access to the company's proxy soliciting materials for the purpose of nominating directors;
b) whether shareholder nominations are permissible under state law and consistent with Congressional intent in enacting Exchange Act Section 14(a);
c) what type of rule would be most appropriate and what criteria should be applied to nominating shareholders;
d) whether the proxy rules should apply to soliciting activities by a nominating shareholder; and
e) whether nominating shareholders should be subject to the then-existing rules governing election contests.

[9] Release No. 34-14970 (July 18, 1978). *See also* Release No. 34-15384 (December 6, 1978).

[10] The Task Force on Corporate Accountability was formed as an outgrowth of the review of the proxy rules that began in 1977. The work of the Task Force culminated in the Staff Report on Corporate Accountability, completed and presented to the Senate Committee on Banking, Housing, and Urban

however, that the staff monitor the development of nominating committees and their consideration of shareholder recommendations.[11] The staff report further cautioned that, if an insufficient number of companies adopted nominating committees or the efforts of these committees with regard to shareholder nominations proved insufficient, Commission action might be necessary.[12]

In the broad proxy revisions adopted in 1992,[13] the Commission briefly revisited the shareholder access issue in connection with amendments to the bona fide nominee rule set out in Exchange Act Rule 14a-4, which provides that no person shall be deemed a bona fide nominee "unless he has consented to being named in the proxy statement and to serve if elected."[14] In adopting the Exchange Act Rule 14a-4 amendments, the Commission noted "… the difficulty experienced by shareholders in gaining a voice in determining the composition of the board of directors," but stated the following with regard to shareholder access to the company's proxy materials:

> Proposals to require the company to include shareholder nominees in the company's proxy statement would represent a substantial change in the Commission's proxy rules. This would essentially mandate a universal ballot including both management nominees and independent candidates for board seats.[15]

Rather than mandating a "universal ballot," the Commission revised the bona fide nominee rule to allow shareholders seeking minority board representation to "fill out" a partial or "short slate" with management nominees, thus making it easier for shareholders to conduct an election contest in a non-control context. For example, if a shareholder wishes to nominate only two candidates to a seven person board, Exchange Act Rule 14a-4(d) permits the shareholder to choose five of management's nominees to fill out his or her ballot, provided that the shareholder does not name those management nominees on his or her proxy card, but instead names only those management candidates that the shareholder is opposing. Although the shareholder still must disseminate and file a separate proxy statement and proxy card, he or she can now, in essence, allow shareholders to vote for some of management's nominees on the shareholder's proxy card.

Affairs. *Division of Corporation Finance, Securities and Exchange Comm'n, Staff Report on Corporate Accountability (Sept. 4, 1980) (printed for the use of Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.),* at A60-65.

[11] The *Staff Report on Corporate Accountability* states: "…all nominating committees should be open to suggestions of nominees from shareholders." *Id.*, at A56.

[12] *Id.,* at A60-65, A69.

[13] *See* Release No. 34-31326 (October 16, 1992).

[14] Exchange Act Rule 14a-4(d).

[15] Release No. 34-31326 (October 16, 1992).

Currently, shareholders who wish to effect a change in the composition of a board of directors may conduct an election contest, as noted briefly above, nominate a candidate at an annual meeting, or recommend candidates to a company's nominating committee or group of directors fulfilling a similar role. Election contests can require substantial expenditure by the shareholder, who must prepare and disseminate proxy materials that comply with the Commission's proxy rules. Shareholders may instead nominate directors at the annual meeting, subject to compliance with applicable state law requirements, as well as any requirements contained in the company's governing instruments; however, most shareholders vote through the grant of a proxy before the meeting instead of voting in person. Accordingly, a nominee presented at an annual meeting has little chance of receiving sufficient support. Finally, although shareholders generally may recommend candidates to a company's nominating committee or group of directors fulfilling this role, shareholders have indicated that this is not effective, as companies rarely nominate candidates recommended by shareholders.

B. Summary of Public Recommendations for Greater Shareholder Involvement in the Election of Directors

In Press Release 2003-59, issued on May 1, 2003, the Commission solicited public views on the Division's review of the proxy rules and regulations relating to the nomination and election of directors.[16] The majority of commenters supported the Commission's decision to direct this review. Reflecting concern over the lack of accountability of corporate directors and recent corporate scandals, the commenters generally urged the Commission to adopt rules that would grant shareholders greater access to the nomination process and greater ability to exercise their rights and responsibilities as owners of their companies. In addition, many commenters noted that the current director nomination procedures afford little meaningful oversight to shareholders.

The 690 commenters who responded to the solicitation were comprised of the following:

- 424 individuals;
- 165 unions, pension funds, institutional investors, and institutional investor associations;
- 24 social, environmental, and religious funds and their related service providers;
- 18 law firms and attorneys;
- 16 associations;
- 10 corporations and corporate executives;
- 10 shareholder resource providers;
- 8 investment advisers and managers;

[16] *See* Release No. 34-47778 (May 1, 2003). In addition, the Division spoke with interested parties representing shareholders, the business community and the legal community, including individuals from the Amalgamated Bank LongView Funds, the American Bar Association Task Force on Shareholder Proposals, the American Federation of Labor and Congress of Industrial Organizations, AFSCME, the American Society of Corporate Secretaries, Automatic Data Processing, Inc., The Business Roundtable, the California Public Employees' Retirement System, the Committee of Concerned Shareholders, the Connecticut Retirement Plans and Trust Funds, CorpGov.Net, Hermes Investment Management, the International Brotherhood of Teamsters, Laborer's International Union of North America, and the United Brotherhood of Carpenters and Joiners of America.

- 5 academics;
- 5 other shareholder groups;
- 2 governmental representatives; and
- 3 miscellaneous commenters.

The vast majority of commenters supported modifying the proxy rules and regulations related to the nomination and election of directors. Commenters who did not support such a modification included all of the corporations and corporate executives, most of the legal community, and the majority of associations (mostly business associations).

Few commenters provided specific suggestions about how the proxy rules should be reformed to allow shareholders to access proxy materials to nominate directors. Of those commenters who did submit detailed proposals, the level of specificity in those proposals ranged from merely suggesting minimum shareholder ownership thresholds for submitting director nominations to outlining extensive proposals for general proxy reform.

Most of the individual investors who commented indicated that they consider the current process for the nomination and election of directors to be an ineffective means of providing shareholders with the rights of company ownership, but very few offered detailed proposals. Shareholder groups who supported some level of proxy reform stated that, aside from providing shareholders with access to the election process to nominate director candidates who would represent investors' best interests, such reform also would have the effect of making all corporate directors more responsive to shareholder concerns. An explicit or implicit reason behind the desire for reform in several comment letters was that reform was particularly necessary in those cases where the proxy process and shareholder communications were ineffective.

Commenters who opposed proxy reform to provide shareholders with access to company proxy materials to nominate directors advocated a cautious approach with regard to any changes to the nomination and election process. In this regard, the commenters posited that such access would be "terribly disruptive to the corporate governance process" and the Commission instead should give the Sarbanes-Oxley Act of 2002 and proposed listing standard changes "a chance to operate before making such a fundamental change to the director nomination process."[17] In addition, some commenters also questioned the Commission's authority to adopt shareholder access rules under Exchange Act Section 14(a).

A few of the commenters opposing shareholder access to company proxy materials recommended that the Commission instead consider requiring enhanced disclosure about nominating committees or revising Exchange Act Rule 14a-8(i)(8) to allow shareholder proposals to establish a process for shareholder nominees on a company-by-company basis.

For an expanded discussion of the comments received, please refer to the Summary of Comments, attached as Appendix A.

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[17] Alston & Bird LLP.

III. ALTERNATIVES

Based on the public comments, the principal alternatives for increasing shareholder involvement in the nomination and election of directors, some of which could be employed in combination with others, appear to include the following:[18]

- requiring companies to include shareholder nominees in company proxy materials;
- requiring companies to deliver nominating shareholder proxy cards along with company proxy materials;
- requiring expanded disclosure regarding companies' nominating committees, the nominating process, and nominating committee consideration of shareholder recommendations, with possible requirements under applicable listing standards that nominating committees consider shareholder recommendations;
- requiring expanded disclosure regarding shareholder communications with board members, with possible requirements under applicable listing standards that companies provide shareholders with increased access to, and direct communications with, boards of directors; and
- revising Exchange Act Rule 14a-8 to allow shareholder proposals relating to a company's nomination process.

A. Alternative A – Require Companies to Include Shareholder Nominees in Company Proxy Materials

Under this alternative, a company would include on its proxy card the shareholder nominee or nominees and would include specified information, such as biographical information, about the shareholder nominee in the proxy statement. Arguments for and against each of the company's and the nominating shareholder's candidates could be included either in a word-limited form in the proxy statement or wholly outside the proxy statement, for example, on one or more designated websites. All soliciting materials, including website postings, would be filed electronically with the Commission, as is currently the case for definitive additional soliciting materials. In addition, all disclosure and communications would be subject to the prohibition against false and misleading statements in Exchange Act Rule 14a-9.

To the extent that the Commission determines to propose new rules based on this alternative, it may want or need to consider the following topics, among others:

- whether there should be triggering events for enhanced shareholder access;

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[18] The Division's review of the proxy rules and regulations focused on operating companies. However, investment companies generally are treated like operating companies under the proxy rules. Ultimately, the Commission will need to determine, and request comment on, how any changes to the proxy rules should apply to investment companies.

- if enhanced shareholder access is based on triggering events, whether there should be time limits following these events for the enhanced access;

- whether to impose nominating shareholder eligibility requirements, such as percentage of company stock held and length of time held thresholds;

- whether to allow aggregation of shareholders into groups for purposes of forming a "nominating shareholder";

- whether there should be limits on the number of directors or percentage of the board that may be nominated by shareholders and/or hold office at any given time under a shareholder access rule;

- whether there should be a process for assuring that shareholder nominees are qualified to serve on the board;

- whether there should be independence standards for the shareholder nominee, both from the company and from the nominating shareholder;

- requirements applicable to any related solicitations, both for formation of a shareholder nominating group and for election of a shareholder nominee;

- the extent of shareholder nominee disclosure, if any, to be included in the company's proxy materials;

- possible conflicts between any rule changes and controlling state corporate law, federal law, or listing standards;

- whether nominating shareholders, including groups, should be deemed to have a "control" purpose that would create additional beneficial ownership filing and disclosure requirements;

- whether to adopt an exemption from Exchange Act Section 16 reporting requirements for nominating shareholder groups; and

- whether to create a safe harbor to provide that nominating shareholders would not be deemed "affiliates" of the company solely as a result of using a shareholder access rule to nominate a candidate.

Two fundamental considerations in proposing any shareholder access rule, which are reflected in the list above, are when the rule may be used and by whom. In addressing the former, the Commission would need to determine whether the proposal should require one or more types of triggering events to occur before a shareholder could invoke the rule to nominate a director or directors. The result of conditioning the operation of a proposal on triggering events would be to focus the impact of the rule on those companies where there are objective criteria showing that the proxy process may be ineffective. This approach could address the concerns of

some commenters regarding the adverse impact of such a proposal on all public companies. Although a triggering event requirement would add additional complexity to the operation of the rule, it also would limit the use of a shareholder access rule to situations where the proxy process may otherwise have failed to permit shareholder views to be adequately taken into account. The clear purpose of such a shareholder access proposal, particularly where conditioned on triggering events, would be to improve the proxy process.

Triggering events could include a company's failure to act on shareholder proposals that receive majority votes or the receipt of significant percentages of "withhold" votes in director elections.[19] Another triggering event could be approval of a shareholder proposal to activate the shareholder access rule.[20] Though other triggering events could be used, including economic performance, *e.g.*, lagging a peer index for a specified number of consecutive years,[21] the Division is of the view that any triggering event should be more closely tied to evidence of ineffectiveness in the proxy process.

A related issue if the Commission proposes a shareholder access rule that uses triggers based on percentage of withhold votes or shareholder proposals is whether the use of these triggers would result in increased numbers of shareholder proposals and "vote no" campaigns by shareholders who are attempting to trigger the nomination procedure.[22] With regard to "vote no" campaigns, the Division has been advised that the possibility of triggering Exchange Act Schedule 13D reporting requirements currently may have a chilling effect on shareholders who otherwise would organize such an effort. Accordingly, the Commission may wish to consider whether the Commission or the Division should issue an interpretation stating its views with regard to "vote no" campaigns and beneficial ownership reporting. A similar interpretation may be appropriate with regard to the application of the proxy rules to these activities.

The second consideration, shareholder eligibility, generated a great deal of comment from the public. While some believe that all shareholders should be able to access a company's proxy materials for the purpose of nominating directors, others advocate share ownership

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[19] In the election of directors, shareholders may vote for or withhold authority to vote for each nominee rather than vote for, against or abstain as is the case for other matters to be voted on by shareholders. *See* Exchange Act Rule 14a-4(b)(2). As discussed in footnote 25 and accompanying text, below, withhold votes have little or no effect under plurality voting.

[20] For example, a shareholder who does not believe that the proxy process has been effective at a company in which that shareholder holds stock could submit a proposal through Exchange Act Rule 14a-8 to request that the company comply with the shareholder access procedure. Although most proposals are precatory in nature, a majority vote on such an "opt-in" proposal could trigger a shareholder access rule. This alternative would require a revision to Exchange Act Rule 14a-8 to reflect shareholders' ability to submit such a proposal under the rule (provided that the shareholder and the proposal otherwise meet all procedural and substantive requirements).

[21] Other triggering events could include being delisted by a market, sanctioned by the Commission, indicted on criminal charges, or having to restate earnings more than once in a specified period.

[22] In "vote no" campaigns, a shareholder or group of shareholders attempts to persuade other shareholders (*e.g.*, through press releases or website postings) to vote against a proposal or "withhold" their votes for certain or all of a company's nominees for director.

thresholds ranging from the $2,000 threshold required to submit an Exchange Act Rule 14a-8 proposal to substantial share ownership percentages (*e.g.*, from 3% to 10% or more) of a company's outstanding common stock. Those who advocate no threshold or a nominal dollar amount argue that the imposition of a threshold would unfairly advantage larger shareholders who already may have the resources to run their own slates using the existing rules for contested elections. Those who advocate a larger share ownership threshold contend that, to use company funds to nominate a candidate, a nominating shareholder should have a substantial stake in the company. In addition, advocates of a larger share ownership threshold point out that the composition of the board of directors is critical to a corporation's functions and, accordingly, shareholders should have to satisfy a substantial threshold in order to use any new shareholder access rule.

The eligibility thresholds recommended most frequently were 3% and 5%. For example, the Council of Institutional Investors, which has expressed its support for shareholder access to company proxy materials, advocated that "a long-term investor or group of long-term investors owning in aggregate at least 5% of a company's voting stock" should have access to company proxy materials to nominate "less than a majority of the directors." The CII expressed the position that nominating shareholders must have owned their stock for "at least three years" and company proxy materials and related mailings should provide "equal space and equal treatment" of shareholder nominees. The AFL-CIO, another supporter of shareholder access to company proxy materials, has recommended that the Commission adopt new rules granting shareholder access to those who have held a minimum of 3% of the company's shares, where a majority of those shares have been held for more than one year. Under this recommendation, nominating shareholders could nominate the greater of two directors or one-third of the nominees standing for election at a particular meeting, but in no case a majority of the board.

The determination of the appropriate eligibility threshold for share ownership will affect not only who may use the rule, but also the reporting requirements to which nominating shareholders may be subject. For example, a share ownership eligibility threshold of 5% or greater raises the issue of subjecting a nominating shareholder group to the beneficial ownership reporting requirements of Exchange Act Section 13(d) or Exchange Act Section 13(g).[23] Thus, some may argue that a benefit of establishing an eligibility requirement of less than 5% would be that nominating shareholders or shareholder groups will not necessarily become subject to the disclosure obligation imposed by Exchange Act Schedule 13D or Exchange Act Schedule 13G. On the other hand, there may be more benefit in establishing a threshold percentage that would trigger the beneficial ownership reporting requirements to ensure that nominating shareholders or shareholder groups provide notice of their intentions in the form of a beneficial ownership report filed electronically with the Commission. In addition, a possibility with regard to the shareholder nomination alternative is to create a new "passive investor" category of filer who could nominate a director and still use the short-form Exchange Act Schedule 13G, provided that the filer could certify that he or she did not acquire or hold the securities with a control purpose or effect and could also confirm that he or she (or the nominating shareholder group to which he or she belongs) had held the subject securities for the minimum holding period specified under a

[23] Any shareholder who acquires, directly or indirectly, beneficial ownership of greater than 5% of an equity security registered under Exchange Act Section 12 must report such ownership on Exchange Act Schedule 13D or, if eligible, on Exchange Act Schedule 13G. *See* Exchange Act Rule 13d-1.

shareholder access rule. This certification of non-control intent and eligibility for shareholder access could provide additional certainty that shareholder access was being used for the intended purpose and not to facilitate a surreptitious contest for control.

For shareholder groups with holdings of 10% or more, an additional consideration is Exchange Act Section 16, which provides, among other things, that a director or officer of a company with a class of equity securities registered under Exchange Act Section 12, or a shareholder who beneficially owns more than 10% of such a class of equity securities, must report the amount of securities owned and any changes in such ownership. Because the rules under Exchange Act Section 16 define beneficial ownership for purposes of determining who is a 10% owner by reference to the definition under Exchange Act Section 13(d), a shareholder who is a member of a "group" will be deemed to own beneficially the securities owned by the other members of the group. Accordingly, a shareholder who is not otherwise subject to Exchange Act Section 16, but who joins a nominating shareholder group that holds, in the aggregate, greater than 10% of a company's equity securities, may be viewed as owning the aggregate amount and, therefore, be subject to Exchange Act Section 16. Although Exchange Act Rule 16a-1(a)(1) provides that specified institutional investors who hold for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business shall not be deemed beneficial owners of the securities for Exchange Act Section 16 reporting purposes, there is no similar exception for passive investors who do not also fit within one of the institutional investor categories listed in Exchange Act Rule 16a-1(a)(1). Therefore, any 10% or greater eligibility requirement for nominating shareholder groups may trigger additional reporting requirements by the members of the nominating shareholder group, as well as possible short-swing profit liability under Exchange Act Section 16(b) and the short sale prohibitions in Exchange Act Section 16(c).

Another consideration in evaluating any eligibility threshold greater than 10% is the operation of shareholder rights plans (poison pills) under state law, which frequently are triggered by beneficial ownership of 15% or greater. Thus, if nominating shareholders or shareholder groups beneficially own 15% or more of a company's shares, nominating shareholders may trigger applicable poison pill provisions under state law.[24]

In considering rules mandating shareholder access to company proxy materials regarding the nomination and election of directors and how best to structure those rules, the Commission will need to consider the scope of its authority under the federal securities laws. In this regard, several commenters raised questions about the Commission's authority to adopt such rules. The Commission historically has been found to have significant authority to adopt rules in the proxy area, and that authority has been found to extend beyond mere disclosure. However,

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[24] Other, more general effects of any shareholder access rule may include changes in companies' policies with respect to the election of directors. In the Commission's 1977 request for comments in connection with its review of shareholder communications, shareholder participation in the corporate electoral process, and corporate governance, commenters asserted that granting shareholders enhanced access to the proxy would be effective only if bundled with cumulative voting for and/or the annual election of directors. An indirect effect of implementing the enhanced shareholder access alternative could be that companies would adopt corporate governance policies to insulate incumbent board members. Companies also may attempt to avoid use of a shareholder nomination procedure by limiting shareholder nominations to the extent allowed under state or federal law.

Commission authority in this area is not unlimited, as indicated by some court decisions taking a more narrow view of the Commission's authority. The Division believes that Exchange Act Section 14 provides an appropriate basis for Commission authority to provide for a properly crafted rule in this area. A detailed analysis of authority issues will depend on the contours of an actual rule proposal.

Advantages and Disadvantages

Much of the public input that we have received suggests that shareholder access to a company's proxy materials would be the most direct and effective method of giving shareholders a meaningful role in the nomination and election process. This input also suggests that another result would be to make corporate boards more responsive and accountable to shareholders, as well as, in many instances, more diverse. This alternative has been advocated on a number of occasions over the last 60 years and would certainly give shareholders a new and more cost-effective way to effect change in the management of their companies. As it stands today, shareholders generally are given an opportunity to vote only on those candidates nominated by the company. In addition, many companies use plurality rather than majority voting for board elections, which means that candidates can be elected regardless of whether they receive more than 50% of the shareholder vote.[25] Accordingly, all board nominees generally are elected, regardless of the number of "withhold" votes by shareholders. Many shareholders, therefore, view the proxy process as ineffective and the election of directors as a mere formality or "rubber stamping" of the board's choices.

Currently, a shareholder or group of shareholders that is dissatisfied with the leadership of a company must undertake a proxy contest, at its own expense, to put nominees before the shareholders for a vote. A board's nominees, on the other hand, do not bear the cost of their candidacies, which are funded out of corporate assets. While shareholders can recommend a candidate to a company's nominating committee, shareholder comments suggest that this rarely is effective and that, in some cases, it may be difficult for shareholders to gain access to members of company boards and their committees.

On the other hand, the business community and many of its legal advisors commented that giving shareholders access to company proxy materials could turn every election of directors into a contest, which would be costly and disruptive to companies and could discourage some qualified board candidates from agreeing to appear on a company's slate. Because the composition of the board of directors is fundamental to a company's corporate governance, the current filing and disclosure requirements applicable to shareholders who wish to propose an alternate slate are, in the view of these commenters, more appropriate than the shareholder access alternative. Also, shareholder nominees who are elected to the board could alter the dynamics of the board and cause the board to become fragmented and less efficient. In particular, corporate commenters have posited that a shareholder access rule would result in "special interest" board members who represent particular causes rather than the interests of the company and its

[25] Under plurality voting, the candidate with the greatest number of votes is elected; therefore, in an election in which there are the same number of nominees as there are board positions open, all nominees will be elected.

shareholders overall. Finally, while nominating committee members have a fiduciary duty to act in the company's best interest, commenters noted that nominating shareholders would not have this same duty. Accordingly, it is argued that candidates advanced by a nominating shareholder may not be as qualified to serve on a board as a company nominee. Although this concern may be mitigated if a shareholder access rule were drafted to require all shareholder nominees to be screened through the board's nominating committee, such a provision could create additional problems of its own, *e.g.*, nominating committees may not want to take on the duties and any attendant liabilities associated with recommending a shareholder's nominee. In any event, it likely would be difficult to ensure that the same screening criteria are applied to management and shareholder nominees, and shareholders may view the screening process as a deterrent to nominating candidates.

A shareholder access proposal could require that shareholder nominees meet applicable independence requirements from companies. The proposal also could impose limitations on relationships between nominating shareholders and their nominees, as well as disclosure requirements regarding nominee interests. These types of requirements could narrow the potential pool of persons who could be nominated by shareholders, but they would also, at least in part, address some of the concerns regarding nominees who would represent the interests of particular shareholders or be "single-issue" directors.

Refinements to a shareholder access proposal could affect the balance of advantages and disadvantages in important ways. For example, requiring triggering events to occur before allowing enhanced shareholder access to the proxy process would be expected to significantly restrict the number of companies where access is available. It would also, therefore, be expected to limit the number of companies subject to the perceived risks of frequent proxy contests, chilling effects on board nominees, and altered board dynamics. While it would restrict access, access based on triggering events would limit the proposal to only those companies where specified criteria may suggest that the proxy process has otherwise not permitted adequate or effective access for shareholders in the past.

Potential Questions for Public Comment

1. Would adoption of modified proxy rules to give shareholders the ability to place shareholder nominees in a company's proxy materials conflict with state law, *e.g.*, state law requirements applicable to the expenditure of corporate assets or nominating procedures?

2. Should any new rule require a triggering event to occur before shareholders would be able to use the shareholder nomination process? If so, what events should trigger the access? Should there be a time limit on the access? If so, how long after a triggering event should shareholders be able to use the nomination process, (*e.g.*, two years, three years)? How should shareholders be notified that a triggering event has occurred?

3. What, if any, eligibility requirements should the Commission impose on nominating shareholders? For example, should nominating shareholders be required to beneficially own a specified dollar amount or percentage of company securities, *e.g.*, 3% of voting securities, in order to place a nominee on the company's proxy card? Should this

percentage be higher or lower (*e.g.*, 1%, 5%, 10%)? Should nominating shareholders be required to have held their shares continuously for a minimum period of time? If so, what is the appropriate length of time, (*e.g.*, one year, two years, three years)?

4. Should shareholders be permitted to aggregate their holdings in order to meet any ownership eligibility requirement to nominate directors? If so, must all members of a nominating shareholder group individually satisfy the minimum holding period?

5. Should all or any of the proxy rules apply to soliciting activities by shareholders attempting to form a nominating shareholder group? If so, what rules? For example, should this type of soliciting activity be exempted from the proxy rules, subject to limitations on the number of shareholders solicited and/or the content of the soliciting materials?

6. In order to avoid the use of a shareholder nomination procedure in contests for corporate control, should there be a limit on the number of directors or the percentage of the board that shareholders may nominate? Should there be a limit on the number of shareholder-nominated directors that could hold office at any given time? If so, what limitations are appropriate? Would such a limitation conflict with state law? Should there be other requirements to ensure the "non-control" purpose of those using a procedure of this type?

7. What independence standards should apply to shareholder nominees? Should they be independent of the company? If so, under what independence standard? Should nominating shareholders be required to establish the nominee's independence, *e.g.*, by certifying to the company that the nominee is independent? Should shareholder nominees be independent of nominating shareholders? If so, under what independence standard?

8. Should nominating shareholders be independent of the company? If so, under what independence standard?

9. Should there be required qualifications for shareholder nominees? If so, should shareholder nominees be screened by the company's nominating committee? Should the nominating committee be able to reject shareholder nominees based on objective criteria related to the nominee's qualifications?

10. Is there a risk that companies will form "friendly" nominating groups to ensure that a candidate of the company's choice is nominated through any new shareholder access rule? If so, should the Commission adopt rules to address this possibility? For example, should a nominating shareholder be required to confirm that it is acting solely on its own behalf and not that of the company? Should the company be required to disclose any communications between board members and nominating shareholders?

11. Should companies be exempted from a shareholder nomination procedure for any election of directors in which another party commences, or evidences its intent to commence, a solicitation in opposition as defined in Exchange Act Rule 14a-12(c)? If so,

should the period in which shareholders may use the nomination process be extended to the next year (assuming a time limitation)?

12. What requirements should apply to soliciting activities conducted by nominating shareholders? For example, what filing requirements and specific parameters should apply to any such solicitations? Should all soliciting materials be filed with the Commission on the date of first use?

13. Should all soliciting activities be limited to one or more designated websites? If so, who should pay for the websites?

14. What shareholder nominee and/or nominating shareholder disclosure, if any, should be included in company proxy materials and/or be made available on a designated website? For example, should nominating shareholders be required to provide biographical information about the nominee? Should nominating shareholders be required to provide "participant" disclosure similar to that required in a traditional election contest?[26] Should nominating shareholders be entitled to space in a company's proxy materials to campaign for the shareholder nominee? If so, should there be a word limit on the nominating shareholder's disclosure? What would be an appropriate word limit?

15. Should nominating shareholders, including groups, be deemed to have a "control" purpose that would create additional filing and disclosure requirements under Exchange Act Section 13(d)?

16. Would Exchange Act Section 16 reporting and short-swing profit liability deter the formation of nominating shareholder groups with greater than 10% beneficial ownership? If so, should nominating shareholder groups be exempted from reporting under Exchange Act Section 16(a)?

17. Should the Commission create a safe harbor that provides that nominating shareholders will not be deemed "affiliates" of the company solely as a result of using a shareholder nomination procedure?

18. What would be the cost to companies if the Commission adopted proxy rules giving shareholders access to companies' proxy materials to nominate directors? Who should bear that cost?

19. What direct or indirect effect would enhanced shareholder access have on companies' policies relating to the election of directors? For example, will companies be more or less likely to adopt cumulative voting policies and/or elect directors annually?

20. What impact would this alternative have on small businesses? Would this alternative

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[26] For example, a participant, as defined in Instruction 3 to Item 4(b) of Schedule 14A, must describe any substantial interest in the matter to be acted on at the meeting and disclose his or her name, business address and occupation. *See* Item 5(b) of Schedule 14A.

have a disproportionate impact on small businesses as compared to other public companies?

21. Would shareholders without access to electronic media be disadvantaged in making their voting decisions by having certain information available only on a website? Would this represent a significant change from current requirements?

22. Do large and small shareholders share the same interests? If not, how do they differ and how would each be served under a shareholder access rule?

23. Is a shareholder access rule consistent with Congressional intent regarding Exchange Act Section 14(a)?

B. Alternative B – Require Companies to Deliver Nominating Shareholders' Proxy Cards with Company Proxy Materials

A variation on the above alternative has been noted by the individual members of the ABA's Task Force on Shareholder Proposals. Under this variation, the Commission could propose new rules requiring companies to include a nominating shareholder's proxy card along with the company's proxy materials and proxy card. Similar to the shareholder access alternative discussed above, as Alternative A, this alternative could be limited to situations where a triggering event has occurred. A company would be required to note briefly in its proxy materials that a shareholder or shareholder group had nominated a candidate to the board of directors, that the shareholder's proxy card is included in the company's mailing, and that additional disclosure about the shareholder nominee may be found on a specified website. Any disclosure related to nominating shareholders and shareholder nominees, in addition to any campaigning for shareholder nominees, would appear on nominating shareholders' websites and would be filed electronically with the Commission. Similarly, a company's soliciting materials could be required to appear on the company's website. As with communications under the enhanced shareholder access alternative, all disclosure and communications would be subject to the prohibition against false and misleading statements in Exchange Act Rule 14a-9.

This alternative differs from the enhanced shareholder access alternative discussed above, in that it would not result in shareholder nominees appearing in the company's proxy materials. Instead, a company would absorb the cost of mailing a nominating shareholder's proxy card.[27] Because this alternative would involve the mailing of both a company and a shareholder proxy card, rather than one company card that includes shareholder nominees, this alternative would be equivalent to running a "short slate" (nominating fewer candidates than there are available board seats) without the disclosure and filing requirements associated with a traditional proxy contest.

Another potential difference between this alternative and the enhanced shareholder access

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[27] Note that, under Exchange Act Rule 14a-7, a company currently may decide to mail a shareholder's proxy materials rather than provide the shareholder with its shareholder list; however, under the current rules, a company mails the shareholder's proxy materials separately from the company materials, at the shareholder's expense.

alternative relates to disclosure by nominating shareholders. Currently, no person engaged in a solicitation may deliver a proxy card to a shareholder unless the shareholder is concurrently given, or has previously received, a definitive proxy statement.[28] Under this alternative, a company would mail a nominating shareholder's proxy card, but shareholders would not concurrently receive proxy statement disclosure about the shareholder nominee. Any new rule would, therefore, need to allow a means to provide shareholders with the disclosure required to make an informed voting decision between board nominees and shareholder nominees. As noted above, one possibility would be to allow shareholders to provide all biographical and other appropriate information about their nominees on a designated website.

Advantages and Disadvantages

As with the enhanced shareholder access alternative, this alternative would decrease substantially the cost for shareholders to nominate a candidate to the board of directors, in that a nominating shareholder would not be required to print and mail a full proxy statement satisfying the requirements of Exchange Act Schedule 14A. Instead, a company would incur the mailing cost of distributing the nominating shareholder's proxy card and the nominating shareholder could place all required disclosure and other communications on a website. In addition, if all shareholder nominee disclosure appeared outside the proxy statement, companies would avoid the printing and mailing costs of expanding the proxy statement to include this disclosure. Also, a separate proxy card may mitigate any state law concerns related to a shareholder's right to nominate directors by imposing a mailing requirement on the company rather than a requirement that a company give shareholders access to the company's proxy materials.

On the other hand, this alternative could be viewed as a substantial departure from our current requirement that specified disclosure be included with, or precede, the delivery of a proxy card to shareholders. In addition, this option has many of the same potential disadvantages raised in the comments with regard to an enhanced shareholder access proposal, including the possibility that the new rule could turn every election of directors into a contest, thus disrupting a company's operations, requiring substantial expenditures of corporate funds, discouraging qualified nominees from agreeing to run for election, and fragmenting boards. As discussed with regard to the enhanced shareholder access alternative, however, the use of triggering events would address, at least in part, some of the more serious disadvantages perceived by the corporate community.

Potential Questions for Public Comment

With a few exceptions, most of the questions applicable to an enhanced shareholder access proposal would also be relevant to this alternative. The following additional questions may also be appropriate:

1. Should all soliciting activities and/or disclosure be limited to one or more designated websites? If so, who should pay for the websites? Is a designated website an adequate

[28] *See* Exchange Act Rule 14a-4(f).

means to provide shareholders with required disclosure? Why or why not? For example, would shareholders without Internet access be disadvantaged?

2. Should disclosure relating to shareholder nominees and nominating shareholders be provided on a website in advance of, or simultaneously with, a company's mailing of a nominating shareholder's proxy card? If not, what effect would this have on shareholders' ability to make informed voting decisions? If so, how should shareholders be made aware that such information is available on a website? For example, should shareholders receive notice through a company's proxy statement alone or should the nominating shareholder be required to provide separate notice? If a nominating shareholder is required to provide such notice, when should the notice be provided and by what means, (*e.g.*, in a press release)?

3. What would be the cost savings to companies and shareholders of this alternative as compared to an enhanced shareholder access proposal?

4. Should a nominating shareholder pay the additional costs to the company for printing and mailing an additional proxy card?

C. Alternative C - Nominating Committee Disclosure

Another alternative that would provide shareholders with increased information and access to the nomination process would be to require expanded disclosure in company proxy statements regarding a company's nominating committee and the nominating process. This could be in addition to possible changes to the markets' listing standards to require nominating committees to consider shareholder nominees. While companies currently are required to disclose whether they have a nominating committee and, if so, whether the nominating committee considers shareholder nominees, the Commission could expand this disclosure requirement to require the committee to report on how many nominees were submitted by shareholders (or by shareholders meeting certain qualifications) for the current election and, for any such nominees who are not included on the company's proxy card, a report on the committee's reasons for not nominating those candidates. The Commission also could propose rules requiring companies to disclose to shareholders information that would make the nomination process more accessible and understandable, such as a description of the qualifications the company looks for in director nominees, its process for developing and considering nominees, and how the board initially became aware of, or associated with, each of its nominees.

As described below, both the New York Stock Exchange and the Nasdaq Stock Market have proposed revised listing standards that would require listed companies to have independent nominating committees; however, they have not proposed any changes that would require nominating committees to consider shareholder nominees. Accordingly, to effectuate this alternative using a means other than Commission disclosure rules that are based on the beneficial impacts of transparency, markets would need to add such a requirement to their listing standards.

Background

The current disclosure requirement related to nominating committees was proposed and adopted in connection with the Commission's 1977 review of the proxy rules.[29] In addition to soliciting comment on shareholder access to company proxy materials, the Commission requested comment on whether more disclosure requirements related to the nomination process and nominating committees would be appropriate.[30]

The Commission put forth a series of questions relating to nominating committee disclosure in preparation for the 1977 public hearings. As is the case now, some commenters favored increased shareholder access to the nominating committee and increased disclosure relating to the actions taken by the nominating committee rather than direct shareholder access to a company's proxy statement.[31] In particular, commenters recommended that the nominating committee be required to consider shareholder nominees, that outside directors comprise all or a majority of nominating committees,[32] and that shareholders be advised of "the existence and purpose of such committee and its standards for director qualifications."[33] Other recommendations were that shareholders be encouraged to suggest nominees to the committee and that nominating shareholders be given adequate notice in order to undertake an election contest if the nominee were rejected.[34] In addition, some commenters thought that the nominating committee should issue a report to shareholders concerning its determinations.[35] Advocates of the nominating committee alternative emphasized that this approach would limit conflict and enable the committee to ensure that the proxy statement included a limited number of shareholder nominees.[36] They also asserted that the committee was better equipped than shareholders to ensure that the nominees were qualified.[37] These alternatives, as well as the arguments for them, are very similar to those advanced by representatives of the business community and legal community who have provided their views in the course of the current review.

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29 *See* Release Nos. 34-14970 (July 18, 1978) and 34-15384 (December 6, 1978). The nominating committee disclosure currently is required under Item 7 of Schedule 14A.

30 *See* Release Nos. 34-13482 (April 28, 1977) and 34-13901 (August 29, 1977).

31 *See Staff Report on Corporate Accountability, supra* note 10, at A53-57.

32 *See* Re-Examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Summary of Comments (1978), at 65.

33 *Staff Report on Corporate Accountability, supra* note 10, at A54.

34 *See* Summary of Comments, *supra* note 32, at 65.

35 *Id.*

36 *See* Summary of Comments, *supra* note 32, at 65; *Staff Report on Corporate Accountability*, *supra* note 10, at A55-56.

37 *Id.*

Commenters favoring disclosure in 1977 thought that it would encourage shareholders to contact nominating committee members with their recommendations; however, the 1977 commenters were less supportive of disclosure relating to the nominee selection process, the criteria to be applied by the nominating committee in selecting nominees, and the required qualifications of nominees.[38] Those who did not support expanded nominating committee disclosure stated their concern that companies would merely make "self-serving 'boilerplate'" disclosures.[39] This concern, in particular, has been repeated by some of the commenters who have provided their views in the course of the current review. The general sentiment of these commenters seems to be that, though increased disclosure might be helpful if it were not merely boilerplate, it would not be sufficient on its own to adequately provide shareholders with a meaningful role in the proxy process relating to the nomination and election of directors, at least where the process was otherwise inadequate in reflecting shareholder input.

When it proposed amendments to the proxy rules to include the current disclosure requirements related to nominating committees, the Commission stated generally its belief that the new disclosure requirements would facilitate improved accountability.[40] Specifically, the Commission stated that:

> … information relating to nominating committees would be important to shareholders because a nominating committee can, over time, have a significant impact on the composition of the board and also can improve the director selection process by increasing the range of candidates under consideration and intensifying the scrutiny given to their qualifications. Additionally, the Commission believes that the institution of nominating committees can represent a significant step in increasing shareholder participation in the corporate electoral process, a subject which the Commission will consider further in connection with its continuing proxy rule re-examination.[41]

Although the Commission received positive feedback on its proposed nominating committee disclosure requirements, some commenters argued that the disclosure was designed to encourage companies to establish nominating committees rather than to provide useful disclosure to shareholders.[42] The Commission noted this concern, but adopted disclosure requirements related

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38 *See* Summary of Comments, *supra* note 32, at 75.

39 *Id.*

40 *See* Release No. 34-14970 (July 18, 1978).

41 *Id.*

42 *See* Release No. 34-15384 (December 6, 1978). In particular, commenters argued that the requirement that companies disclose "whether" they had nominating committees was inappropriately designed to encourage the formation of such committees. Conversely, commenters in 1977 expressed support for such a requirement. *See* Summary of Comments, *supra* note 32, at 74.

to nominating committees substantially as proposed.[43]

In light of the fact that nominating committee disclosure was advanced as, and ultimately adopted as, an alternative to shareholder access to a company's proxy statement in 1978, some likely will argue that any attempt now to facilitate shareholder access to the nomination and election process through nominating committee disclosure will not be any more effective than the existing disclosure has been in facilitating shareholder nominations.[44] At a minimum, any new disclosure requirements would need to strengthen substantially those adopted in 1978. As noted above, possible new listing standards requiring nominating committees to fully consider all qualified shareholder nominees could bolster the effectiveness of this alternative.

Disclosure

The current proxy statement disclosure about whether a company has a nominating committee and will consider shareholder nominees could be expanded to require a discussion of:

- where a company does not have a nominating or similar committee, why the board of directors believes that it is in the best interest of the company not to have such a committee;
- the nominating committee charter, if any;[45]
- nominating committee member independence;
- the criteria used by the nominating committee to screen nominee candidates, including shareholder recommendations;
- the nominating committee's policy with regard to the consideration of shareholder recommendations;
- the qualifications the nominating committee believes company directors, or a given director, should have;
- the nominating committee's process for developing and considering nominees;
- the source of each of the board's nominees, including the use of third-parties to identify potential nominees;

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43 *See* Release No. 34-15384 (December 6, 1978).

44 *See, e.g.*, AFSCME, in which AFSCME contends that "[e]vents that have transpired since the 1977-78 rulemaking . . . demonstrate that reliance on disclosure and nominating committees – whose members, while meeting the legal standard necessary to be considered independent, are nominated by incumbent directors – has not remedied the passivity common to corporate boards."

45 Companies also could be required to make available to shareholders a copy of the nominating committee charter, if any.

- the process by which shareholders can recommend a nominee; and

- if the nominating committee receives a recommended nominee from a shareholder who has beneficially owned a specified amount (*e.g.*, 1%) of the company's voting common stock for a specified period (*e.g.*, at least one year) and the nominating committee chooses not to nominate that candidate:

  - who recommended the candidate;

  - why the nominating committee did not include the candidate as a nominee; and

  - whether each member of the nominating committee believes that it was in the company's best interest not to nominate the candidate and, to the extent members of the nominating committee do not have such belief, why the candidate was not included as a nominee.

NYSE and Nasdaq Proposed Rule Changes

On April 11, 2003 the Commission published a notice for comment regarding proposed rule changes submitted by the NYSE.[46] In the commentary on its proposed rule change, the NYSE describes nominations as "among the board's most important functions."[47] The NYSE proposes to amend its listing standards in an effort to help restore investor confidence by addressing director independence and strengthening corporate governance practices. One of the features of the proposed rule changes is the requirement that listed companies have a "nominating/corporate governance committee composed entirely of independent directors."[48] The proposed rule provides that these committees have a written charter that addresses:

- the committee's purpose – which, at a minimum, must be to: identify individuals qualified to become board members and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation;

- the committee's goals and responsibilities – which must reflect, at a minimum, the board's criteria for selecting new directors and oversight of the evaluation of the board and management; and

- an annual performance evaluation of the committee.[49]

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46 *See* Release No. 34-47672 (April 11, 2003).

47 *Id.*

48 *Id.*

49 *Id.*

The Nasdaq Stock Market also has submitted a proposed rule change, which was published for comment by the Commission on March 17, 2003.[50] Although the proposed changes to the Nasdaq listing requirements also address director independence and nominating committee standards, they do not include a requirement that the nominating committee have a charter. Nasdaq's proposal would require, with certain exceptions, that either a majority of independent directors or a nominating committee comprised solely of independent directors nominate directors.[51]

These proposed rule changes demonstrate the current focus on the importance of the nominating process and the nominating committee. In addition, they represent a substantial difference from 1978, when the Commission proposed and adopted the current disclosure requirements for nominating committees. As the summary of comments relating to the 1978 proposals demonstrates, much of the input received from commenters and participants in the 1977 hearings focused on the need for outside directors on the nominating committees. The combination of independence standards and, in the case of the NYSE, the charter requirement, represent a strengthening of the nominating committee that may well support the efficacy of the nominating committee disclosure alternative. The proposed rule changes do not, however, require that candidates recommended by shareholders be considered.

Advantages and Disadvantages

An advantage to this alternative is that it could serve as a vehicle for shareholders to influence board composition without requiring extensive changes to the proxy rules or implicating state law issues surrounding the nomination and election of directors. As is noted frequently by members of the business community from whom we have received input, this option could provide shareholders with access to the board and to the nomination process without involving contested board seats. On the other hand, this option would not ensure that shareholder recommended candidates are included in the company's proxy materials, and commenters raise the concern that some companies may include boilerplate disclosure in their

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50 *See* Release No. 34-47516 (March 17, 2003).

51 Under the proposed Nasdaq listing standard, nominating committees of three or more directors may include one director who is not independent, provided that he or she is not a current officer, employee or family member of a current officer or employee, and "exceptional and limited circumstances" cause that individual's membership to be in the best interests of the company and its shareholders. In this case, the board would have to include disclosure in the next annual meeting proxy statement describing the nature of the relationship that causes the director not to be independent and the reasons for the "best interests" determination. Such members could serve for no more than two years. A second exception would allow a director to serve who owns 20% or more of the company's common stock or voting power, who is not independent by virtue of his or her position as an officer, if the board determines that the individual's membership on the nominating committee is in the best interests of the company and its shareholders. The board would have to disclose the nature of the director's relationship and the reasons for including that individual on the nominating committee. Finally, those companies that meet the definition of a "controlled company," would be exempt from the requirements related to director independence, including the nominating committee requirements. A "controlled company" is a company of which more than 50% of the voting power is held by an individual, a group or another company. These companies would have to disclose in their annual meeting proxy statements that they are controlled companies. *Id.*

proxy statements to satisfy any expanded disclosure requirements. Some undoubtedly will argue that this alternative to shareholder access has been tried and, over the past 25 years, has not led to a change in the ability of shareholders to have their candidates nominated, though this position would not take into account the proposed new listing standards and other changes that have occurred since 1978.

Potential Questions for Public Comment

1. Would increased disclosure related to the nominating committee and its policies and criteria for considering nominees be an effective means to improve shareholder involvement in the nomination process, board accountability, board responsiveness, and corporate governance policies?

2. If so, what disclosure would be most useful? For example, should a company disclose how many shareholder recommendations it considered, what criteria it applied to shareholder recommendations, and why it rejected any shareholder recommendations? If so, would this type of disclosure raise privacy issues for rejected candidates, even if the candidates are not specifically named in the company's disclosure?

3. Do most corporations currently consider shareholder recommended candidates to the board? If so, do these corporations apply the same criteria to shareholder recommendations as to company nominees?

4. Would it be helpful if the markets amended their listing standards to require nominating committees to consider shareholder recommendations? Since not all companies would be subject to any listing requirements that require companies to consider shareholder recommendations, is this an appropriate result for those companies who are not listed?

5. Would this alternative be a less costly means to address issues of board accountability, board responsiveness, and corporate governance than an enhanced shareholder access proposal?

D. Alternative D – Disclosure Regarding Shareholder Communications With the Board

Similar to the nominating committee disclosure alternative, another alternative would be for the Commission to propose that companies be required to disclose what process, if any, companies have in place for shareholders to communicate directly with board members. If the company has no such process, it would need to disclose this fact and the reason(s) it has no such process in place. As with the nominating committee disclosure, the impact of the disclosure would be more effective if coupled with a change in market listing standards. The NYSE's proposed listing standard amendments would require a means for shareholders to communicate directly with independent directors, as discussed in more detail below.[52]

[52] See Release No. 34-47672 (April 11, 2003).

The Commission did not specifically consider this alternative in its 1942, 1977 or 1992 reviews of the proxy rules. Representatives from the business community have suggested that an alternative to an enhanced shareholder access proposal would be to disclose current processes that companies have in place to provide shareholder access to board members, as well as to further expand and explore changes to listing requirements.

Shareholders have demonstrated ongoing interest in meeting with board members over the past proxy season. For example, two pension funds submitted proposals seeking greater shareholder access to corporate boards. The AFSCME Employees Pension Plan submitted a shareholder proposal to The Kroger Co. to amend Kroger's bylaws to provide for the creation of a shareholder committee to communicate with the board regarding shareholder proposals under Exchange Act Rule 14a-8 that were approved but not adopted.[53] Several New York City pension funds[54] submitted shareholder proposals to Advanced Fibre Communications, Inc. and PeopleSoft, Inc. requesting that these Nasdaq-listed companies establish an "Office of the Board of Directors" to facilitate communications between non-management directors and shareholders, including meetings, based on the proposed NYSE standard.[55]

Although Exchange Act Rule 14a-8 already creates a mechanism for shareholders to seek further access to the board, investors and investor advocacy groups have indicated that a change through listing standards would be more effective by allowing shareholders to communicate with board members about issues that may be significant but that constitute "ordinary business." Shareholder proposals, amendments to listing standards, and required disclosure relating to board communications would strengthen further the effectiveness of this alternative. There also has been some explicit and implicit suggestion that improved communications between shareholders and boards, and structural encouragement of those communications would lessen the need for more intrusive measures, such as reforms to the proxy process.

Disclosure

If the Commission chooses to propose disclosure requirements related to communications between shareholders and boards, the disclosure could address:

- whether or not the company provides a process for shareholders to send

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53 *The Kroger Co*. (April 11, 2003). The Division did not grant a no-action position to Kroger regarding exclusion of the proposal under the ordinary business exclusion, as the proposal limited the nature of the communications to other than ordinary business matters.

54 The New York City Employees' Retirement System, the New York City Teachers' Retirement System, the New York City Police Pension Fund, and the New York City Fire Department Pension Fund submitted the proposals.

55 *Advanced Fibre Communications, Inc*. (March 10, 2003); *PeopleSoft, Inc*. (March 14, 2003). The Division granted a no-action position to PeopleSoft and Advanced Fibre regarding exclusion of the proposals under the ordinary business exclusion, as the proposals did not limit the nature of the communications to other than ordinary business matters.

communications to the board of directors;

- if the company does not have a process for shareholders to send communications to the board of directors, why the company does not have such a process and why the board of directors believes that it is in the best interest of the company not to have such a process;

- the manner in which shareholders can send communications to the board;

- identification of those board members to whom shareholders can send communications;

- if all shareholder communications are not sent directly to board members, the company's process for determining which communications must be relayed to board members;

- the number of times individual board members met with shareholders in the prior year; and

- any action taken by the board as a result of the communications.

NYSE Proposed Rule Change

As with the nominating committee disclosure, this alternative would be more effective if the markets amended their listing requirements to mandate a process to allow shareholders to communicate with board members. The NYSE's proposed changes to its listing standards address briefly the issue of greater access to the board.[56] Specifically, proposed Section 303A(3) states, "In order that interested parties may be able to make their concerns known to non-management directors, a company must disclose a method for such parties to communicate directly and confidentially with the presiding director or with non-management directors as a group."[57] Under the NYSE's proposal, that method could include shareholder communications and be analogous to any process established for communications with the audit committee required by Section 303A(7)(c)(ii), which states that the audit committee must "establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters."[58]

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56 *See* Release No. 34-47672 (April 11, 2003).

57 *Id.*

58 *Id.*

Advantages and Disadvantages

Representatives of the business community contend that an advantage of this alternative is that it may address issues of accountability and responsiveness without imposing the disruption and costs associated with the enhanced shareholder access alternative. In particular, they assert that the current proposed listing standards, Sarbanes-Oxley reforms, and the increasing popularity of, and responsiveness by companies to, shareholder proposals will resolve many of these issues.

Although investors and investor advocacy groups believe that this alternative would be helpful, they contend that it would not fully address any problems with boards' lack of accountability and responsiveness to shareholders. In particular, they note that larger minority shareholders already can meet with board members in many public companies and that this has not served to effectively change board behavior. Further, the existence of a process for shareholders to communicate with board members does not ensure that the board members will be responsive to shareholder concerns. Representatives of the business community also have indicated that the greater the number of communications with board members, the less likely it is that a board member may be responsive to a particular communication. Moreover, an intermediary may be necessary to screen voluminous communications.

Because not all companies would be subject to listing requirements that require companies to provide a means for shareholder communication with board members, the Commission would need to consider this alternative's lack of impact on unlisted companies. This could be a significant issue, as some groups contend that issues of accountability and responsiveness can be more problematic with smaller companies.

Potential Questions for Public Comment

1. Would increased disclosure relating to shareholder communications with board members be an effective means to improve board accountability, board responsiveness, and corporate governance policies?

2. If so, what disclosure would be most useful? For example, should companies disclose the specific policies in place with regard to shareholder communications with board members, how the communications are screened, and how the communications are relayed to board members?

3. Do corporations currently provide a means for allowing shareholders to communicate with board members? How effective have these methods been in improving board accountability, board responsiveness, and corporate governance policies?

4. Would it be helpful if the markets expanded upon existing listing standards or adopted new listing standards to allow shareholders to communicate with board members?

5. If so, what type of communications should be available to shareholders? A general e-mail account? The establishment of an office associated with the board of directors? In-person meetings with board members? Should there be any limitation on the type of

communications? Should there be a share ownership eligibility threshold in order to communicate with board members or to have access to a particular means of communication?

6. Should communications with board members that are addressed in disclosure rules or listing standards be limited to independent directors or should the communications extend to the entire board? Should only shareholders be able to communicate with board members or should all interested third parties be able to communicate with board members?

7. Because not all companies would be subject to any listing requirements that require shareholders to be able to communicate with board members, is this an appropriate result for unlisted companies?

8. Would this alternative be an effective and less costly means than an enhanced access proposal to address issues of board accountability, board responsiveness, and corporate governance?

E. Alternative E – Revise Exchange Act Rule 14a-8(i)(8)

Exchange Act Rule 14a-8(i)(8) allows companies to exclude proposals that "relate[] to an election for membership on the company's board of directors or analogous governing body." As evidenced by its determination regarding the AFSCME Employees Pension Plan nomination proposals discussed in Section I, the Division's analysis under Exchange Act Rule 14a-8(i)(8) focuses on whether the proposal either directly or indirectly may result in an election contest. If a proposal may have such a result, the Division's analysis permits a company to exclude the proposal.

An alternative to an enhanced shareholder access proposal would be to establish a new analysis under existing Exchange Act Rule 14a-8(i)(8) or an amendment to Exchange Act Rule 14a-8(i)(8) that would allow for inclusion of proposals seeking to establish a process to allow shareholders to access a company's proxy card in a non-control context. Under this framework, state law would require at least many of the proposals to be precatory, leaving the board to decide whether to implement a process to allow shareholders to nominate directors.[59] Exchange Act Rule 14a-8(i)(8) could continue to be a basis for exclusion of certain proposals, such as those that nominate a particular person to the board, proposals that seek to remove current directors from the board, and proposals that seek to indirectly affect an election of directors by questioning the business judgment, competence and service of a particular board member who is up for election.

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[59] A shareholder proposal that would mandatorily effect a change in the company's bylaws may violate state law and/or a company's governing instruments. *See, e.g., AOL Time Warner Inc*., Exhibit B (February 28, 2003) (legal opinion from Richards, Layton & Finger regarding the AFSCME Employees Pension Plan proposal submitted to AOL Time Warner).

Impact on Other Proxy Rules

Any change to Exchange Act Rule 14a-8(i)(8) or the Division's analysis of that rule to allow for shareholder proposals seeking access to the proxy card for the purpose of nominations, would have to be addressed in other proxy rules. A company's adoption of a procedure to allow shareholders to access company proxy materials to nominate directors, either through its own actions based on a precatory proposal or through a mandatory bylaw proposal, would:

- impact many of the same rules as the enhanced shareholder access alternative; and
- require clarification of the application of the requirements governing election contests, as defined by Exchange Act Rule 14a-12(c), to nominating shareholders.

As noted above, the majority of shareholder proposals under this alternative likely would be precatory. In such a case, the board could adopt a proposal that seeks to establish a process to allow shareholders to nominate directors. Because the board would decide whether to implement the process, the nomination of a candidate to the board by a shareholder likely should not be viewed as a "contest" as defined by Exchange Act Rule 14a-12(c). The Commission could take the position that the board's decision to implement a process to allow shareholders to nominate candidates to the board constitutes, in essence, board sanctioning of these nominees and, thus, there would not be a "contest" as defined by Exchange Act Rule 14a-12(c). This also may be analogous to bylaws that allow shareholders to recommend nominees to the board directly or on the floor at an annual meeting.

A mandatory bylaw proposal that forces the board to include shareholder nominees in company proxy materials could raise issues under state law. Further, if a mandatory bylaw proposal to allow shareholders to nominate directors is permitted, the Commission would need to determine whether a mandatory process that allows for shareholder nominees and board nominees on the company's card is a "contest" as defined by Exchange Act Rule 14a-12(c). This is a more difficult determination because, unlike precatory proposals, the board would not have discretion in implementing the process. As such, it is more difficult to make the argument that any shareholder nominees are sanctioned by the board.

Advantages and Disadvantages

There are several advantages to this alternative. Exchange Act Rule 14a-8 proposals can be drafted individually to reflect the make up of a particular company as opposed to a "one size fits all" access rule that applies to all companies. The exemption in Exchange Act Rule 14a-8 for proposals that would violate state law would eliminate any potential federal law or state law authority issues. Investor groups have questioned the intrinsic fairness of providing only larger minority shareholders (*e.g.*, 3% or 5%) with access to company proxy materials to nominate directors, given that these individuals can best afford the cost of conducting a contest as defined by Exchange Act Rule 14a-12(c). This alternative would provide shareholders with the flexibility to draft each proposal to establish different thresholds for ownership, length of holding period and other applicable requirements, on which all of a company's shareholders could then vote.

There are, however, also disadvantages to this alternative. Investor groups supporting an enhanced shareholder access proposal have claimed that the impact on board accountability and responsiveness to shareholder concerns would not be as significant under this framework. In the case of a precatory proposal, the board would not be required to implement the proposal. In the case of a mandatory bylaw proposal, it is unclear whether companies could avoid implementing this type of proposal by amending their governing instruments to require board approval of shareholder nominees. Further, because each proposal could be drafted differently, this alternative may create a complex structure that does not set clearly a universal standard for interpreting the proxy rules, as each proposal, and its effect, will need to be examined on a company-by-company basis. Finally, the flexibility offered by this proposal brings some disadvantages, as shareholder access could become subject to an array of confusing company-specific rules.

Potential Questions for Public Comment

1. Would revising Exchange Act Rule 14a-8 or its interpretation be an effective means of improving board accountability, board responsiveness, and corporate governance policies?

2. What are the potential benefits and detriments of granting access to company proxy materials through shareholder proposals? For example, would a company-by-company approach allow a shareholder to tailor a proposal to account for a company's characteristics such as board composition, record on accountability, responsiveness to shareholder proposals, and corporate governance policies? Would this be a less costly mechanism than an enhanced shareholder access proposal?

3. If a company establishes a process to allow shareholder access to company proxy materials to nominate directors for less than a majority of the seats, would the Division still need to provide interpretive guidance on the applicability of the proxy rules? If so, should shareholders who nominate a director under a procedure established in response to a shareholder proposal be subject to the proxy rules governing election contests? Should solicitations for the purpose of forming a shareholder group to nominate directors and/or other soliciting materials be exempt from the proxy rules? Should nominating shareholders, including groups, be deemed to have a "control" purpose that would create additional filing and disclosure requirements under Exchange Act Section 13(d)?

4. Would a proposal seeking a mandatory bylaw to establish a process to allow shareholders to nominate directors be appropriate under state law? Could a company negate the effect of a mandatory bylaw proposal to establish a process to allow shareholders to nominate directors by amending its governing instruments to require board approval of all nominees?

IV. RECOMMENDATION

The Division recommends that the Commission solicit public comment with regard to proposed changes in two areas – improved disclosure and improved shareholder access to the director nomination process. The Division, therefore, recommends that the Commission publish

proposals and solicit public comment with regard to the following actions:

- requiring more robust disclosure related to nominating committees and the nomination process;
- requiring specific disclosure regarding shareholder communications with board members; and
- requiring conditional shareholder access to a company's proxy materials for purposes of nominating candidates for election as director.

Accordingly, the Division recommends that the Commission, consistent with its authority under Exchange Act Section 14(a), proceed with the rulemaking process that we describe below.

Recommended Disclosure Enhancements

The Division recommends that the Commission propose and solicit comment on new requirements for disclosure in company proxy materials relating to nominating committees and the company's procedures, if any, for allowing shareholders to communicate with board members, as follows:

- *Enhanced disclosure regarding a company's nomination process, including:*
    - the nominating committee charter, if any;
    - nominating committee member independence;
    - the criteria used by the nominating committee to screen nominee candidates, including candidates recommended by shareholders;
    - the nominating committee's policy with regard to candidates recommended by shareholders;
    - the qualifications the nominating committee believes company directors, or a given director, should have;
    - the nominating committee's process for developing and considering nominees;
    - the source of each of the board's nominees;
    - how shareholders can recommend a nominee; and
    - if the nominating committee receives a recommended nominee from a shareholder who has beneficially owned greater than a specified amount of the company's voting common stock for a minimum specified period of time, and the nominating committee chooses not to nominate that candidate:

- who recommended the candidate;

- why the nominating committee did not include the candidate as a nominee; and

- whether each member of the nominating committee believes that it was in the company's best interest not to nominate the candidate.

- *Disclosure regarding shareholder communications with board members, including:*

    - the manner in which shareholders can send communications to the board;

    - identification of those board members to whom shareholders can send communications;

    - if all shareholder communications are not sent directly to board members, the company's process for determining those communications that are relayed to board members;

    - the number of times individual board members met with shareholders in the prior year; and

    - any action taken by the board as a result of the communications.

Shareholder Access to Company Proxy Materials

Recommended Structure for Shareholder Access to Company Proxy Materials

The Division recommends that the Commission propose and solicit public comment on new proxy rules that would allow a shareholder or a group of shareholders to place their nominees in a company's proxy materials within the following parameters:

- applicable state corporate law must provide the company's shareholders with the right to nominate a candidate for election as a director;

- neither the candidacy nor the election of a shareholder nominee may otherwise violate, or cause the company to violate, controlling state law, federal law or listing standards;

- the availability of a shareholder nomination process should be premised upon the occurrence of one or more triggering events that are objective criteria evidencing potential deficiencies in the proxy process such that shareholder views – especially those of a majority – may not otherwise be adequately taken into account;

- there should be appropriate standards for independence of shareholder nominees;

- there should be minimum standards with regard to shareholdings and the length of

time those shares have been held by a nominating shareholder or shareholder group; and

- there should be limitations on the total number or percentage of permitted shareholder nominees.

Impact of Recommendation on Other Commission Rules

Proposal of a shareholder access rule could affect a number of existing proxy rules and regulations, as well as the reporting requirements for large shareholders and shareholder groups. Some of the key changes that the Commission may wish to consider if it proposes a shareholder access rule include the following:

- possible amendments to the proxy rules to address specifically soliciting activities in connection with the formation of a nominating shareholder group;
- possible amendments to the proxy rules to address specifically soliciting activities by the nominating shareholder(s) in support of the shareholder nominee;
- possible amendments to the proxy rules to facilitate solicitations by electronic means on one or more specified websites;
- possible amendments to the beneficial ownership reporting requirements to address specifically nominating shareholders and nominating shareholder groups;
- possible amendments to the insider transaction reporting requirements to address specifically nominating shareholder groups; and
- possible amendments to the definition of "affiliate" to address specifically nominating shareholders and nominating shareholder groups.

Attachments: Appendix A – Summary of Comments