

MEMO# 16681

October 22, 2003

SEC PROPOSAL TO PERMIT INCLUSION OF SECURITY HOLDER NOMINEES FOR DIRECTOR IN COMPANY PROXY MATERIALS

[16681] October 22, 2003 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 55-03 SEC RULES COMMITTEE No. 85-03 RE: SEC PROPOSAL TO PERMIT INCLUSION OF SECURITY HOLDER NOMINEES FOR DIRECTOR IN COMPANY PROXY MATERIALS Over the past several months, the Securities and Exchange Commission and its Division of Corporation Finance have undertaken an extensive review of the proxy process relating to the nomination and election of directors. In July, the Division staff issued a report recommending possible changes to the SEC's proxy rules.¹ In August, the SEC proposed new disclosure requirements relating to the operation of board nominating committees and the means by which security holders may communicate with directors.² Most recently, the SEC has proposed new rules that would conditionally require companies to include in their proxy materials security holder nominees for election as director.³ The proposed rules would apply to all companies that are subject to the SEC's proxy rules, including investment companies. The SEC has requested public comment on a range of issues relating to the proposed procedure for security holder nominations, including whether the procedure should apply to investment companies and, if so, whether any aspects of the procedure should be modified for investment companies. Comments on the proposal must be provided to the SEC on or about December 21. We have scheduled a conference call for Tuesday, November 4 at 2:00 Eastern time to discuss the Institute's comments on the SEC's proposal. The dial-in number for the call is (877) 709-5342 and the passcode is proxy. If you, or someone else from your organization, plan to participate in the conference call, please contact Stephanie Holly by phone at (202) 326-5814 or e-mail at sholly@ici.org. Set forth below is a summary of the most significant aspects of the proposal. 1 See Institute Memorandum to Closed-End Investment Company Members No. 61-03, Investment Adviser Members No. 27-03 and SEC Rules Members No. 95-03 [16317], dated July 17, 2003. 2 See Institute Memorandum to SEC Rules Members No. 106-03 and Closed-End Investment Company Members No. 68-03 [16433], dated August 12, 2003. The Institute submitted a comment letter that was generally supportive of the SEC proposal. See Institute Memorandum to Closed-End Investment Company Members No. 72-03 and SEC Rules Members No. 123-03 [16547], dated September 16, 2003. 3 SEC Release Nos. 34-48626, IC-26206 (October 14, 2003) ("Release"). The Release is available from the SEC's website at <http://www.sec.gov/rules/proposed/34-48626.htm>. 2 I. Proposed Procedure for Security Holder Nominations The SEC proposes to allow certain security holders a "limited access right" to a company's proxy materials for the purpose of including security holder nominees

for election as director. The proposed nomination procedure, which is set forth in proposed Rule 14a-11 under the Securities Exchange Act of 1934, would involve a two-step process: first, the occurrence of a “triggering event” which, in the view of the SEC, would suggest that the company has been unresponsive to security holder concerns as they relate to the proxy process; and second, inclusion in the company’s proxy of a limited number of director candidates nominated by a security holder or security holder group satisfying certain share ownership requirements. The proposed procedure would be available only if the security holders of a company have an existing right under applicable state law to nominate candidates for director.

A. Nomination Procedure Triggering Events Generally speaking, a company would become subject to the proposed security holder nomination procedure upon the occurrence of one of the following events, at any time after January 1, 2004:

- **Withhold votes in director election:** In an election of directors, at least one of the director candidates nominated by the company receives “withhold” votes from more than 35% of the votes cast by security holders.
- **Passage of direct access proposal:** A security holder or security holder group holding more than 1% of a company’s securities for at least one year submits a proposal pursuant to Exchange Act Rule 14a-8 to subject the company to the nomination procedure (“direct access proposal”), and the direct access proposal receives more than 50% of the votes cast by security holders on the proposal.⁴ The SEC requests comment on whether to adopt the following additional triggering events:
- **Non-implementation of security holder proposal:** A security holder or security holder group holding more than 1% of a company’s securities for at least one year submits a proposal pursuant to Exchange Act Rule 14a-8 (other than a direct access proposal), the proposal receives more than 50% of the votes cast by security holders on the proposal and the company’s board of directors fails to implement the proposal by the 120th day prior to the date that the company mailed its proxy materials.
- **Other events:** (1) lagging a peer index for a specified number of consecutive years, (2) being delisted by a market, (3) SEC sanctions against the company, (4) criminal indictment or (5) restatement of earnings.

⁴ The SEC proposes an amendment to Exchange Act Rule 14a-8 to clarify that a company may not exclude a direct access proposal in reliance upon the rule’s exclusion in paragraph (i)(8) for proposals relating to the election of directors.

³ Upon the occurrence of a triggering event, an investment company would be required to disclose that fact in its next filing made on Form N-CSR. For other companies, the required disclosure would be made in the next quarterly report to the SEC on Form 10-Q or 10-K. The SEC requests comment on, among other things: (1) the possible consequences of requiring a triggering event; (2) whether the proposed triggering events are appropriate for investment companies; (3) whether the “withhold votes” triggering event should be based on a percentage of votes cast or votes outstanding; (4) whether disclosure of a triggering event on Form N-CSR will provide security holders of an investment company with sufficient time to exercise effectively the nomination procedure, or whether the disclosure should be required on a different form; (5) whether an investment company that does not hold an annual meeting, or which has changed the date of its annual meeting by more than 30 days from the previous year, should be required to disclose on Exchange Act Form 8-K the date by which a nominating security holder or group must submit notice of its intent to require the inclusion of its nominee(s) in the investment company’s proxy materials; (6) whether companies should be able to take specified steps to prevent application of the proposed nomination procedure (e.g., company agrees not to exclude any security holder proposal submitted by an eligible security holder pursuant to Exchange Act Rule 14a-8, company implements all security holder proposals that receive passing votes); and (7) whether companies subject to proposed Exchange Act Rule 14a-11 should be permitted to exclude certain security holder proposals (e.g., precatory proposals, proposals relating to corporate governance matters generally, proposals relating to the structure or composition of the

company's board of directors). B. Eligibility Standards for Nominating Security Holders In order to submit one or more nominees for inclusion in a company's proxy materials, a security holder or security holder group would be required to satisfy the following eligibility standards:

- Beneficial ownership (by the security holder individually or by the security holder group in the aggregate) of more than 5% of the company's securities eligible to vote in the next election for directors, with each of the securities used for purposes of calculating that ownership having been held continuously for at least two years as of the date of the nomination.
- Intent to continue to own the securities through the date of the election.
- Eligibility to report beneficial ownership on Exchange Act Schedule 13G in lieu of Exchange Act Schedule 13D.5 As proposed, this requirement would not apply to a security holder or group seeking to nominate one or more candidates for director of a mutual fund, because security holders of mutual funds are not required to file on either schedule.6 Instead, such security holder or group would be required to include beneficial ownership information in its notice to the mutual fund regarding inclusion of the security holder or group's nominee(s) in 5 Eligibility to report on Exchange Act Schedule 13G would establish that the nominating security holder or group is not seeking control of the company's board of directors. 6 See Release at n.97. 4 the mutual fund's proxy materials (see Section I.D below).
- Certification on Exchange Act Schedule 13G that the security holder or group has satisfied the beneficial ownership requirements outlined above. A security holder or group seeking to nominate one or more candidates for director of a mutual fund would be required to include the certification in a separate notice to the mutual fund (see Section I.D below). If more than one security holder or group is eligible to nominate directors using the proposed procedure, the company would be required to include in its proxy materials the nominee(s) of the security holder or group with the largest beneficial ownership, up to and including the total number of nominees required to be included (see Section I.D below). The SEC requests comment on, among other things: (1) the appropriateness of the proposed eligibility requirements for a nominating security holder or group; and (2) whether a security holder or group seeking to nominate one or more candidates for director of a mutual fund should be required to report on Exchange Act Schedule 13G upon reaching a 5% beneficial ownership threshold and, if so, whether there are any items on Exchange Act Schedule 13G that should be modified for this purpose.

C. Eligibility Standards for Security Holder Nominees The nominee(s) for director submitted by an eligible security holder or security holder group for inclusion in the company's proxy materials would likewise be required to satisfy certain eligibility standards:

- A nominee's candidacy or board membership may not violate state or federal law or applicable rules of a national securities exchange or the NASD.
- The nominating security holder or group would be required to represent that a nominee meets the objective criteria for "independence" under applicable rules of a national securities exchange or the NASD. For investment companies and business development companies, the nominee may not be an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940.
- A nominee would be required to meet certain standards of independence from the nominating security holder or each member of the nominating security holder group.7 7 Specifically, as proposed: (1) the nominee may not nominate himself or herself, be a member of the nominating security holder group or be a member of the immediate family of the nominating security holder or member of the nominating security holder group; (2) neither the nominee nor his or her immediate family members may have been employed by the nominating security holder or member of the nominating security holder group during the current or preceding calendar year; (3) neither the nominee nor his or her immediate family members may have directly or indirectly accepted, in the year of nomination or the immediately preceding calendar year, any consulting, advisory or compensatory fee from the nominating security holder, a member of the nominating security holder group or any affiliate of the security holder or

group member; (4) the nominee may not be an executive officer or director of, or person fulfilling similar functions for, the nominating security holder, a member of the nominating security holder group or any affiliate of the security holder or group member; and (5) the nominee may not control the nominating security holder or a member of the nominating security holder group may have a direct or indirect agreement with the company regarding the nomination. The SEC requests comment on, among other things: (1) the appropriateness of the proposed independence standards; (2) whether the “interested person” standard in Section 2(a)(19) of the Investment Company Act is the appropriate test of independence with regard to investment companies and business development companies, or whether a different standard should apply; and (3) whether there should be exceptions to the prohibition on any affiliation between a nominee and the nominating security holder or group.

D. Other Aspects of the Nomination Procedure

Duration. Once a company becomes subject to the proposed nominating procedure, an eligible security holder or security holder group would be able to submit one or more nominees for inclusion in the company’s proxy materials. The nomination procedure would remain available for any election of directors during (1) the remainder of the calendar year in which the triggering event occurred, (2) the following calendar year and (3) the portion of the following calendar year up to and including the time of the election.

Number of security holder nominees. The number of security holder nominees to be included in the company’s proxy materials would depend upon the size of the company’s board of directors. If the board has eight or fewer members, a company would be required to include one security holder nominee; that number would rise to two nominees if there are between nine and nineteen board members and to three nominees if the board has twenty or more members. In the case of a company with a staggered board, these numbers would be adjusted downward if one or more directors who had been nominated by a security holder or group would be continuing to serve on the board (i.e., is not up for reelection).

Notice by the nominating security holder or group. An eligible security holder or group would be required to notify the company of its intention to submit director nominee(s) for inclusion in the company’s proxy materials no later than 80 days before the mailing date for those materials. The security holder or group also would be required to file the notice with the SEC.⁸ Among other things, the notice would be required to contain:

- A representation as to the nominating security holder or group’s eligibility to submit nominee(s) to the company pursuant to the nomination procedure.
- A statement that, to the knowledge of the nominating security holder or group, a nominee’s candidacy, and service if elected, would not violate applicable state or federal law or listing standards.

security holder or any member of the nominating security holder group or, in the case of a security holder or member that is an investment company, the nominee may not be an interested person of such holder or member.

⁸ The notice would be viewed as soliciting material and, accordingly, would be subject to the provisions of Exchange Act Rule 14a-9.

6 • Representations that a nominee satisfies the other independence requirements (see Section I.C above).

- A copy of the security holder or group’s report on Exchange Act Schedule 13G, together with representations relating to (1) eligibility to file on Exchange Act Schedule 13G and (2) the security holder or group’s continuous ownership of the securities listed in the report. A security holder or group seeking to nominate one or more candidates for director of a mutual fund would be required to provide information as to the specific classes of shares beneficially owned by such holder(s) and a certification relating to continuous ownership of such shares.
- The methods by which the nominating security holder or group may solicit security holders, including any website address on which the nominating security holder or group may post soliciting materials.

Company determinations; information in company proxy materials. A company receiving a notice as outlined above would be required to determine whether (1) the nominating security holder

or group has complied with the provisions of proposed Exchange Act Rule 14a- 11 and (2) each security holder nominee satisfies applicable requirements. If the company determines that such requirements have been met, it would be required to include certain specified information about each such nominee in its proxy materials. The company, in its discretion, may choose also to include statements supporting company nominees and/or opposing security holder nominee(s) that go beyond a mere recommendation to vote in favor of, or withhold votes for, specified candidates. If the company includes such additional statements, it would be required to give the nominating security holder or group the opportunity to include its own statement of support for its nominee(s) in the proxy materials. The SEC requests comment on, among other things: (1) whether to incorporate a procedure whereby the company could gather information additional to that in the notice provided by the nominating security holder or group that is reasonably necessary for the company to determine whether it is required to include a security holder nominee in its proxy materials; (2) if yes, whether such procedure should be the same for operating companies, investment companies and business development companies, or whether there should be unique procedures for each type of entity; (3) whether it is appropriate for a company to make the specified determinations regarding the basis on which a nominee would not be included and, if so, by what means should the company's determination be subject to review (e.g., by the courts, the SEC, the SEC staff); and (4) whether there should be a mechanism by which a nominating security holder or group could "cure" a defective notice and, if so, how such a mechanism should be structured.

II. Miscellaneous Issues

Liability under the federal securities laws.

The nominating security holder or group, and not the company, would be liable for any false or misleading statements included in its notice to the company. If the company chooses, however, to incorporate by reference any statements from the notice into the company's proxy materials, the disclosure of that information would be treated as the company's own statement for purposes of determining liability under the federal securities laws.

7 Solicitations by a nominating security holder or group.

The SEC proposes a limited exception from certain of the proxy rules under the Exchange Act that would enable security holders of a company to communicate for the purpose of forming a nominating security holder group without having to file and disseminate a proxy statement. The SEC also proposes to permit more flexibility for nominating security holders in their soliciting activities than would exist under the current proxy rules.

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