

proposals are intended to improve the ability of security holders to participate meaningfully in the nomination and election of directors.

#### A. Reasons for the Proposed Action

On April 14, 2003, the Commission directed the Division of Corporation Finance to review the proxy rules and regulations and their interpretations regarding procedures for the nomination and election of corporate directors<sup>229</sup> and on May 1, 2003, the Commission solicited public input on the Division's review.<sup>230</sup> On July 15, 2003, after considering the views expressed by commenters, the Division of Corporation Finance provided to the Commission its report and recommended changes to the proxy rules related to the nomination and election of directors.<sup>231</sup> To best address many of the issues raised by commenters, the Division recommended changes in two areas—disclosure related to nominating committee functions and security holder communications with boards of directors and enhanced security holder access to the proxy process relating to the nomination of directors.<sup>232</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>233</sup> Today, we are proposing rules that would implement the second of the Division's recommendations. These proposals would create a mechanism for long-term security holders, or groups of long-term security holders, with significant holdings to access company proxy materials to nominate directors.

#### B. Objectives

The proposed amendments have two primary objectives. The first objective is to improve the ability of security holders to participate meaningfully in the nomination and election of

directors. The second objective is to meet the first objective without unduly burdening companies. We seek to limit the cost and burden on companies by limiting the proposed security holder nomination procedure to only those companies:

- Where the company's security holders are permitted under state law to nominate a candidate or candidates for election as directors;
- Where there are criteria showing that the proxy process may be ineffective—specifically, only after the occurrence of one or both of the following triggering events:

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

- Where the nominating security holder or group of security holders demonstrate continuous beneficial ownership of more than 5% of the company's securities for at least two years as of the date of the nomination.

These limitations would lower the cost to companies while still improving the ability of security holders to participate meaningfully in the nomination and election of directors. This increased participation may improve corporate governance by increasing director accountability and responsiveness and aligning the interests of the board and security holders, thereby, giving investors greater confidence that the board is serving the interest of security holders. This may, in turn, enhance the value of security holders' investments.

#### C. Legal Basis

We are proposing amendments to the forms and rules under the authority set forth in Sections 3(b), 10, 13, 14, 15, 16, 23(a) and 36 of the Securities Exchange

Act of 1934, as amended, and Sections 10, 20(a) and 38 of the Investment Company Act of 1940, as amended.

#### D. Small Entities Subject to the Proposed Rules

The proposals would affect companies that are small entities. Exchange Act Rule 0–10(a)<sup>234</sup> defines a company to be a “small business” or “small organization” for purposes of the Regulatory Flexibility Act if it had total assets of \$5 million or less on the last day of its most recent fiscal year.<sup>235</sup> We estimate that there were approximately 2,500 public companies, other than investment companies, that may be considered small entities. We estimate from information compiled by the Commission staff that there are less than 25 listed investment companies and less than 25 non-listed investment companies that are small entities that file proxy statements. As discussed below, we believe that the proposals would affect virtually no small entities that are reporting companies.

As noted above, the number of security holder proposals that receive a majority vote, the number of directors that receive 35% withhold votes, and the percentage of nominating security holders that meet the ownership threshold and holding periods may be more infrequent for small entities because insiders may hold a larger percentage of shares in such entities.<sup>236</sup>

We request comment on the number of small entities that would be impacted by our proposals, including any available empirical data.

#### E. Reporting, Recordkeeping and Other Compliance Requirements

The proposed rules are expected to impact a limited number of companies because the nomination procedure would be triggered only where there are criteria showing that the proxy process may be ineffective. For purposes of the PRA, we estimate that the proposed nomination procedure would be triggered at only 73 operating companies and 14 funds and that only 41 operating companies and 9 funds would be subject to that procedure. Given the limited number of security holder proposals received by small entities and the ownership makeup of smaller entities, the proposed rules are likely to have virtually no impact on small entities.

<sup>234</sup> 17 CFR 240.0–10(a).

<sup>235</sup> An investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year. 17 CFR 270.0–10.

<sup>236</sup> Ang *et al.*, above at note 225.

<sup>229</sup> See Press Release No 2003–46 (April 14, 2003).

<sup>230</sup> See Release No 34–47778 (May 1, 2003).

<sup>231</sup> See Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15, 2003).

<sup>232</sup> See *id.*

<sup>233</sup> See Release No 34–48301 (August 14, 2003).