

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.⁴³

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

II. Proposed Changes to the Proxy Rules

A. Proposed Security Holder Director Nomination Rule

1. Background

a. Discussion

Section 14(a) of the Exchange Act⁴⁴ prohibits any person from soliciting proxies with respect to a Section 12⁴⁵-registered security where that solicitation is in contravention of Commission rules and regulations. Section 14(a) "stemmed from the congressional belief that 'fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange.' It was intended to 'control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which * * * [had] frustrated the free exercise of the voting rights of shareholders.'" ⁴⁶ Section 14(a)

authorizes the Commission to prescribe proxy solicitation rules that are "necessary or appropriate in the public interest or for the protection of investors."⁴⁷ As described and discussed below, we believe that today's proposals further the goals of Section 14,⁴⁸ in that they will help facilitate the full and informed exercise of existing security holder nomination and voting rights through the proxy process by requiring companies to include disclosure regarding security holder nominees in company proxy materials in specified circumstances.

Based on the comments received in response to our solicitation of public input on the Division's review of the proxy rules relating to the election of directors, it is apparent that many of the issues raised in the Commission's 1977 review of the proxy rules merit reconsideration. In particular, because the disclosure requirements regarding nominating committees that were adopted in 1977 do not appear to have made the operation of those committees sufficiently transparent, we have proposed enhancements to those disclosure requirements. Further, it appears that the presence of nominating committees has not eliminated the concerns among some security holders with regard to the barriers to meaningful participation in the proxy process in connection with the nomination and election of directors.⁴⁹ Although we recognize that the self-regulatory organizations have proposed changes to their listing standards concerning nominating committees and related corporate governance issues, these proposed changes do not address the role of security holders in the nomination procedure.

Much of the public input that we have received suggests that including security holder nominees in company proxy materials would be the most direct and effective method of giving security

holders a more effective role in the proxy process in connection with the nomination and election of directors.⁵⁰ This input also suggests that security holders believe that another result would be to make corporate boards more responsive and accountable to security holders, as well as, in many instances, more diverse.⁵¹ Today, security holders 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 a majority of the security holder vote.⁵² Accordingly, all board nominees generally are elected, regardless of the number of "withhold" votes by security holders. Commenters indicated that many security holders, therefore, view the proxy process as ineffective and the election of directors as a mere formality or "rubber stamp" of the board's choices presented in the company's proxy materials.⁵³

Currently, a security holder or group of security holders that is dissatisfied with the leadership of a company generally must undertake a proxy contest, along with its related expenses, to put nominees before the security holders for a vote.⁵⁴ A board's nominees, on the other hand, do not bear the cost of their candidacies, which are funded out of corporate assets. While security holders can recommend a candidate to a company's nominating committee, security holder comments suggest that these recommendations rarely are effective and that, in some cases, it may be difficult for security holders to gain access to members of company boards and their committees.⁵⁵

On the other hand, the business community and many of its legal advisors commented that giving security

⁵⁰ See 2003 Summary of Comments.

⁵¹ See *id.*

⁵² 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, each nominee receiving even a single vote will be elected, regardless of the number of votes "withheld" from a candidate.

⁵³ See 2003 Summary of Comments.

⁵⁴ Under some circumstances, security holders may be able to effect change in board membership through security holder lawsuits. For example, security holders at Hanover Compressor Company and Homestore, Inc. recently obtained the right to nominate candidates for the boards of directors as a result of the settlement of security holder lawsuits against each of these companies. See Hanover Compressor Company, Form 8-K filed May 13, 2003 and Homestore, Inc., Form 8-K filed August 13, 2003.

⁵⁵ See 2003 Summary of Comments.

⁴³ Release No 34-31326 (October 16, 1992).

⁴⁴ 15 U.S.C. 78n(a).

⁴⁵ 15 U.S.C. 78l.

⁴⁶ *I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (citing H.R. Rep. No. 1383, 73rd Cong., 2d Sess. 13-14). See also *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 676 (D.C. Cir. 1970), vacated as

moot, 404 U.S. 403 (1972) ("Congress intended by its enactment of section 14 * * * to give true vitality to the concept of corporate democracy.").

⁴⁷ 15 U.S.C. 78n(a). Cf. *Medical Committee*, 432 F.2d at 671 ("Through section 14 of the Act, Congress has invested the Securities and Exchange Commission with sweeping authority to regulate the solicitation of corporate proxies.").

⁴⁸ Professors Loss and Seligman have described the Commission's rules promulgated under this section as "designed * * * to make the proxy device the closest practicable substitute for attendance at the [shareholder] meeting." Loss & Seligman, Chapter 6.C.2b. Securities Regulation (3d ed.).

⁴⁹ In our discussion of the proxy rules and our proposals, we use the term "security holders," which is the term used currently throughout our proxy rules. For purposes of our proposals, the term generally refers to shareholders having a right to vote at the meeting and on the matter in question.