

SEC Adopts Final Rules Requiring Disclosure of Nominating Committee Functions and Communications Between Shareholders and Boards of Directors

On November 19, 2003, the SEC adopted final rules requiring new disclosure by public companies of (i) nominating committee processes and (ii) the process by which shareholders may communicate with directors. We previously sent an SEC Alert that described the SEC's proposed rules on this topic, which is available on our website at www.ropesgray.com under "News and Events." Except for a few minor modifications, the final rules are substantially the same as the rules proposed in August. In this Alert, we summarize the final rules and highlight any changes from the proposed rules.

The final rules may be found on the SEC's website at: <http://www.sec.gov/rules/final/33-8340.htm>

Effective Date

The new rules apply to proxy and information statements first sent or given to shareholders on or after January 1, 2004 and to periodic reports for the first reporting period ending after January 1, 2004. Thus, the rules will apply to the upcoming proxy season.

Final Rules Requiring Additional Disclosure of Nominating Committee processes

Currently, companies must disclose in their proxy statements whether they have a nominating committee, whether the committee considers nominees recommended by shareholders, and, if so, how shareholders should submit such recommendations. The new rules require the following additional disclosure:

- *Nominating Committee*: Whether the company has a nominating or similar committee¹, and if not,
 - the reasons why it is appropriate for the company not to have a committee, and
 - the identity of each director who participates in the consideration of director nominees.
- *Nominating Committee Charter*: If the nominating committee has a charter, whether or not the charter is available to shareholders on the company's website, and if it is, the address of the company's website²; and
 - if the nominating committee does not have a charter, a statement to that effect.

¹ NYSE has adopted listing standards requiring listed companies to have nominating committees, with charters, consisting solely of independent directors. Nasdaq requires that directors be selected either by a majority of independent directors or by a nominating committee made up of independent directors. It is not required that Nasdaq companies have a nominating committee.

² There are alternative forms of disclosure of the charter, such as appending it to the proxy statement or identifying where it was previously appended. As a practical matter, companies with websites will simply post the charter.

- *Director Independence*: If the company has an exchange or Nasdaq listing, whether the members of the nominating committee are independent as defined in the listing standards where it is listed or quoted. If the company is not listed, it shall disclose whether each of the members of the nominating committee is independent³.
- *Director Nominations by Shareholders*: A description of the material elements of any policy on consideration of director candidates recommended by shareholders, including whether the committee will consider director candidates recommended by shareholders.
 - If the committee will consider shareholder nominations, the company shall provide a description of the procedures to be followed by shareholders in submitting recommendations. If, however, the nominating committee does not have a policy regarding shareholder nominations, the company shall disclose why the board believes it is not appropriate for the company to have such a policy.
 - If the nominating committee receives, by a date not later than the 120th calendar day⁴ before the date of the company's proxy statement released to shareholders in connection with the previous year's annual meeting, a recommended nominee from a shareholder or a group of shareholders that beneficially own either individually or in the aggregate over 5%⁵ of the company's common stock for at least one year as of the date of the recommendation, the company shall disclose the identity of the candidate⁶ and the shareholder or group of shareholders that recommended the candidate and whether the nominating committee chose to nominate the candidate.
- *Qualifications for Director Nominees*: A description of:
 - any specific minimum qualifications that the nominating committee believes are required for committee-recommended nominees; and
 - any specific qualities or skills that the nominating committee believes are necessary for one or more of its directors to possess⁷.

³ In determining whether a member is independent, the company must use a definition of independence of a national securities exchange or a national securities association that has been approved by the SEC. and identify the definition used. Whatever definition the company chooses, it must apply that definition consistently to all members of the nominating committee and use the same independence standards for purposes of nominating committee disclosure under this requirement and audit committee disclosure under '34 Act Rule 10A-3;

⁴ Where a company has changed its meeting date by more than 30 days, a shareholder must make its recommendation by a date that is a reasonable time before the company begins to print and mail its proxy statement in order to trigger the additional disclosures.

⁵ Where the shareholder or group members are not registered holders, the shareholder or group members must provide proof of the required ownership and holding period to the company at the time of the recommendations. The proposed rules had suggested a 3% threshold.

⁶ Such disclosure is only required with the written consent of both the shareholder or group of shareholders and the candidate to be so identified. The proposed rules did not require the disclosure of the candidate's name.

⁷ The proposed rules had also required disclosure of any specific standards for the overall structure and composition of the company's board of directors.

- *Director Nomination Process*: A description of the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by shareholders, and any differences in the manner in which the nominating committee evaluates shareholder and board recommended nominees;
- with regard to each nominee approved by the nominating committee for inclusion on the company's proxy card (other than nominees who are executive officers or who are directors standing for re-election), a statement as to which one or more of the following categories of persons or entities recommended that nominee: shareholder, non-management director, chief executive officer, other executive officer, third-party search firm, or other specified source⁸;
- *Third Party Finders Fee*: If the company pays a fee to any third party to identify or assist in identifying potential nominees, the function played by each such third party;

Any material changes in the procedure for shareholder nominations of directors must be disclosed in the Form 10-Q/OSB or 10-K/KSB for the period in which the material change occurs. Note that adoption of a shareholder nomination process will constitute a material change.

Final Rules Requiring Disclosure Regarding the Ability of Shareholders to Communicate with Board of Directors

The final rules also call for the disclosure in the company's proxy statement, when action is to be taken with respect to the election of directors, of information regarding shareholder communications with the board of directors.⁹ Such disclosure includes the following:

- Whether or not the company has a process for shareholders to send communications to the board of directors and, if not, the reasons why it is appropriate for the company not to have such a process;
 - Communications from an officer or director, or from employees, other than those made in their capacity as shareholders, are not considered communications covered by this rule.
 - Shareholder proposals submitted pursuant to SEC Rule 14a-8 are also not considered shareholder communications covered by the rule.

⁸ Companies should identify any person or entity that initially recommended or caused a particular candidate to be recommended. For example, if the chief executive officer asks a third party to evaluate a potential candidate, and that third party ultimately recommends the candidate to the nominating committee, both the chief executive officer and the third party should be identified as recommending parties in the company's disclosure. If there are multiple sources recommending a nominee, all such sources should be disclosed.

⁹ NYSE proposed listing standards would require listed companies to disclose a method for interested parties to communicate directly and confidentially with the presiding director or the non-management directors as a group.

- If the company has a process for shareholders to send communications to the board of directors, a description of the manner by which shareholders can send such communications and, if applicable, the identity of specific board members to whom shareholders can send communications;
- If all shareholder communications are not sent directly to board members, a description of the company's process for determining which communications are relayed to board members; and
 - However, a company's process for collecting and organizing shareholder communications need not be disclosed provided that the process is approved by a majority of the company's independent directors.
- The company's policy, if any, regarding director attendance at annual meetings and a statement of the number of directors that attended the prior year's annual meeting^{10,11}
 - Disclosure regarding the prior three bullets may be disclosed on the company's website rather than in the proxy statement if the company discloses in its proxy the website address where such information can be found.

Registered Investment Companies

All of these proposals apply to proxy statements of registered investment companies in the same manner that they apply to other companies, although the proposals require disclosure as to whether or not the members of the fund's nominating committee are "interested persons" rather than independent under the listing standards applicable to operating companies.

Contact Information

If you have any questions or would like to learn more about these rules, please contact your usual legal advisor at Ropes & Gray.

¹⁰ This disclosure was not required by the proposed rules.

¹¹ The proposed rule had required a description of any material action taken by the board in the preceding fiscal year as a result of communications with shareholders.