

security holder access to the proxy process relating to the nomination of directors.<sup>208</sup> On August 14, 2003, we published for comment proposed rules that would implement the first of the Division's recommendations—new disclosure standards requiring more robust disclosure of the nominating committee processes of public companies, including the consideration of candidates recommended by security holders, as well as more specific disclosure of the processes by which security holders may communicate with the directors of the companies in which they invest.<sup>209</sup> Today, we are proposing rules that would implement the second of the Division's recommendations. These proposed rules would require companies to include in their proxy materials security holder nominees for election as director under certain limited circumstances.

Under the existing structure, security holders generally can have input in the director nomination procedure in two ways: Undertake an election contest and recommend candidates to the nominating committee. In the broad proxy revisions adopted in 1992, the Commission eased the requirements for security holders conducting an election contest in a non-control context when it revised Exchange Act Rule 14a-4(d) to allow security holders seeking minority board representation to "fill out" a partial or "short" slate with management nominees. Under the current proxy rules, these security holders still must disseminate and file a separate proxy statement. Although commenters noted the availability of this existing alternative, many other commenters noted the prohibitive expense in conducting an election contest.<sup>210</sup> Pursuant to a company's bylaws, security holders also may recommend board candidates to the nominating committee. Several commenters noted that this process is not effective and expressed the view that nominating committees rarely include security holder candidates in company proxy materials.<sup>211</sup>

After reviewing the existing proxy rules and comments from the public, we are proposing rules that would create a mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to be included in company proxy materials. The intent of the proposed amendments is to improve the ability of security holders to participate

meaningfully in the nomination and election of directors where evidence suggests that the company has been unresponsive to security holder concerns as they relate to an effective proxy process. Greater security holder involvement also may increase director accountability and responsiveness to security holders and their concerns.

The Commission has considered a variety of reforms to achieve its regulatory objectives. As one possible approach, we considered requiring companies to include a separate security holder proxy card in the company mailing. Alternatively, we considered amending Exchange Act Rule 14a-8(i)(8)<sup>212</sup> to allow security holder proposals requesting access to the company's proxy card for the purpose of making nominations. Based on comments we have received to date, we believe that requiring companies to include in their proxy materials security holder nominees for election as director under certain limited circumstances would best address the concerns raised by commenters and would provide the most benefit for the least cost.

#### **B. Potential Benefits of the Proposed Rules**

The proposed amendments may serve to align the interests of the board and security holders, thereby giving investors greater confidence that the board is serving the interest of security holders, even if the provisions of the rule are rarely used.<sup>213</sup> This alignment can occur in three ways. First, the presence of triggering events, as described below, may improve the responsiveness of boards to security holder preferences. Second, the disclosure requirements may enable investors to better understand and evaluate the performance of the board. Third, the ability of relatively large and long-term security holders to make a board nomination that is included in the company's proxy materials may improve corporate governance by enhancing security holders' ability to participate meaningfully in the proxy process.

The security holder nomination procedure would become operative only if one or both of the following triggering events occur:

- At least one of the company's nominees for the board of directors for whom the company solicited proxies received "withhold" votes from more than 35% of the votes cast at an annual meeting of security holders; or

- A security holder proposal submitted pursuant to Exchange Act Rule 14a-8 providing that the company become subject to the security holder nomination procedure in proposed Exchange Act Rule 14a-11 (a) was submitted for a vote of security holders at an annual meeting of security holders by a security holder or group of security holders that held more than 1% of the company's securities entitled to vote on the proposal for one year as of the date the proposal was submitted and provided evidence of such holding to the company; and (b) that "direct access" proposal received more than 50% of the votes cast on that proposal at that meeting.

Allowing security holders access to company proxy materials in these two circumstances would limit the use of proposed Exchange Act Rule 14a-11 to companies where there is evidence indicating ineffectiveness of or dissatisfaction with the proxy process. In addition, the triggering events may serve to make boards more responsive to security holder concerns and security holder dissatisfaction with directors in cases where companies wish to avoid triggering the procedure in proposed Exchange Act Rule 14a-11.

Under the proposed rules, a company would be required to disclose the security holder vote with respect to either of the triggering events and whether the company would be subject to proposed Exchange Act Rule 14a-11. These proposed notice requirements may benefit security holders by providing greater transparency of the level of security holder discontent with the company's nominees and the degree to which security holders believe a company is responsive to security holder concerns.

In those cases where proposed Exchange Act Rule 14a-11 is triggered, requiring companies to include nominees of larger, long-term security holders or groups of security holders may benefit security holders by allowing them to have greater input in the nomination procedure where there is evidence indicating that the proxy process may be ineffective. Greater security holder input may lead to better performing boards whose interests are better aligned with security holders. When a security holder nominee is elected to a board, commenters were also of the opinion that this may lead to a more diverse board that could offer a

<sup>208</sup> See *id.*

<sup>209</sup> See Release No 34-48301 (August 14, 2003).

<sup>210</sup> See 2003 Summary of Comments.

<sup>211</sup> See *id.*

<sup>212</sup> Exchange Act Rule 14a-8(i)(8) permits a company to exclude a security holder proposal from its proxy statement if the proposal "relates to an election for membership on the company's board of directors or analogous governing body."

<sup>213</sup> See 2003 Summary of Comments. Several commenters noted that better corporate governance would increase the long-term value of security holders' investments in companies.