



# Federal Register

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**Friday,  
November 28, 2003**

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## **Part V**

# **Securities and Exchange Commission**

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**17 CFR Parts 228, 229, 240 et al.  
Disclosure Regarding Nominating  
Committee Functions and  
Communications Between Security  
Holders and Boards of Directors; Final  
Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 228, 229, 240, 249, 270 and 274

[Release Nos. 33-8340; 34-48825; IC-26262; File No. S7-14-03]

RIN 3235-AI90

### Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** We are adopting new disclosure requirements and amendments to existing disclosure requirements to enhance the transparency of the operations of boards of directors. Specifically, we are adopting enhancements to existing disclosure requirements regarding the operations of board nominating committees and a new disclosure requirement concerning the means, if any, by which security holders may communicate with directors. These rules require disclosure but do not mandate any particular action by a company or its board of directors; rather, the new disclosure requirements are intended to make more transparent to security holders the operation of the boards of directors of the companies in which they invest.

**DATES:** *Effective Date:* January 1, 2004.

*Compliance Dates:* Registrants must comply with these disclosure requirements in proxy or information statements that are first sent or given to security holders on or after January 1, 2004, and in Forms 10-Q, 10-QSB, 10-K, 10-KSB, and N-CSR for the first reporting period ending after January 1, 2004. Registrants may comply voluntarily with these disclosure requirements before the compliance date.

*Comments:* Comments regarding the "collection of information" requirements, within the meaning of the Paperwork Reduction Act of 1995, of Regulations S-B and S-K, and Forms 10-Q, 10-QSB, 10-K, 10-KSB, and N-CSR should be received by January 1, 2004.

**ADDRESSES:** To help us process and review your comments more efficiently, comments should be sent by one method—U.S. mail or electronic mail—only. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW.,

Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-14-03. This number should be included in the subject line if sent via electronic mail. Electronically submitted comment letters will be posted on the Commission's Internet Web site (<http://www.sec.gov>). We do not edit personal information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Lillian C. Brown, at (202) 942-2920, Andrew Thorpe, at (202) 942-2910, or Andrew Brady, at (202) 942-2900, in the Division of Corporation Finance, or with respect to investment companies, Christian L. Broadbent, at (202) 942-0721, in the Division of Investment Management, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington DC 20549.

**SUPPLEMENTARY INFORMATION:** We are adopting amendments to Item 401<sup>1</sup> of Regulation S-B<sup>2</sup> and Item 401<sup>3</sup> of Regulation S-K<sup>4</sup> under the Securities Act of 1933,<sup>5</sup> Items 7 and 22 of Schedule 14A<sup>6</sup> under the Securities Exchange Act of 1934,<sup>7</sup> Rule 30a-2<sup>8</sup> under the Investment Company Act of 1940,<sup>9</sup> Forms 10-Q<sup>10</sup> and 10-QSB<sup>11</sup> under the Exchange Act, and Form N-CSR<sup>12</sup> under the Exchange Act and the Investment Company Act. Although we are not adopting amendments to Schedule 14C<sup>13</sup> under the Exchange Act, the amendments will affect the disclosure provided in Schedule 14C, as Schedule 14C requires disclosure of some items of Schedule 14A. Similarly, although we are not adopting amendments to Forms 10-K<sup>14</sup> and 10-KSB<sup>15</sup> under the Exchange Act, the amendments to Item 401 of Regulations S-B and S-K will affect the disclosure under Forms 10-K and 10-KSB, as those forms require disclosure of the

information required by Item 401 of Regulations S-K and S-B.

### I. Background

On August 8, 2003, we proposed new disclosure standards intended to increase the transparency of nominating committee functions and the processes by which security holders may communicate with boards of directors of the companies in which they invest.<sup>16</sup> The disclosure standards that we adopt today are, in most respects, those proposed on August 8, 2003. Overall, most commenters supported new disclosure standards relating to nominating committee functions and security holder communications with directors;<sup>17</sup> however, as noted below, we received a number of comments and suggestions with regard to specific components of the proposed disclosure standards.<sup>18</sup> We have revised some elements of the proposed disclosure standards in response to these comments and suggestions.

The requirements we proposed on August 8, 2003,<sup>19</sup> and are adopting today, follow in many respects the recommendations made by the Division of Corporation Finance in a report provided to the Commission on July 15, 2003.<sup>20</sup> This report resulted from our April 14, 2003 directive to the Division to review the proxy rules relating to the election of corporate directors.<sup>21</sup> In preparing the report and developing its recommendations, the Division considered the input of members of the investing, business, legal, and academic communities.<sup>22</sup> The majority of these

<sup>16</sup> See Release No. 34-48301 (August 8, 2003) [68 FR 48724]. Comments received in response to the proposals, as well as a summary of these comments ("Summary of Comments") may be found in File No. S7-14-03 and on our Web site at <http://www.sec.gov>.

<sup>17</sup> See Summary of Comments—File No. S7-14-03.

<sup>18</sup> See *id.*

<sup>19</sup> See Release No. 34-48301 (August 8, 2003).

<sup>20</sup> The Division also recommended that we propose amendments to the proxy rules regarding the inclusion in company proxy materials of security holder nominees for election as directors. Our proposals regarding this issue were included in a separate release. See Release No. 34-48626 (October 14, 2003) [68 FR 60784]. As such, this adopting release does not address that issue directly. The Division's Staff Report to the Commission, detailing the results of its review of the proxy process related to the nomination and election of directors, can be found on our Web site at <http://www.sec.gov>. Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15, 2003).

<sup>21</sup> See Press Release No. 2003-46 (April 14, 2003).

<sup>22</sup> On May 1, 2003, we solicited public views on the Division's review of the proxy rules relating to the nomination and election of directors. See Release No. 34-47778 (May 1, 2003) [68 FR 24530]. In addition to receiving written comments, the

<sup>1</sup> 17 CFR 228.401.

<sup>2</sup> 17 CFR 228.10 *et seq.*

<sup>3</sup> 17 CFR 229.401.

<sup>4</sup> 17 CFR 229.10 *et seq.*

<sup>5</sup> 15 U.S.C. 77a *et seq.*

<sup>6</sup> 17 CFR 240.14a-101.

<sup>7</sup> 15 U.S.C. 78a *et seq.*

<sup>8</sup> 17 CFR 270.30a-2.

<sup>9</sup> 15 U.S.C. 80a-1 *et seq.*

<sup>10</sup> 17 CFR 249.308a.

<sup>11</sup> 17 CFR 249.308b.

<sup>12</sup> 17 CFR 249.331 and 17 CFR 274.128.

<sup>13</sup> 17 CFR 240.14c-101.

<sup>14</sup> 17 CFR 249.310.

<sup>15</sup> 17 CFR 249.310b.

commenters supported our decision to direct the review and, reflecting concern over corporate director accountability and recent corporate scandals, generally urged us to adopt rules that would grant security holders greater access to the nomination process and greater ability to exercise their rights and responsibilities as owners of their companies.<sup>23</sup> Many of the comments received in connection with the Division's review evidenced a growing concern among security holders that they lack sufficient input into decisions made by the boards of directors of the companies in which they invest.<sup>24</sup> Two particular areas of concern related to the nomination of candidates for election as director and the ability of security holders to communicate effectively with members of boards of directors.<sup>25</sup> We seek to address these concerns with the new disclosure standards we are adopting today.

## II. New Disclosure Requirements

### A. Disclosure Regarding Nominating Committee Processes

#### 1. Discussion

We are adopting new proxy statement disclosure requirements that will provide greater transparency regarding the nominating committee and the nomination process.<sup>26</sup> This enhanced

Division spoke with a number of interested parties representing security holders, the business community, and the legal community. Each of the comment letters received, memoranda documenting the Division's meetings, and a summary of the comments ("Summary of Comments") may be found in File No. S7-10-03 and on our Web site, <http://www.sec.gov>. Summary of Comments in Response to the Commission's Solicitation of Public Views Regarding Possible Changes to the Proxy Rules (July 15, 2003).

<sup>23</sup> See Summary of Comments—File No. S7-10-03.

<sup>24</sup> See *id.*

<sup>25</sup> See *id.*

<sup>26</sup> Prior to the effectiveness of these amendments, companies must disclose whether they have a nominating committee and, if so, whether that committee considers nominees recommended by security holders and how any such recommendations may be submitted. See Paragraphs (d)(1) and (d)(2) of Item 7 of Exchange Act Schedule 14A. See also Release No. 34-15384 (December 6, 1978) [43 FR 58522], in which the Commission adopted these disclosure standards. In the 1978 release proposing these disclosure requirements, the Commission stated generally its belief that the new disclosure requirements would facilitate improved accountability and, more specifically, that:

[I]nformation relating to nominating committees would be important to security holders because a nominating committee can, over time, have a significant impact on the composition of the board and also can improve the director selection process by increasing the range of candidates under consideration and intensifying the scrutiny given to their qualifications. Additionally, the Commission believes that the institution of nominating committees can represent a significant step in

disclosure is intended to provide security holders with additional, specific information upon which to evaluate the boards of directors and nominating committees of the companies in which they invest. Further, we intend that increased transparency of the nomination process will make that process more understandable to security holders. In particular, we are adopting a number of specific and detailed disclosure requirements because we believe that disclosure in response to each of these requirements will assist security holders in understanding each of the processes and policies of nominating committees and boards of directors regarding the nomination of candidates for director.

Detailed disclosure regarding nomination processes will provide security holders with important information regarding the management and oversight of the companies in which they invest. The specific disclosure requirements we are adopting today will cause companies to provide security holders with that information. We believe that specific, detailed disclosure requirements are necessary and appropriate to assure that investors are provided with disclosure that presents the desired degree of clarity and transparency. In the absence of these specific disclosure requirements, we believe that disclosure could be at a level of generality that would not be sufficiently useful to security holders.

Each of the requirements we are adopting today furthers the goal of providing the transparency that is necessary for security holders to understand the nomination process. For example, the rules we are adopting requiring disclosure of the following matters are necessary to give security holders a more complete overview of the nomination process for directors of the companies in which they invest:

- A company's determination whether to have a nominating committee;
- The nominating committee's charter, if any;
- The nominating committee's processes for identifying and evaluating candidates; and
- The minimum qualifications for a nominating committee-recommended nominee and any qualities and skills that the nominating committee believes are necessary or desirable for board members to possess.

increasing security holder participation in the corporate electoral process, a subject which the Commission will consider further in connection with its continuing proxy rule re-examination.

Release No. 34-14970 (July 18, 1978) [43 FR 31945].

In addition, as noted in the proposing release,<sup>27</sup> we believe that information as to whether nominating committee members are independent within the requirements of listing standards applicable to a company is meaningful to security holders in evaluating the nomination process of a company, how that process works, and the seriousness with which the nomination process is considered by a company. Further, information regarding the persons who recommended each nominee and disclosure as to whether there are third parties that receive compensation related to identifying and evaluating candidates will provide important information as to the process followed by a company.

The ability to participate in the nomination process is an important matter for security holders.<sup>28</sup> Accordingly, we believe that it is important for security holders to understand the specific application of the nomination processes to candidates put forward by security holders. Disclosure as to whether and how they may participate in a company's nomination process, and the manner in which their candidates are evaluated, including differences between how their candidates and how other candidates are evaluated, therefore, represents important information for security holders. Finally, an additional, specific disclosure requirement regarding the treatment of candidates put forward by large security holders or groups of security holders that have a long-term investment interest is appropriate, as it will provide investors with information that is useful in assessing the actions of the nominating committee.

#### 2. Disclosure Requirements

The amendments we are adopting today will expand the current proxy statement disclosure regarding a company's nominating or similar committee to include:

- A statement as to whether the company has a standing nominating committee or a committee performing similar functions<sup>29</sup> and, if the company does not have a standing nominating committee or committee performing similar functions, a statement of the basis for the view of the board of directors that it is appropriate for the company not to have such a committee and identification of each director who

<sup>27</sup> See Release No. 34-48301 (August 8, 2003).

<sup>28</sup> See Release No. 34-14970 (July 18, 1978). See also Summary of Comments "File No. S7-10-03 and Summary of Comments "File No. S7-14-03.

<sup>29</sup> As noted earlier in this release, this disclosure currently is required under Paragraph (d)(1) of Item 7 of Exchange Act Schedule 14A.

participates in the consideration of director nominees;<sup>30</sup>

- The following information regarding the company's director nomination process:<sup>31</sup>

- If the nominating committee has a charter, disclosure of whether a current copy of the charter is available to security holders on the company's Web site. If the nominating committee has a charter and a current copy of the charter is available to security holders on the company's Web site, disclosure of the company's Web site address. If the nominating committee has a charter and a current copy of the charter is not available to security holders on the company's Web site, inclusion of a copy of the charter as an appendix to the company's proxy statement at least once every three fiscal years. If a current copy of the charter is not available to security holders on the company's Web site, and is not included as an appendix to the company's proxy statement, identification of the prior fiscal year in which the charter was so included in satisfaction of the requirement;<sup>32</sup>

- If the nominating committee does not have a charter, a statement of that fact;<sup>33</sup>

- If the company is a listed issuer<sup>34</sup> whose securities are listed on a national securities exchange registered pursuant to section 6(a) of the Exchange Act<sup>35</sup> or in an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A(a) of the Exchange Act<sup>36</sup> that has independence requirements for nominating committee members, disclosure as to whether the members of the nominating committee are independent, as independence for nominating committee members is

defined in the listing standards applicable to the listed issuer;<sup>37</sup>

- If the company is not a listed issuer,<sup>38</sup> disclosure as to whether each of the members of the nominating committee is independent. In determining whether a member is independent, the company must use a definition of independence of a national securities exchange registered pursuant to section 6(a) of the Exchange Act or a national securities association registered pursuant to section 15A(a) of the Exchange Act that has been approved by the Commission (as that definition may be modified or supplemented), and state which definition it used. Whatever definition the company chooses, it must apply that definition consistently to all members of the nominating committee and use the independence standards of the same national securities exchange or national securities association for purposes of nominating committee disclosure under this requirement and audit committee disclosure required under Item 7(d)(3)(iv) of Exchange Act Schedule 14A;<sup>39</sup>

- If the nominating committee has a policy with regard to the consideration of any director candidates recommended by security holders, a description of the material elements of that policy, which shall include, but need not be limited to, a statement as to whether the committee will consider director candidates recommended by security holders;<sup>40</sup>

- If the nominating committee does not have a policy with regard to the consideration of any director candidates recommended by security holders, a statement of that fact and a statement of the basis for the view of the board of directors that it is appropriate for the company not to have such a policy;<sup>41</sup>

- If the nominating committee will consider candidates recommended by security holders, a description of the procedures to be followed by security holders in submitting such recommendations;<sup>42</sup>

- A description of any specific, minimum qualifications that the nominating committee believes must be met by a nominating committee-recommended nominee for a position on the company's board of directors, and a description of any specific qualities or skills that the nominating committee believes are necessary for one or more of the company's directors to possess;<sup>43</sup>

- A description of the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether the nominee is recommended by a security holder;<sup>44</sup>

- 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: security holder, non-management director, chief executive officer, other executive officer, third-party search firm, or other, specified source;<sup>45</sup>

- If the company pays a fee to any third party or parties to identify or evaluate or assist in identifying or

<sup>30</sup> See new Paragraph (d)(2)(i) of Item 7 of Exchange Act Schedule 14A.

<sup>31</sup> For the remainder of our discussion of this disclosure requirement, the term "nominating committee" refers to a nominating committee or similar committee or group of directors fulfilling the role of a nominating committee. That group may comprise the full board. See the Instruction to new Paragraph (d)(2)(ii) of Item 7 of Exchange Act Schedule 14A. If the company has a standing nominating committee or a committee fulfilling the role of a nominating committee, Item 7(d)(1) of Exchange Act Schedule 14A requires identification of the members of that committee. If the company does not have such a standing committee, new Paragraph (d)(2)(i) of Item 7 of Exchange Act Schedule 14A will require identification of each director who participates in the consideration of director nominees.

<sup>32</sup> See new Paragraph (d)(2)(ii)(A) of Item 7 of Exchange Act Schedule 14A.

<sup>33</sup> See new Paragraph (d)(2)(ii)(B) of Item 7 of Exchange Act Schedule 14A.

<sup>34</sup> As defined in Exchange Act Rule 10A-3 [17 CFR 240.10A-3].

<sup>35</sup> 15 U.S.C. 78f(a).

<sup>36</sup> 15 U.S.C. 78o-3(a).

<sup>37</sup> See new Paragraph (d)(2)(ii)(C) of Item 7 of Exchange Act Schedule 14A.

<sup>38</sup> As defined in Exchange Act Rule 10A-3.

<sup>39</sup> See new Paragraph (d)(2)(ii)(D) of Item 7 of Exchange Act Schedule 14A.

<sup>40</sup> See new Paragraph (d)(2)(ii)(E) of Item 7 of Exchange Act Schedule 14A. As adopted, this disclosure requirement specifies that the company's description of the material elements of its policy with regard to consideration of security holder candidates "need not" be limited to a statement as to whether the nominating committee will consider security holder-recommended candidates. This revision was made in response to a commenter's concern that the proposed requirement (that the disclosure "shall not" be limited to a statement as to whether the committee will consider security holder recommended candidates) implied that a company could not merely have a policy of considering security holder recommended candidates, but instead was required to put in place a more detailed policy with respect to consideration of such candidates. See Committee on Federal Regulation of Securities of the American Bar Association's section of Business Law ("ABA").

<sup>41</sup> See new Paragraph (d)(2)(ii)(F) of Item 7 of Exchange Act Schedule 14A.

<sup>42</sup> Prior to the effectiveness of these amendments, this disclosure is required under Paragraph (d)(2) of Item 7 of Exchange Act Schedule 14A. As a result of the amendments to Item 7 of Exchange Act Schedule 14A that we are adopting today, this requirement will be moved to new Paragraph (d)(2)(ii)(G) of Item 7 of Exchange Act Schedule 14A. In addition, we are adopting a new requirement in Regulations S-B and S-K, and a new reference to that requirement in Exchange Act Forms 10-Q and 10-QSB, that will require companies to disclose any material changes to the procedures that were previously disclosed pursuant to this item. See new Paragraph (b) of Item 5 of Part II to Exchange Act Forms 10-Q and 10-QSB, new Paragraph (g) of Item 401 of Exchange Act Regulation S-B, and new Paragraph (j) of Item 401 of Exchange Act Regulation S-K. In those instances where a material change is implemented during the last quarter of a company's fiscal year, companies will be required to include disclosure of such change in their Exchange Act Form 10-K or 10-KSB. See Item 10 of Part III of Exchange Act Form 10-K, Item 9 of Part III of Exchange Act Form 10-KSB, new Paragraph (g) of Item 401 of Exchange Act Regulation S-B, and new Paragraph (j) of Item 401 of Exchange Act Regulation S-K.

<sup>43</sup> See new Paragraph (d)(2)(ii)(H) of Item 7 of Exchange Act Schedule 14A.

<sup>44</sup> See new Paragraph (d)(2)(ii)(I) of Item 7 of Exchange Act Schedule 14A.

<sup>45</sup> See new Paragraph (d)(2)(ii)(J) of Item 7 of Exchange Act Schedule 14A.

evaluating potential nominees, disclosure of the function performed by each such third party;<sup>46</sup> and

- If the company's nominating committee received, by a date not later than the 120th calendar day before the date of the company's proxy statement released to security holders in connection with the previous year's annual meeting, a recommended nominee from a security holder that beneficially owned more than 5% of the company's voting common stock for at least one year as of the date the recommendation was made, or from a group of security holders that beneficially owned, in the aggregate, more than 5% of the company's voting common stock,<sup>47</sup> with each of the securities used to calculate that ownership held for at least one year as of the date the recommendation was made,<sup>48</sup> identification of the candidate

<sup>46</sup> See new Paragraph (d)(2)(ii)(K) of Item 7 of Exchange Act Schedule 14A.

<sup>47</sup> Our use of a more than 5% beneficial ownership threshold to trigger this additional disclosure obligation means that recommendations generally will be made by security holders or groups that have a reporting obligation under Exchange Act Regulation 13D [17 CFR 240.13d-240.13d-102]. Recommending security holders, like other beneficial owners, will continue to report on Exchange Act Schedule 13G [17 CFR 240.13d-102] or Exchange Act Schedule 13D [17 CFR 240.13d-101] based on their purpose or effect in acquiring or holding the company's securities. That determination is not intended to be affected by our adoption of this new disclosure obligation. In addition, we anticipate that security holders may communicate with each other in an effort to aggregate more than 5% of a company's securities before submitting a recommended candidate to a company's nominating committee. The determination as to what communications may be deemed solicitations, either subject to or exempt from the proxy rules, is based on facts and circumstances and is not intended to be affected by our adoption of this new disclosure obligation.

<sup>48</sup> Similar to the method used in Exchange Act Rule 14a-8 [17 CFR 240.14a-8] with regard to security holder proponents, the percentage of securities held by a recommending security holder, as well as the holding period of those securities may be determined by the company, on its own, if the security holder is the registered holder of the securities. If not, the security holder can submit one of the following to the company to evidence the required ownership and holding period:

(1) a written statement from the "record" holder of the securities (usually a broker or bank) verifying that, at the time the security holder made the recommendation, he or she had held the required securities for at least one year; or

(2) if the security holder has filed a Schedule 13D, Schedule 13G, Form 3 [17 CFR 249.103], Form 4 [17 CFR 249.104], and/or Form 5 [17 CFR 249.105], or amendments to those documents or updated forms, reflecting ownership of the securities as of or before the date of the recommendation, a copy of the schedule and/or form, and any subsequent amendments reporting a change in ownership level, as well as a written statement that the security holder continuously held the required securities for the one-year period as of the date of the recommendation.

See Instruction 3 to new Paragraph (d)(2)(ii)(L) of Item 7 of Item 7 of Exchange Act Schedule 14A.

and the security holder or security holder group that recommended the candidate and disclosure as to whether the nominating committee chose to nominate the candidate, provided, however, that no such identification or disclosure is required without the written consent of both the security holder or security holder group and the candidate to be so identified.<sup>49</sup>

### 3. Comments Regarding, and Revisions to, the Proposed Disclosure Requirements

In response to our request for comment on the proposed nominating committee disclosure requirements, a majority of commenters who supported the proposed rules believed that increased disclosure about nominating committee processes would be effective in increasing security holder understanding of the nomination process,<sup>50</sup> board accountability,<sup>51</sup> board responsiveness,<sup>52</sup> and a company's corporate governance policies.<sup>53</sup> With regard to the particular components of the proposed disclosure standards, commenters provided more specific input, which we considered carefully in revising certain of the disclosure standards that we are adopting today.

#### a. Nominating Committee Charter

Commenters generally were of the view that summary disclosure of the material terms of the nominating committee's charter within a company's proxy statement was unnecessary and would lead to excessively lengthy proxy statements.<sup>54</sup> These commenters suggested that it would be adequate to identify where the charter could be found, provide the charter to security holders upon request, and/or attach the charter to the proxy statement once

<sup>49</sup> See new Paragraph (d)(2)(ii)(L) of Item 7 of Exchange Act Schedule 14A.

<sup>50</sup> See, e.g., American Federation of State, County, and Municipal Employees ("AFSCME"); Council of Institutional Investors ("CII"); Creative Investment Research, Inc. ("CIR"); Andrew Randall; Pennsylvania State Employees' Retirement System ("SERS").

<sup>51</sup> See, e.g., J.A. Glynn & Co. ("J.A. Glynn"); Robert Schneeweiss.

<sup>52</sup> See, e.g., CII; CIR.

<sup>53</sup> See, e.g., American Community Bankers ("ACB"); California Public Employees' Retirement System ("CalPERS"); CIR; United Brotherhood of Carpenters and Joiners of America ("UBC").

<sup>54</sup> See, e.g., The Business Roundtable ("BRT"); Foley & Lardner ("Foley"); Independent Community Bankers Association ("ICBA"); International Paper Company ("Int'l Paper"); Jenkens & Gilchrist ("Jenkins"); McGuireWoods LLP ("McGuireWoods"); Committee on Securities Regulation of the Business Section of the New York State Bar Association ("NYSBAR"); Sullivan & Cromwell, LLP ("Sullivan"); Wells Fargo & Company ("Wells Fargo").

every three years (as is the case for audit committee charters).<sup>55</sup>

The disclosure standard that we are adopting today does not include the proposed requirement that companies describe the material terms of the nominating committee charter. Companies will, instead, be required to disclose whether a current copy of the charter is available to security holders on the company's Web site. Where a company does not make the charter available on its Web site, the company would be required to include a copy of the charter as an appendix to its proxy statement at least once every three fiscal years and, in those proxy statements that do not include the charter as an appendix, the company would be required to identify in which of the prior years the charter was so included. We believe that this disclosure standard will provide security holders with the information regarding a company's nominating committee that was sought in the proposal, without unduly burdening companies.

#### b. Independence of Nominating Committee Members

In response to the proposed disclosure requirement that listed issuers disclose any instance during the prior fiscal year in which any member of the nominating committee did not satisfy the definition of independence included in the listing standards to which the company is subject, a number of commenters suggested that we revise or delete this requirement.<sup>56</sup> At least one of these commenters believed that independence determinations are interpretive matters and that board members could be unaware of developments that would impact independence.<sup>57</sup> Another commenter suggested that we revise the disclosure requirement to conform to the recently adopted provision that requires companies to state whether members of their audit committees are independent, as defined in applicable listing standards.<sup>58</sup> We believe that it is appropriate to use an approach consistent with the audit committee disclosure standards. Accordingly, the disclosure standard we are adopting will require companies to disclose whether each member of the nominating committee is independent, as independence for nominating committee members is defined in the

<sup>55</sup> See, e.g., ICBA; Int'l Paper; McGuireWoods; NYSBAR.

<sup>56</sup> See, e.g., ABA; Sullivan.

<sup>57</sup> See ABA.

<sup>58</sup> See Sullivan. This disclosure requirement is set forth in Paragraph (d)(3)(iv) of Item 7 of Exchange Act Schedule 14A.

listing standards applicable to the listed issuer.

#### c. Qualifications and Skills of Candidates and Overall Board Composition

Commenters provided input with regard to the proposed requirement that companies describe the qualifications, qualities, skills, and overall composition that companies are seeking with regard to board membership. In this regard, some commenters noted that nominating committees' selection processes do not tend to be precise, and that the characteristics a nominating committee looks for may change as the composition of the board changes.<sup>59</sup> In consideration of these comments, the disclosure requirements we are adopting today do not include the proposed requirement that companies describe "any specific standards for the overall structure and composition of the company's board of directors."<sup>60</sup> We are adopting the remaining disclosure items substantially as proposed, as we believe that they will provide valuable information to security holders regarding the nomination process, without resulting in boilerplate disclosures.

Many commenters that supported the disclosure requirements suggested that we expand the requirements to require companies to disclose the extent to which they take into consideration diversity, in particular race and gender, in nominating candidates.<sup>61</sup> We have not included such a requirement in the standards we are adopting today, as we believe this particular consideration, as well as other considerations made by a company, will likely be addressed adequately by the new disclosure item requiring companies to disclose their criteria for considering board

candidates. Further, we do not view it as appropriate to identify any specific criteria that a company must address in describing the qualities it looks for in board candidates.

#### d. Sources of nominees

Some of the most extensive comment, particularly from the business and legal communities, arose from the proposal to require companies to identify the source of all director nominees, other than incumbent directors and executive officers.<sup>62</sup> Generally speaking, these commenters were of the view that, as proposed, the required disclosure would be difficult to make in a clear and accurate manner because there are multiple "sources" for most nominees.<sup>63</sup> In addition, these commenters objected to naming the specific source on the basis that this disclosure could have a "chilling effect on the search process,"<sup>64</sup> would be immaterial,<sup>65</sup> and could imply that a nominee was unqualified to serve on the board based solely on the position held by the individual (*e.g.*, the chief executive officer) who originally recommended the nominee.<sup>66</sup> While some commenters recommended that we delete this provision, others recommended that we instead require disclosure of the general category of persons who recommended the nominee (*e.g.*, management or security holders).<sup>67</sup> Another commenter recommended that we, instead, require companies to disclose whether nominees are independent from the company and, in the case of nominees proposed by security holders, from the recommending security holders.<sup>68</sup>

We continue to believe that information regarding the sources of company nominees is important for security holders; however, we have revised the disclosure standard to require companies to identify the category or categories of persons or entities that recommended each nominee. In this regard, we have retained the requirement that companies specifically note those instances where a nominee was recommended by the chief executive officer of the company. In providing the required disclosure, companies should consider what

category of person initially recommended, or otherwise brought to the attention of the nominating committee, each candidate. In disclosing the category of persons or entities that initially recommended a candidate to the nominating committee, companies should ensure that they identify also any person or entity that 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. We have provided for disclosure of more than one type of source for a nominee to address the possibility of multiple sources.

#### e. Additional Disclosure Regarding Nominees of Large, Long-Term Security Holders

The additional disclosure requirement with regard to nominees recommended by large, long-term security holders elicited a great deal of comment from most categories of commenters. Generally, commenters from the business and legal communities recommended either deleting the disclosure requirement related to security holder recommendations altogether or increasing the beneficial ownership requirement to 5% or 10% and/or increasing the holding period to two or more years.<sup>69</sup> With regard to the 5% and 10% recommendations, at least one commenter noted that those recommending security holders would be required to report their beneficial ownership under Exchange Act Regulation 13D.<sup>70</sup>

Some of the reasons given by commenters for deleting the requirement were:

- The requirement would give special status to larger security holders;<sup>71</sup>
- 3% security holders could use the disclosure requirement for their own "special interests";<sup>72</sup>
- There could be more than one triggering nomination, thus resulting in complex and confusing disclosure;<sup>73</sup>
- The requirement would create a bias to accept marginal director candidates;<sup>74</sup>

<sup>59</sup> See, *e.g.*, Foley; Jenkins; McGuireWoods; NYSBAR; Wells Fargo.

<sup>60</sup> Release No. 34-48301 (August 8, 2003).

<sup>61</sup> See, *e.g.*, Boston Common Asset Management ("Boston"); Calvert Group Ltd. ("Calvert"); Christian Brothers Investment Services ("CBIS"); Nathan Cummings Foundation ("Cummings"); Domini Social Investments LLC ("Domini"); ISIS Asset Management ("ISIS"); J.A. Glynn; James McRitchie, Editor, CorpGov.net and PERSWatch.net, Letter dated September 13, 2003 ("McRitchie2"); Mehri & Skalet PLLC ("Mehri & Skalet"); Denise L. Nappier, Connecticut State Treasurer ("Nappier"); Social Investment Forum Ltd. ("SIF"); Socially Responsible Investment Coalition ("SRIC"); William C. Thompson, Jr., Controller of the City of New York ("Thompson"); The General Board of Pension and Health Benefits of the United Methodist Church ("UMC"); Walden Asset Management ("Walden"). See also Jesse Smith Noyes Foundation ("Noyes"). We also received a number of letters that are substantially similar in content that supported additional disclosure describing board consideration of diversity. See Letter Type A ("Letter A"); Letter Type B ("Letter B").

<sup>62</sup> See, *e.g.*, ABA; BRT; Intel Corporation ("Intel"); Leggett & Platt Inc. ("Leggett"); NYSBAR; Valero Energy Corporation ("Valero"); Wells Fargo.

<sup>63</sup> See *id.*

<sup>64</sup> American Society of Corporate Secretaries. See also, American Corporate Counsel Association ("ACCA"); Valero.

<sup>65</sup> See, *e.g.*, BRT.

<sup>66</sup> See Sullivan.

<sup>67</sup> See Boston; Intel; Walden.

<sup>68</sup> See ABA.

<sup>69</sup> See, *e.g.*, ACB; ACCA; Compass Bancshares, Inc. ("Compass"); Foley; ICBA; Intel; Int'l Paper; Jenkins; Leggett; NYSBAR; Sullivan; Wells Fargo.

<sup>70</sup> See Sullivan.

<sup>71</sup> See *id.*

<sup>72</sup> *Id.* See also ABA.

<sup>73</sup> See ABA.

<sup>74</sup> See Sullivan.

• The requirements, specifically those regarding giving the reasons for rejecting nominees, would “chill” nominating committee discussions;<sup>75</sup>

- The disclosure would not be material to security holders;<sup>76</sup> and
- The disclosure would raise privacy issues for the nominating security holder and candidate.<sup>77</sup>

Conversely, this disclosure item also received strong support from security holders, many of whom recommended that we use a lower ownership percentage trigger or a trigger no more stringent than that proposed.<sup>78</sup>

With regard to the requirement that the reasons for not nominating a candidate be given, many commenters believed that this requirement would be difficult to satisfy, as:

- Nominating committee determinations are not always precise in nature;

- The disclosure would expose candidates to ridicule; and/or
- The disclosure would be an invasion of privacy for all parties involved in the process, including the nominating committee members, whose deliberations would be made public as a result of the disclosure requirement.<sup>79</sup>

Some commenters also expressed the view that this requirement would expose the company and nominating committee members to risk of litigation and would allow security holders to “second guess” the nominating committee’s determinations.<sup>80</sup> On the other hand, some commenters were of the view that we should retain the proposed disclosure standard and expand it to require companies to disclose the identity of rejected candidates, provided that the candidates consent to be so identified.<sup>81</sup>

After considering the comments, we continue to believe that disclosure of director recommendations made by large, long-term security holders would provide valuable information that would enable security holders to better understand the nomination process. We have re-evaluated the 3% threshold to trigger the additional disclosure requirement, however, and have

determined that ownership of more than 5% is a more appropriate threshold at which to require companies to provide additional disclosure.<sup>82</sup> In this regard, we agree with commenters that a more than 5% ownership threshold has a significant advantage over a lesser ownership threshold, in that recommending security holders would be subject to the beneficial ownership reporting requirements of Exchange Act Regulation 13D. We anticipate that a more than 5% ownership threshold will, in many cases, simplify the process by which a company and the recommending security holder determine that the recommending security holder satisfies the ownership threshold to trigger the additional disclosure requirement and, where a security holder or group has reported its beneficial ownership prior to making a recommendation, will help to ensure that the company and its security holders have basic information about the recommending security holder. This will benefit the company by providing the nominating committee with additional information regarding the recommending security holder and, possibly, the recommended candidate. Further, security holders will benefit through having additional information upon which they can evaluate the nominating committee’s response to the security holder recommendation.<sup>83</sup>

In addition, the new disclosure standard will require that companies make the specified disclosures, including identifying both the nominating security holder or security holder group and candidate, only in those instances where both parties have provided to the company their consent to be identified and, where the security holder or group members are not registered holders, the security holder or group members have provided proof of the required ownership and holding period to the company. A security holder or group that seeks to require a

<sup>82</sup> On October 14, 2003, we proposed new rules regarding the inclusion of security holder nominees for director in company proxy materials. See Release No. 34-48626 (October 14, 2003). The issue of the appropriate ownership threshold, if any, for any such inclusion of security holder nominees for director is a separate issue from the appropriate ownership threshold for the disclosure we are adopting today and is not addressed in this release.

<sup>83</sup> In this regard, information available to our Office of Economic Analysis indicates that, of the companies listed on the New York Stock Exchange, Nasdaq Stock Market and American Stock Exchange as of December 31, 2002, 57% had at least one institutional security holder that beneficially owned 5% of the common equity or similar securities and 1.4% had five or more such security holders. This information was derived from filings on Exchange Act Form 13-F [17 CFR 249.325] that indicated that the filing security holder had held its securities for at least one year.

company to provide disclosure related to a recommendation would provide their written consent and proof of ownership to the company at the time of the recommendation. The company would not be obligated to request such materials where a security holder or group does not otherwise provide their consent and proof of ownership.<sup>84</sup>

In consideration of the concerns expressed by commenters, including those with regard to boilerplate disclosure and privacy issues, the disclosure standard that we are adopting today does not include the proposed requirement that companies disclose the specific reasons for not nominating a candidate. The requirement will, however, require that companies identify the candidate in addition to the recommending security holder or group. While not required, a company could, of course, choose to explain why it did not nominate one or all of the security holder-recommended candidates.

We also have added language to the disclosure requirement to clarify the date by which a security holder must submit a recommended nominee in order to trigger the additional disclosure requirement by the company—a security holder’s recommendation would have to be received by a company’s nominating committee by a date not later than the 120th calendar day before the date the company’s proxy statement was released to security holders in connection with the previous year’s annual meeting.<sup>85</sup> We have added a new instruction clarifying that, where a company has changed its meeting date by more than 30 days, a security holder 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.<sup>86</sup>

In addition, we have added a new instruction that responds to commenters’ suggestion that we address how the percentage of securities owned by a nominating security holder would be calculated.<sup>87</sup> In this regard we have clarified that the percentage of securities held by a recommending security holder may be determined by reference to the

<sup>84</sup> See Instruction 4 to new Paragraph (d)(2)(ii)(L) of Item 7 of Exchange Act Schedule 14A.

<sup>85</sup> As is currently required in Exchange Act Rule 14a-8, this date would be calculated by determining the release date disclosed in the previous year’s proxy statement, increasing the year by one, and counting back 120 calendar days.

<sup>86</sup> See Instruction 2 to new Paragraph (d)(2)(ii)(L) of Item 7 of Exchange Act Schedule 14A. The new instruction is modeled after the approach used with regard to Exchange Act Rule 14a-8 security holder proposals, as set forth in Exchange Act Rule 14a-8(e)(2) [17 CFR 240.14a-8(e)(2)].

<sup>87</sup> See, e.g., ABA.

<sup>75</sup> See, e.g., *id.*

<sup>76</sup> See *id.*

<sup>77</sup> See *id.*

<sup>78</sup> See, e.g., American Federation of Labor and Congress of Industrial Organizations (“AFL-CIO”); CII; International Brotherhood of Teamsters (“IBT”); ISIS; McRitchie2; Nappier; SERS; Trillium Asset Management (“Trillium”); UBC. See also AFSCME; Association of the Bar of the City of New York’s Special Committee on Mergers, Acquisitions and Corporate Control Contests (“NYCBA”).

<sup>79</sup> See, e.g., ABA; BRT; Foley; Jenkens; NYSBAR; Sullivan; Valero.

<sup>80</sup> See, e.g., Compass; Foley; Jenkens.

<sup>81</sup> See CII; CIR; Cummings; SERS.

company's most recently filed quarterly or annual report (or any subsequent current report), unless the party relying on such report knows or has reason to believe that the information included in the report is inaccurate.<sup>88</sup>

#### 4. Interaction of the Disclosure Requirements With Recently Revised Market Listing Standards

The New York Stock Exchange and the Nasdaq Stock Market have adopted revised listing standards that, among other requirements, require listed companies to have independent nominating committees.<sup>89</sup> While these listing standard changes demonstrate the importance of the nomination process and the nominating committee, and represent a strengthening of the role and independence of the nominating committee, they do not require nominating committees to consider security holder nominees or companies to make the disclosures described in this release. The disclosure requirements we are adopting today will provide useful information to security holders regarding the nomination process, the manner of evaluating nominees, and the extent to which the boards of directors of the companies in which they invest have a process for considering, and do in fact consider, security holder recommendations. Accordingly, the disclosure requirements we are adopting today will operate in conjunction with the revised listing standards regarding nominating committees.

A number of commenters from the business and legal communities recommended that we delay adoption of the proposed disclosure standards in order to allow the new listing standards regarding nominating committees to take effect.<sup>90</sup> We agree with these commenters that the new listing standards represent a significant strengthening of the nomination process; however, we believe that the

<sup>88</sup> See Instruction 1 to new Paragraph (d)(2)(ii)(L) of Item 7 of Exchange Act Schedule 14A. The new instruction is modeled after Exchange Act Rule 13d-1(j) [17 CFR 240.13d-1(j)], which specifies on what basis beneficial holders may calculate the percentage of subject securities they hold for purposes of Exchange Act Regulation 13D.

<sup>89</sup> See Release No. 34-48745 (November 4, 2003) [68 FR 64154]. While the NYSE standards include a requirement that listed companies have an independent nominating committee (NYSE section 303A(4)(a)), the Nasdaq standards provide that the nomination of directors may, alternatively, be determined by a majority of the independent directors (NASD Rule 4350(c)). In discussing the NYSE and Nasdaq standards, our references to independent nominating committees encompass this alternative under the Nasdaq standards.

<sup>90</sup> See, e.g., ABA; ACB; ACCA; BRT; CSX Corporation; Foley; ICBA; Jenkins; Valero.

disclosure standards that we adopt today are a necessary complement to those listing standards and, accordingly, do not believe such a delay is necessary or appropriate.

#### *B. Disclosure Regarding the Ability of Security Holders To Communicate With Boards of Directors*

##### 1. Discussion

We are adopting new disclosure standards with regard to security holder communications with board members. These disclosure standards are intended to improve the transparency of board operations, as well as security holder understanding of the companies in which they invest.<sup>91</sup>

In response to our May 1, 2003 solicitation of input into the proxy process review by the Division of Corporation Finance, representatives of the business community commented that disclosure regarding the means by which security holders may communicate directly with the board of directors would address issues of accountability and responsiveness without extensive disruption or costs.<sup>92</sup> Comments from investors and investor advocacy groups also indicated the view that this disclosure would be helpful;<sup>93</sup> however, these commenters also noted that disclosure alone would not address all issues related to accountability and responsiveness.<sup>94</sup>

We received similar comment with regard to the proposed disclosure requirements, with no clear consensus as to whether the proposed rules would be an effective means to improve board accountability, board responsiveness,

<sup>91</sup> In Exchange Act Release No. 34-48745 (November 4, 2003), the Commission approved a new NYSE listing standard that addresses security holder communications with board members. This standard provides that: "In order that interested parties may be able to make their concerns known to non-management directors, a company must disclose a method for such parties to communicate directly and confidentially with the presiding director [of the non-management directors] or with non-management directors as a group." See NYSE Section 303A(3). This method could be analogous to the method in the NYSE listing standards required by Exchange Act Rule 10A-3 regarding audit committees. See Commentary to NYSE Section 303A(3). Exchange Act Rule 10A-3(b)(2) requires listing standards relating to audit committees to require that "[e]ach audit committee \* \* \* establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

<sup>92</sup> See Summary of Comments—File No. S7-10-03.

<sup>93</sup> See id.

<sup>94</sup> See id.

and corporate governance policies.<sup>95</sup> Some commenters believed the disclosure would be useful to security holders, including one commenter who expressed the view that the proposed disclosure would provide security holders with important information that provides an understanding of a company's process for communications with the board.<sup>96</sup> Conversely, other commenters did not believe that the proposed rules would be an effective means to improve board accountability, board responsiveness, and corporate governance policies and expressed the view that the disclosure would not be useful to security holders.<sup>97</sup> Overall, we continue to believe that the disclosure will provide security holders with useful information about their ability to communicate with board members. Accordingly, we are adopting, substantially as proposed, the disclosure standards related to security holder communications with board members.

##### 2. Disclosure Requirements

We are adopting a number of specific and detailed disclosure requirements regarding communications by security holders with boards of directors because we believe that these requirements will provide security holders with a better understanding of the manner in which security holders can engage in these communications. In particular, we believe that the disclosure requirements, including whether a board has a process by which security holders can communicate with it, are necessary to give security holders a better picture of a critical component of the board's interaction with security holders. Detailed disclosure regarding that process at a company, if it exists, will be important to security holders in evaluating the nature and quality of the communications process. Further, we believe that the level of specificity in the new disclosure standards will discourage boilerplate disclosure.

Companies will be required to provide the following disclosure with regard to their processes for security holder communications with board members:

- A statement as to whether or not the company's board of directors provides a process for security holders to send communications to the board of directors and, if the company does not have such a process for security holders to send communications to the board of

<sup>95</sup> See Summary of Comments—File No. S7-14-03.

<sup>96</sup> See CIR.

<sup>97</sup> See, e.g., ABA; ABA; BRT; Les Greenberg, Chairman, Committee of Concerned Shareholders, Letter dated August 9, 2003 ("CCS1"); Valero.

directors, a statement of the basis for the view of the board of directors that it is appropriate for the company not to have such a process;<sup>98</sup>

- If the company has a process for security holders to send communications to the board of directors:
- a description of the manner in which security holders can send communications to the board and, if applicable, to specified individual directors;<sup>99</sup> and
- If all security holder communications are not sent directly to board members, a description of the company's process for determining which communications will be relayed to board members;<sup>100</sup> and
- A description of the company's policy, if any, with regard to board members' attendance at annual meetings and a statement of the number of board members who attended the prior year's annual meeting.<sup>101</sup>

### 3. Comments Regarding, and Revisions to, the Proposed Disclosure Requirements

#### a. Scope of the Disclosure Requirement

We received a number of comments suggesting that we clarify the application of the disclosure requirements to communications with the board by officers, directors, employees, and agents of the company who also own company securities.<sup>102</sup> We do not believe that all communications from officers, directors, employees, and agents of the company are the types of communications that the disclosure standards should capture. We have, therefore, added a general instruction to the new disclosure requirements clarifying that:

- Communications from an officer or director of the company will not be viewed as security holder communications for purposes of the disclosure requirement;<sup>103</sup> and
- Communications from an employee or agent of the company will be viewed as security holder communications for purposes of the disclosure requirement only if those communications are made solely in such employee's or agent's capacity as a security holder.<sup>104</sup>

<sup>98</sup> See new Paragraph (h)(1) of Item 7 of Exchange Act Schedule 14A.

<sup>99</sup> See new Paragraph (h)(2)(i) of Item 7 of Exchange Act Schedule 14A.

<sup>100</sup> See new Paragraph (h)(2)(ii) of Item 7 of Exchange Act Schedule 14A.

<sup>101</sup> See new Paragraph (h)(3) of Item 7 of Exchange Act Schedule 14A.

<sup>102</sup> See, e.g., Wells Fargo.

<sup>103</sup> See Instruction 1 to new Paragraph (h) of Item 7 of Exchange Act Schedule 14A.

<sup>104</sup> See id.

In response to our request for comment as to whether the new disclosure standard should apply to communications made in connection with security holder proposals submitted pursuant to Exchange Act Rule 14a-8, one commenter suggested that it would be "inappropriate" to exclude Exchange Act Rule 14a-8 proposals from the new disclosure standard;<sup>105</sup> however, other commenters suggested that Exchange Act Rule 14a-8 communications should be expressly excluded.<sup>106</sup> In particular, one commenter noted that, "[b]oth the security holder proponent and the company are subject to specific, detailed requirements, conditions and deadlines, including regulation of the content of statements about the proposal \* \* \* There is no need to impose another disclosure requirement on this process."<sup>107</sup> We agree that the current disclosure requirements with regard to security holder proposals are adequate to inform security holders of how they may communicate with boards via that mechanism. Accordingly, we have expressly excluded security holder proposals submitted pursuant to Exchange Act Rule 14a-8, and communications made in connection with such proposals, from the definition of "security holder communications" for purposes of the new disclosure standard.<sup>108</sup>

#### b. Process for Communicating With Board Members

We proposed a standard that would have required companies to identify those directors to whom security holders could send communications. Commenters noted that they did not believe that it would be appropriate to include such a requirement on the basis that named directors could then be targeted for inappropriate correspondence and that some companies may not include specified recipients of security holder communications in their communications procedures.<sup>109</sup>

In consideration of these concerns, we have revised the disclosure requirement to specify that companies should describe how security holders can send communications to the board and, if applicable, to specified individual directors.<sup>110</sup> We also have added a new instruction providing that, in lieu of

<sup>105</sup> AFSCME.

<sup>106</sup> See NYSBAR; Valero.

<sup>107</sup> NYSBAR.

<sup>108</sup> See Instruction 2 to new Paragraph (h) of Item 7 of Exchange Act Schedule 14A.

<sup>109</sup> See NYSBAR.

<sup>110</sup> See new Paragraph (h)(2)(f) of Item 7 of Exchange Act Schedule 14A.

describing in the proxy statement the manner in which security holders may communicate with board members, the manner in which the company determines those communications that will be forwarded to board members, the company's policy regarding director attendance at annual meetings, and the number of directors who attended the prior year's annual meeting, such information may instead be placed on the company's Web site, provided that the company discloses in its proxy statement the Web site address where such information may be found.<sup>111</sup>

Commenters also expressed concern about the proposed disclosure item related to companies' policies with regard to "filtering" communications.<sup>112</sup> Some commenters suggested that extensive disclosure of a company's process for determining which communications are forwarded to board members would imply that a company was improperly blocking communications from security holders.<sup>113</sup> Such a filtering process is necessary, in the opinion of these commenters, because many security holder communications are related to company products and services, are solicitations, or otherwise relate to improper or irrelevant topics.<sup>114</sup> At least one commenter posited that the proposed disclosure item does not relate directly to company processes to facilitate communications with directors and should be deleted as unnecessary.<sup>115</sup> Another commenter suggested that we revise the disclosure requirement to clarify that purely ministerial activities, such as organizing and collating security holder communications, need not be disclosed.<sup>116</sup> Other commenters noted that, should we retain the disclosure requirement, we should not expand it to include the identity of the party that is responsible for filtering communications.<sup>117</sup>

In consideration of these comments, the disclosure item we are adopting today does not include the requirement that companies identify the department or other group within the company that is responsible for determining which communications are forwarded to directors. We also have added an instruction to clarify that a company's process for collecting and organizing security holder communications, as well

<sup>111</sup> See the Instruction to new Paragraphs (h)(2) and (h)(3) of Item 7 of Exchange Act Schedule 14A.

<sup>112</sup> See, e.g., ABA; BRT; Intel; NYSBAR; Sullivan.

<sup>113</sup> See Sullivan. See also ABA.

<sup>114</sup> See, e.g., Wells Fargo.

<sup>115</sup> See ABA.

<sup>116</sup> See Sullivan.

<sup>117</sup> See, e.g., NYSBAR; Wells Fargo.

as similar or related activities, need not be disclosed, provided that the company's process is approved by a majority of the independent directors.<sup>118</sup>

#### c. Material Actions Taken by the Board of Directors as a Result of Security Holder Communications

Many commenters expressed concern with regard to the proposal that would have required companies to describe any material action taken by the board of directors during the preceding fiscal year as a result of security holder communications.<sup>119</sup> Most of these commenters suggested deleting this disclosure requirement on the basis that it would be too difficult to tie board actions to specific security holder recommendations.<sup>120</sup> One commenter suggested that the disclosure requirement was too vague and companies would be unsure as to what actions must be disclosed.<sup>121</sup> In consideration of these concerns, the disclosure requirements we are adopting today do not include the proposed requirement related to material actions taken in response to security holder communications.

#### d. Director Attendance at Annual Meetings

In the proposing release, we asked whether there were alternative ways to achieve our objectives. We further solicited comment on whether we should provide guidance to companies or otherwise address appropriate procedures for companies to implement with regard to security holder communications with board members. We also noted that the term "communications" was meant to be broadly construed. Several commenters suggested that we require companies to disclose whether they have a policy regarding attendance by directors at annual meetings and provide information about annual meeting attendance by directors.<sup>122</sup> We believe that such a disclosure requirement would further our broad objective to provide investors with information about a company's communications

policies and general responsiveness to investors' concerns.

Directors' attendance at annual meetings can provide investors with an opportunity to communicate with directors about issues affecting the company. We are adopting a requirement that companies disclose their policy with regard to director attendance at annual meetings and the number of directors who attend the annual meetings, as that disclosure will give security holders a more complete picture of a company's policies related to opportunities for communicating with directors.

#### C. Related Disclosure in Quarterly and Annual Reports

In response to our request for comment regarding whether material changes to a company's process for security holders to submit nominees for election as director to the company should be disclosed in periodic or current reports, a number of commenters indicated the need to provide security holders with more current information regarding that process.<sup>123</sup> These commenters expressed the concern that the procedures described in a company's proxy statement could change during the course of a fiscal year, and the absence of information regarding those changes could impair significantly security holders' opportunities to submit recommended nominees.<sup>124</sup> In response to these comments, we are adopting new disclosure standards that will require companies to report any material changes to the procedures for security holder nominations in the Exchange Act Form 10-Q, 10-QSB, 10-K, or 10-KSB filed for the period in which the material change occurs.<sup>125</sup> We also are including an instruction clarifying that, for purposes of this disclosure obligation, adoption of procedures by which security holders may recommend nominees to a company's board of directors, where the company previously disclosed that it

did not have in place such procedures, will constitute a material change.<sup>126</sup>

#### D. Investment Companies

The new disclosure requirements regarding board nominating committees and security holders' communications with members of boards will apply to proxy statements of investment companies.<sup>127</sup> Investment companies currently are required to comply with Exchange Act Schedule 14A when soliciting proxies, including proxies relating to the election of directors.<sup>128</sup> Item 22(b)(14)(iv) of Exchange Act Schedule 14A requires investment companies to disclose the same information about nominating committees that currently is required for operating companies by Item 7(d)(2).<sup>129</sup> As with operating companies, the enhanced transparency provided by the amendments is intended to provide security holders with additional, specific information upon which to evaluate the boards of directors and nominating committees of the investment companies in which they invest. Commenters generally supported the application of the proposed disclosure requirements to investment companies.<sup>130</sup>

The rules that we are adopting will require disclosure as to whether or not

<sup>126</sup> See Instruction 2 to new Paragraph (g) of Item 401 of Exchange Act Regulation S-B and new Paragraph (j) of Item 401 of Exchange Act Regulation S-K.

<sup>127</sup> See Paragraphs (e) of Item 7 and (b) of Item 22 of Exchange Act Schedule 14A. The disclosure requirements will apply to business development companies as well as investment companies registered under the Investment Company Act of 1940 ("Investment Company Act"), except where otherwise noted. Business development companies are a category of closed-end investment company that are not registered under the Investment Company Act, but are subject to certain provisions of that Act. See sections 2(a)(48) and 54-65 of the Investment Company Act [15 U.S.C. 80a-2(a)(48) and 80a-53 - 64].

<sup>128</sup> See Investment Company Act Rule 20a-1 [17 CFR 270.20a-1] (requiring investment companies to comply with Regulation 14A [17 CFR 240.14a-1-240.14a-101]), Schedule 14A, and all other rules and regulations adopted pursuant to section 14(a) of the Exchange Act [15 U.S.C. 78n] that would be applicable to a proxy solicitation if it were made in respect of a security registered pursuant to section 12 of the Exchange Act [15 U.S.C. 78l].

<sup>129</sup> Investment companies are subject to Items 7 and 22(b) of Exchange Act Schedule 14A when soliciting proxies regarding the election of directors. Currently, in lieu of the disclosure required by Paragraphs (a)-(d)(2) of Item 7, investment companies must provide the information required by Paragraph (b) of Item 22. See Paragraph (e) of Item 7. We are amending Paragraph (e) of Item 7 to apply the disclosure requirements regarding nominating committees in Paragraph (d)(2) of Item 7 to investment companies, and deleting the current disclosure requirement regarding nominating committees in Paragraph (b)(14)(iv) of Item 22 as duplicative.

<sup>130</sup> See, e.g., ABA; AFL-CIO; Investment Company Institute ("ICI").

<sup>118</sup> See the Instruction to new Paragraph (h)(2)(ii) of Item 7 of Exchange Act Schedule 14A.

<sup>119</sup> See, e.g., ABA; ACB; ACCA; Warren J. Archer ("Archer"); BRT; DKW Law Group; Domini; Foley; Intel; Int'l Paper; Jenkins; NYCBAR; NYSBAR.

<sup>120</sup> See, e.g., ABA; BRT; Domini; Foley; Intel; Int'l Paper; Jenkins; NYCBAR; NYSBAR.

<sup>121</sup> See NYSBAR.

<sup>122</sup> See Amalgamated Bank and its Long View Funds ("Amalgamated"); Boston; CBIS; CII; Granary Foundation ("Granary"); Letter B; Maine Retirement System; McRitchie2; SERS; SIF; Walden. See also Connie Hansen.

<sup>123</sup> See, e.g., AFL-CIO; AFSCME; Amalgamated; CalPERS; CII; CIR; Cummings; IBT; Int'l Paper; McRitchie2; SERS; SIF; Smith; Trillium; UBC.

<sup>124</sup> See id.

<sup>125</sup> See new Paragraph (b) of Item 5 of Part II of Exchange Act Forms 10-Q and 10-QSB, new Paragraph (g) of Item 401 of Exchange Act Regulation S-B, and new Paragraph (j) of Exchange Act Regulation S-K. In those instances where a material change is implemented during the last quarter of a company's fiscal year, companies will be required to include disclosure of the change in their Exchange Act Form 10-K or 10-KSB. See Item 10 of Part III of Exchange Act Form 10-K, Item 9 of Part III of Exchange Act Form 10-KSB, new Paragraph (g) of Item 401 of Exchange Act Regulation S-B, and new Paragraph (j) of Item 401 of Exchange Act Regulation S-K.

the members of an investment company's nominating committee are "interested persons" of the company as defined in section 2(a)(19) of the Investment Company Act,<sup>131</sup> rather than independent under the listing standards of a national securities exchange or national securities association, as in the case of operating companies.<sup>132</sup> We are requiring disclosure with respect to the section 2(a)(19) test for investment companies because that test is tailored to capture the broad range of affiliations with investment advisers, principal underwriters, and others that are relevant to "independence" in the case of investment companies. Commenters generally supported the use of this test for independence in the case of investment companies.<sup>133</sup> Similarly, with respect to the instruction that states that in describing a company's process for determining which communications will be relayed to board members, collecting and organizing security holder communications need not be disclosed provided that the company's process is approved by a majority of the independent directors, we are specifying in the case of investment companies that the approval required is of a majority of the directors who are not "interested persons" under section 2(a)(19).<sup>134</sup>

As with operating companies, investment companies will be required to state which one or more of certain categories of persons or entities recommended each nominee who is approved by the nominating committee for inclusion on the company's proxy card.<sup>135</sup> However, in recognition of the fact that investment companies are generally externally managed by an investment adviser, the categories will include the following: security holder, director, chief executive officer, other executive officer, or employee of the investment company's investment adviser, principal underwriter, or any affiliated person of the investment adviser or principal underwriter. With respect to the disclosure requirement regarding nominees recommended by large, long-term security holders, we are adopting an instruction clarifying that, for a registered investment company, the percentage of securities held by a recommending security holder may be determined by reference to the

company's most recent report on Form N-CSR.<sup>136</sup>

Finally, as with operating companies, we are requiring a registered investment company to provide disclosure regarding material changes to the procedures for security holder nominations of directors. This information will be provided in Form N-CSR.<sup>137</sup>

### III. Paperwork Reduction Act

#### A. Background

The amendments to Exchange Act Schedule 14A contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.<sup>138</sup> We published a notice requesting comment on the collection of information requirements in the proposing release, and we submitted these requirements to the Office of Management and Budget for review in accordance with the PRA.<sup>139</sup> The titles for the collections of information are:

- (1) "Proxy Statements—Regulation 14A (Commission Rules 14a-1 through 14a-15 and Schedule 14A)" (OMB Control No. 3235-0059);
- (2) "Information Statements—Regulation 14C (Commission Rules 14c-1 through 14c-7 and Schedule 14C)"<sup>140</sup> (OMB Control No. 3235-0057);
- (3) "Rule 20a-1 under the Investment Company Act of 1940, Solicitations of Proxies, Consents and Authorizations" (OMB Control No. 3235-0158);<sup>141</sup>
- (4) "Form 10-K" (OMB Control No. 3235-0063);
- (5) "Form 10-KSB" (OMB Control No. 3235-0420);
- (6) "Form 10-Q" (OMB Control No. 3235-0070);

<sup>136</sup> See Instruction 1 to new Paragraph (d)(2)(ii)(L) of Item 7 of Exchange Act Schedule 14A. In the case of business development companies, which are not required to file reports on Form N-CSR, the percentage of securities would be determined by reference to the company's reports on Exchange Act Forms 10-K and 10-Q.

<sup>137</sup> See new Item 9 of Form N-CSR. We are renumbering current Items 9 and 10 as Items 10 and 11, and are adopting a conforming change to Rule 30a-2 under the Investment Company Act to reflect the renumbering of Item 10. Because business development companies file reports on Forms 10-K and 10-Q rather than Form N-CSR, they would provide the required disclosure on these forms.

<sup>138</sup> 44 U.S.C. 3501 *et seq.*

<sup>139</sup> 44 U.S.C. 3507(d) and 5 CFR 1320.11.

<sup>140</sup> Exchange Act Schedule 14C requires disclosure of some items of Exchange Act Schedule 14A. Therefore, while we are not amending the text of Exchange Act Schedule 14C, the amendments to Exchange Act Schedule 14A must also be reflected in the PRA burdens for Exchange Act Schedule 14C.

<sup>141</sup> Investment Company Act Rule 20a-1 requires registered investment companies to comply with Exchange Act Regulation 14A or 14C, as applicable. Therefore, the annual responses to Investment Company Act Rule 20a-1 reflect the number of proxy and information statements that are filed by registered investment companies.

(7) "Form 10-QSB" (OMB Control No. 3235-0416);

(8) "Regulation S-K" (OMB Control No. 3235-0071);

(9) "Regulation S-B" (OMB Control No. 3235-0417); and

(10) "Form N-CSR" (OMB Control No. 3235-0570).<sup>142</sup>

These regulations, forms and schedules were adopted pursuant to the Securities Act, Exchange Act and Investment Company Act and set forth the disclosure requirements for annual and quarterly reports and proxy and information statements filed by companies to ensure that investors are informed.<sup>143</sup> The hours and costs associated with preparing, filing, and sending these forms and schedules constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

#### B. Summary of Amendments

Under the amendments, we are expanding the disclosure that currently is required in company proxy or information statements regarding the activities of a company's nominating committee. The new disclosure requirements also will require disclosure in proxy or information statements regarding the policies and procedures regarding security holder communications with boards of directors. We are adopting new requirements for disclosure of company policies with regard to board members' attendance at annual meetings and the number of board members who attended the prior year's annual meeting, as well as disclosure in periodic reports of any material changes to company procedures for security holder nominations. Compliance with the disclosure requirements will be mandatory. There will be no mandatory

<sup>142</sup> The changes to the collections of information entitled "Regulation S-B" and "Regulation S-K" are reflected in our estimates for Forms 10-Q, 10-QSB, 10-K and 10-KSB. Therefore, we are not changing the burden estimates for those titles.

<sup>143</sup> The proxy rules apply to domestic companies with equity securities registered under section 12 of the Exchange Act and to investment companies registered under the Investment Company Act. There is a discrepancy between the number of annual reports by reporting companies and the number of proxy and information statements filed with the Commission in any given year. This is because some companies are subject to reporting requirements by virtue of section 15(d) of the Exchange Act [15 U.S.C. 78o], and therefore are not covered by the proxy rules. In addition, companies that are not listed on a national securities exchange or the Nasdaq Stock Market may not hold annual meetings and therefore would not be required to file a proxy or information statement.

<sup>131</sup> 15 U.S.C. 80a-2(a)(19).

<sup>132</sup> New Paragraph (b)(14)(ii) of Item 22 of Exchange Act Schedule 14A.

<sup>133</sup> See, e.g., ABA; ICI.

<sup>134</sup> See the Instruction to new Paragraph (h)(2)(ii) of Item 7 of Exchange Act Schedule 14A.

<sup>135</sup> See new Paragraph (d)(2)(ii)(f) of Item 7 of Exchange Act Schedule 14A.

retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

### C. Responses to Request for Comments

We requested comment on the PRA analysis contained in the proposing release. While we received only two comment letters specifically addressing our PRA analysis, we received several comment letters responding to the proposals in general.<sup>144</sup> Although we are adopting the disclosure amendments substantially as proposed, we have made some additions and subtractions to the disclosure requirements in the final rules that will have the net effect of reducing the amount of required disclosures. In response to comments, we are adding a requirement for companies to provide updates in periodic reports regarding material changes to the procedures for security holder nominations. We also are adding a requirement for companies to describe in proxy and information statements their policies regarding director attendance at annual meetings and the number of directors who attended the prior year's annual meeting. After considering the comments, we are not adopting certain of the proposed disclosure requirements. For example, the amendments will not require companies to describe:

- The material terms of their nominating committee charters;
- Any specific standards for the overall structure and composition of the board of directors;
- The specific reasons for the nominating committee's determination not to include a security holder candidate as a nominee; and
- Any material action taken by the board of directors as a result of communications from security holders.

The majority of commenters did not comment on the hours and cost burdens for companies that will result from the amendments; however, we received two comment letters that specifically addressed the paperwork burdens in the proposing release.<sup>145</sup> One commenter noted that given the number of unlisted companies, it is difficult to estimate the compliance burden.<sup>146</sup> One commenter believed that the proposing release underestimated the disclosure burden for the proposed rules, and that the

burden could be as high as 12 hours for the first year and 4 hours for following years.<sup>147</sup>

The actual paperwork burden for some companies could be 5 hours per schedule; however, in devising the estimates we considered a number of factors. For example, large companies may incur a greater paperwork burden than small companies, the pre-existing disclosure requirements may enable companies to streamline the collection of information necessary for the new disclosure, and the amendments contain more simplified disclosure requirements from the proposals, which will lower the paperwork burden. After considering these factors, we do not believe that 5 hours per schedule is an accurate burden estimate. However, after considering the comments indicating that we may have underestimated slightly the burden, we are not reducing our burden estimates for proxy and information statements, even though the amendments will reduce the amount of disclosure from that which would have been required by the proposals.

### D. Paperwork Burden Estimates

As a result of the changes described above, the reporting and cost burden estimates for the collections of information have changed. While we are not changing the paperwork burden estimates for proxy and information statements, we are adding collection of information requirements in periodic reports under the Exchange Act.

#### 1. Proxy and Information Statements

For purposes of the PRA, we estimated the annual incremental paperwork burden for proxy and information statements under the new disclosure requirements to be approximately 19,557 hours of company personnel time and a cost of approximately \$1,955,700 for the services of outside professionals.<sup>148</sup> That estimate included the time and the cost of preparing disclosure that has been appropriately reviewed by

<sup>147</sup> See Stoecklein. Using those numbers as inputs into our model, the annual incremental disclosure burden over a three-year time period would be an average of 5 hours per schedule. Accordingly, using the commenter's assumptions, the annual incremental paperwork burden for all companies to prepare the disclosure would be approximately 32,595 hours of company personnel time and a cost of approximately \$3,259,500 for the services of outside professionals.

<sup>148</sup> For convenience, the estimated PRA hour burdens have been rounded to the nearest whole number.

executive officers, the disclosure committee, in-house counsel, outside counsel, and members of the board of directors.<sup>149</sup> Because the current rules already require a company to collect and disclose information about the composition, functions, policies and procedures of its nominating committee, we factored the pre-existing burdens into our estimates for the new disclosure requirements.

We derived the paperwork burden estimates by estimating the total amount of time it will take a company to prepare and review the disclosure. We estimated that, over a three-year time period, the annual incremental disclosure burden will be an average of 3 hours per schedule. This estimate was based on two assumptions:

- Companies spend a greater amount of time preparing the disclosure in year one and will become more efficient in preparing the disclosure over the following two years;<sup>150</sup> and
- Not all proxy and information statements involve action to be taken with respect to the election of directors, and therefore will not require companies to provide the disclosure.<sup>151</sup>

This estimate represents the average burden for all companies, both large and small, that are subject to the proxy rules. We expect that the disclosure burden could be greater for larger companies and lower for smaller companies. Table 1, below, illustrates the incremental annual compliance burden of the collection of information in hours and in cost for proxy and information statements under the Exchange Act and Investment Company Act.

<sup>149</sup> In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of \$300 as the cost of outside professionals that assist companies in preparing these disclosures.

<sup>150</sup> We estimated that it will take 6 hours to prepare the disclosure in year one, 3.13 hours in year two, and 2.03 hours in year three.

<sup>151</sup> We estimate that 20% of all proxy and information statements do not include disclosure about directors, and therefore would not include the disclosure required by the amendments. This estimate is based on the proportion of preliminary proxy statements to definitive proxy statements filed in our 2002 fiscal year (2,555/8,692=29%), which has been adjusted downward by 9% to reflect the fact that some preliminary proxy statements contain disclosure about directors. This estimate is based on the rationale that preliminary proxy statements are less likely to contain disclosure about directors because registrants do not file preliminary proxy statements for security holder meetings where the matters to be acted upon involve only the election of directors or other specified matters. See Exchange Act Rule 14a-6 [17 CFR 240.14a-6].

<sup>144</sup> See discussion of comments in Part II of this release and Summary of Comments—S7-14-03.

<sup>145</sup> See ABA; Stoecklein Law Group ("Stoecklein").

<sup>146</sup> See ABA.

TABLE 1: CALCULATION OF INCREMENTAL PRA BURDEN ESTIMATES

	Annual re-sponses	Incremental hours/form	Incremental burden	75% company	25% professional	\$300 prof. cost
	(A)	(B)	(C)=(A) × (B)	(D)=(C) × 0.75	(E)=(C) × 0.25	(F)=(E) × \$300
SCH 14A .....	7,188	3.00	21,564.00	16,173	5,391.00	\$1,617,300.00
SCH 14C .....	446	3.00	1,338.00	1,004	334.50	100,350.00
Rule 20a-1 .....	1,058	3.00	3,174.00	2,381	793.50	238,050.00
Total .....	8,692	.....	.....	19,557	.....	1,955,700.00

2. Periodic Reports

For purposes of the PRA, we estimate the annual incremental paperwork burden for Exchange Act periodic reports under the new disclosure requirements to be approximately 1,311 hours of company personnel time and a cost of approximately \$131,100 for the services of outside professionals. We estimate that, over a three-year time

period, the annual incremental disclosure burden would be an average of 0.01 hours per Form 10-K and Form 10-KSB, 0.04 hours per Form 10-Q and Form 10-QSB, and 0.03 hours per Form N-CSR.<sup>152</sup> This estimate was based on the following two assumptions:

- Each year, 20% of reporting companies will change materially the procedures by which security holders

may recommend nominees to the board of directors;<sup>153</sup> and

- It will take .25 hours to prepare the disclosure regarding material changes to security holder nomination procedures.

Table 2, below, illustrates the incremental annual compliance burden of the collection of information in hours and in cost for periodic reports under the Exchange Act and Investment Company Act.

TABLE 2: CALCULATION OF INCREMENTAL PRA BURDEN ESTIMATES

	Annual re-sponses	Incremental hours/form	Incremental burden	75% company	25% professional	\$300 prof. cost
	(A)	(B)	(C)=(A) × (B)	(D)=(C) × 0.75	(E)=(C) × 0.25	(F)=(E) × \$300
10-K .....	8,484	0.01	84.84	64	21.21	\$6,000.00
10-KSB .....	3,820	0.01	38.20	29	9.55	3,000.00
10-Q .....	23,743	0.04	949.72	712	237.43	71,000.00
10-QSB .....	11,299	0.04	451.96	339	112.99	34,000.00
N-CSR .....	7,400	0.03	222.00	167	55.50	17,000.00
Total .....	.....	.....	.....	1,311	.....	\$131,000.00

E. Request for Comment

We request comment in order to (a) evaluate whether the collections of information are necessary for the proper performance of our functions, including whether the information will have practical utility, (b) evaluate the accuracy of our estimate of the burden of the collections of information, (c) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected, and (d) evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology.<sup>154</sup>

Any member of the public may direct to us any comments concerning the accuracy of this burden estimate and any suggestions for reducing this

burden. Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy of the comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, with reference to File No. S7-14-03. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7-14-03, and be submitted to the Securities and Exchange Commission, Office of Filings and Information Services, Branch of Records Management, 450 Fifth Street, NW., Washington, DC 20549. Because the

OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

IV. Cost-Benefit Analysis

A. Background

On August 8, 2003 we proposed new disclosure requirements intended to increase the transparency of nominating committee functions and the processes by which security holders may communicate with boards of directors of the companies in which they invest.<sup>155</sup> These proposals followed substantially the recommendations made by the Division of Corporation Finance in a staff report dated July 15, 2003.<sup>156</sup> In

<sup>152</sup> For example, the average burden per form for Form 10-K is calculated as follows: [(8,484 Form 10-Ks × 5% frequency of disclosure × 0.25 hours) / 8,484 Form 10-Ks] = .01. The calculation for Form 10-Q is as follows: [(23,743 Form 10-Qs × 15% frequency of disclosure × 0.25 hours) / 23,743 Form 10-Qs] = .04. The calculation for Form N-CSR is as follows: [(7,400 Form N-CSRs × 10% frequency of disclosure × 0.25 hours) / 7,400 Form N-CSRs] =

.03. The discrepancy in quotients is due to the fact that operating companies report on a quarterly basis, while registered management investment companies report on a semi-annual basis.

<sup>153</sup> Under our assumptions, 5% of operating companies will provide the disclosure each quarter (for a total of 20%), while 10% of registered management investment companies will provide the information semi-annually (for a total of 20%).

<sup>154</sup> Comments are requested pursuant to 44 U.S.C. 3506(c)(2)(B).

<sup>155</sup> See Release No. 34-48301 (August 8, 2003).

<sup>156</sup> See Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15, 2003). The Division's Staff Report, detailing the results of its review of the proxy process related to

committee functions and the processes by which security holders may communicate with boards of directors of the companies in which they invest.<sup>155</sup>

\_\_\_\_\_ preparing this report and developing its recommendations, the Division

These proposals followed substantially the recommendations made by the

\_\_\_\_\_ considered the input of members of the investing, business, legal, and academic communities.<sup>157</sup>

The Commission is adopting the

Division of Corporation Finance in a staff report dated July 15, 2003.<sup>156</sup> In

\_\_\_\_\_ <sup>156</sup> See Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15, 2003). The Division's Staff Report, detailing the results of its review of the proxy process related to

On balance, we believe these estimates are reasonable.

To the extent that the new disclosures influence corporate behavior, however, the costs would extend beyond a disclosure burden. For example, companies may incur additional costs in instituting more responsive policies and procedures regarding director nominations and security holder communications. We have not included these costs in our analysis of the additional disclosure requirement, but have sought comment regarding such costs and related matters. After considering the comments, which are summarized below, we continue to believe that the amendments provide useful information to investors. The amendments do not require a company to adopt any particular policies and procedures. To the extent that a company voluntarily incurs the expense of adopting more responsive board policies, we believe that those costs are justified by the benefits of such policies.

In response to our request for comment, one commenter noted that the initial cost of implementing and maintaining procedures would be high.<sup>173</sup> This commenter identified the indirect cost of the increase in the amount of time that must be spent monitoring corporate activities, which may detract from effective management of the company.<sup>174</sup> The commenter identified costs such as legal fees associated with structuring and reviewing policies, the cost of management time related to structuring policies, fees paid to accountants for managerial and financial statement creation and review, opportunity costs related to missed business opportunities, and other costs.<sup>175</sup>

One commenter believed that the rules could be “extremely costly, time-consuming and potentially disruptive.”<sup>176</sup> This commenter explained that the rules could increase significantly the number of communications that are sent to board members and the more corporate directors must divide their time, the less effectively they will discharge their competing functions.<sup>177</sup> Two commenters believed that the disclosure requirements would increase the burden on boards and discourage service.<sup>178</sup>

#### D. Small Business Issuers

Although the new rules apply to small business issuers, we do not anticipate any disproportionate impact on small business issuers. Like other issuers, small business issuers should incur relatively minor compliance costs to fulfill their disclosure obligations, and should find it unnecessary to hire extra personnel. Several commenters supported requiring small companies to provide the disclosure.<sup>179</sup>

Other commenters recommended granting outright relief to small businesses or deferring application of the rules to small businesses until the Commission evaluates the impact of the rules.<sup>180</sup> One commenter suggested that small companies that have established procedures could comply voluntarily.<sup>181</sup> These commenters sought relief for small businesses for several reasons. One commenter recommended that we not apply the rules to small businesses because it will “waste the money of small publicly held companies, create confusion \* \* \* and provide no useful service to security holders.”<sup>182</sup> This commenter noted that there does not appear to be a significant number of instances where major security holders of small publicly held companies were unable to communicate with boards of directors, particularly because major security holders are in management and/or on the board.<sup>183</sup> Further, this commenter was of the view that, because major unaffiliated security holders potentially can impact the trading price of small business securities, management and the board “take the views of major unaffiliated security holders very seriously.”<sup>184</sup> This commenter also noted that the board and security holders will not agree on every aspect of running the company and it is not clear why small businesses need to set up a procedure for every communication with security holders.<sup>185</sup>

One commenter noted that increasing the incremental cost to small businesses by a certain number of hours and assuming that the staff is available already is flawed.<sup>186</sup> One commenter believed that the benefits of increased disclosure would not outweigh a small business issuer’s need to reduce

expenses.<sup>187</sup> This commenter noted that, as regulatory requirements increase, small businesses will have to hire additional staff or reduce the number of hours spent managing the company.<sup>188</sup>

After reviewing these comments, we are convinced that issues relating to corporate accountability and security holder rights affect small companies as much as they affect large companies. The concerns raised by the commenters addressed primarily the cost of establishing and maintaining new board policies and procedures—not the cost of the disclosure required by the amendments. A small business issuer is not required to adopt new policies and procedures under the amendments. Thus, we do not believe that applying the rules to small business issuers would be inconsistent with the policies underlying the small business issuer disclosure system.

#### V. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act<sup>189</sup> requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The amendments are intended to make information about the functions of a company’s nominating committee of the board of directors, as well as the ability of security holders to communicate with the board of directors, more transparent to investors. We anticipate that the new rules will provide increased information upon which to evaluate the functioning of boards of directors and make investment decisions. The rules may affect competition because they will allow companies to consider their existing policies in relation to policies adopted by other companies. As a result, companies may compete to adopt policies that effectively balance security holder and director interests and, therefore, attract investors.

We have identified one possible area where the rules could potentially place a burden on competition. The new disclosure will enable investors to compare companies’ policies and procedures for director nominations and communications with directors. To the

<sup>179</sup> See CalPERS; CII; Granary; Letter B; McRitchie2; SERS; SIF; Trillium.

<sup>180</sup> See ABA; Archer; Foley; Stoecklein.

<sup>181</sup> See ABA.

<sup>182</sup> See Archer.

<sup>183</sup> See *id.*

<sup>184</sup> See *id.*

<sup>185</sup> See *id.*

<sup>186</sup> See *id.*

<sup>187</sup> See Stoecklein.

<sup>188</sup> See *id.*

<sup>189</sup> 15 U.S.C. 78w(a)(2).

<sup>173</sup> See CIR.

<sup>174</sup> See *id.*

<sup>175</sup> See *id.*

<sup>176</sup> See Foley.

<sup>177</sup> See *id.*

<sup>178</sup> See CIR; Foley.

extent that investors may place a premium on a company that provides security holders with favorable director nomination and communication procedures, a company will be at a disadvantage to other companies that maintain more favorable procedures.

Section 2(b) of the Securities Act,<sup>190</sup> section 3(f) of the Exchange Act<sup>191</sup> and section 2(c) of the Investment Company Act<sup>192</sup> require us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. We believe the disclosure will make information about the operation of a company's director nomination process more transparent. In addition, disclosure regarding the means by which security holders may communicate directly with a company's board of directors may increase security holder involvement in the companies in which they invest. As a result, we believe that investors may be able to evaluate a company's board of directors more effectively and make more informed investment decisions. We believe that, as a consequence of these developments, there may be some positive impact on the efficiency of markets and capital formation. The possibility of these effects, their magnitude if they were to occur, and the extent to which they will be offset by the costs of the new rules, are difficult to quantify.

We requested comment on these matters in the proposing release. We received no comments in response to these requests.

## VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act.<sup>193</sup> This FRFA involves amendments to Items 7 and 22 of Exchange Act Schedule 14A, Item 5 of Exchange Act Forms 10-Q and 10-QSB, Form N-CSR, and Item 401 of Regulations S-B and S-K. The amendments will expand the disclosure that currently is required in company filings regarding the functions of a company's nominating committee. In addition, the amendments will require disclosure regarding the policies and procedures regarding security holder

communications with boards of directors. An Initial Regulatory Flexibility Analysis was prepared in accordance with the Regulatory Flexibility Act<sup>194</sup> in conjunction with the proposing release. The proposing release included the IRFA and solicited comments on it.

### A. Need for the Amendments

The amendments are designed to address the growing concern among security holders over the accountability of corporate directors and the lack of sufficient security holder input into decisions made by the boards of directors of the companies in which they invest. Currently, companies must state whether they have a nominating committee and, if so, must identify the members of the nominating committee, state the number of committee meetings held, and briefly describe the functions performed by such committees.<sup>195</sup> In addition, if a company has a nominating or similar committee, it must state whether the committee considers nominees recommended by security holders and, if so, must describe how security holders may submit recommended nominees.<sup>196</sup> The amendments are designed to build upon existing disclosure requirements to elicit a more detailed discussion of the policies and procedures of nominating committees as well as the means by which security holders can communicate with boards of directors.

The amended disclosure requirements are designed to enhance transparency of the policies of boards of directors, with the goal of providing security holders a better understanding of the functions and activities of the boards of the companies in which they invest. For example, the amendments relating to nominating committees will require disclosure about the source of director candidates and the level of scrutiny accorded to each candidate. The amendments relating to security holder communications with directors may strengthen the association among security holders and directors by providing security holders with a better understanding of the means by which they may communicate with board members. For example, the amended disclosure will inform security holders of the manner in which to send communications to the board. Moreover, the amendments aim to enable investors to better evaluate a company's

responsiveness to security holder issues and inquiries by illuminating the degree of director involvement with security holder concerns.

### B. Significant Issues Raised by Public Comment

The Initial Regulatory Flexibility Analysis appeared in the proposing release. We requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposals, the nature of the impact, how to quantify the number of small entities that would be affected, and how to quantify the impact of the proposals. While we did not receive any comments that responded directly to the IRFA, we did receive comments addressing the impact on small business issuers. Several commenters supported requiring small companies to provide the disclosure.<sup>197</sup> In that regard, commenters stated, "enhanced disclosure would be of great value to all types of investors."<sup>198</sup> Other commenters recommended granting outright relief to small businesses or deferring application of the rules to small businesses until the Commission evaluates the impact of the rules.<sup>199</sup> One commenter suggested that small companies that have established procedures could comply voluntarily.<sup>200</sup>

Those commenters who sought relief for small businesses did so for several reasons. One commenter recommended that we not apply the rules to small businesses because it will "waste the money of small publicly held companies, create confusion \* \* \* and provide no useful service to security holders."<sup>201</sup> This commenter noted that there does not appear to be a significant number of instances where major security holders of small publicly held companies were unable to communicate with boards of directors, particularly because major security holders are in management and/or on the board.<sup>202</sup> Further, this commenter was of the view that, because major unaffiliated security holders potentially can impact the trading price of small business securities, management and the board "take the views of major unaffiliated security holders very seriously."<sup>203</sup> This commenter also noted that the board and security holders will not agree on every aspect of running the company and it is not clear why small businesses

<sup>197</sup> See CalPERS; CII; Granary; Letter B; McRitchie2; SERS; SIF; Trillium.

<sup>198</sup> See Letter B; McRitchie2.

<sup>199</sup> See ABA; Archer; Foley; Stoecklein.

<sup>200</sup> See ABA.

<sup>201</sup> See Archer.

<sup>202</sup> See *id.*

<sup>203</sup> See *id.*

<sup>190</sup> 15 U.S.C. 77b(b).

<sup>191</sup> 15 U.S.C. 78c(f).

<sup>192</sup> 15 U.S.C. 80a-2(c).

<sup>193</sup> 5 U.S.C. 601.

<sup>194</sup> 5 U.S.C. 603.

<sup>195</sup> See Paragraph (d)(1) of Item 7 of Exchange Act Schedule 14A.

<sup>196</sup> See Paragraph (d)(2) of Item 7 of Exchange Act Schedule 14A, prior to adoption of these amendments.

need to set up a procedure for every communication with security holders.<sup>204</sup>

One commenter noted that increasing the incremental cost to small businesses by a certain number of hours and assuming that the staff is available already is flawed.<sup>205</sup> One commenter believed that the benefits of increased disclosure would not outweigh a small business issuer's need to reduce expenses.<sup>206</sup> This commenter noted that, as regulatory requirements increase, small businesses will have to hire additional staff or reduce the number of hours spent managing the company.<sup>207</sup>

After reviewing these comments, we are convinced that issues relating to corporate accountability and security holder rights affect small companies as much as they affect large companies. The concerns raised by the commenters addressed primarily the cost of establishing and maintaining new board policies and procedures "not the cost of the disclosure required by the amendments. A small business issuer is not required to adopt new policies and procedures under the amendments. Thus, we do not believe that applying the rules to small business issuers would be inconsistent with the policies underlying the small business issuer disclosure system. Like other issuers, small business issuers should incur relatively minor compliance costs to fulfill their disclosure obligations, and should find it unnecessary to hire extra personnel. To the extent small businesses decide to adopt such policies, they are likely to do so because they believe the benefits justify the costs.

### C. Small Entities Subject to the Amendments

The amendments will affect companies that are small entities. Exchange Act Rule 0-10(a)<sup>208</sup> defines a company, other than an investment 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. An investment company is considered to be a "small business" 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.<sup>209</sup> As discussed below, we believe that the amendments will affect approximately 805, or 32%, of the small entities that are operating companies. We believe that the amendments also will affect approximately 50 of the small entities that are investment companies.

The Commission received 8,692 separate proxy and information statements in its 2002 fiscal year. We estimate that 6,954, or 80%, of those filings involved the election of directors, and therefore will be affected by the new disclosure requirements.<sup>210</sup> Furthermore, we estimate that 5,257 companies are "listed issuers" (as defined in Exchange Act Rule 10A-3) that are subject to the proxy rules.<sup>211</sup> Because the relevant listing standards of national securities exchanges and Nasdaq require that listed issuers hold annual meetings, and state law provides for the election of directors at annual meetings, we estimate that at least 5,257 proxy and information statements involve elections of directors.<sup>212</sup> Of these proxy and information statements, less than 225 relate to operating companies and less than 25 relate to investment companies that constitute "small entities."<sup>213</sup> Therefore, we deduced that 1,697 proxy and information statements relate to the election of directors for companies that are not "listed issuers."<sup>214</sup> We estimate that approximately 580 of the proxy and information statements for operating companies that are not "listed issuers" will be filed by small entities affected by

the new rules.<sup>215</sup> We also estimate that approximately 25 of the proxy and information statements for investment companies that are not "listed issuers" will be filed by small entities affected by the new disclosure requirements. Therefore, we estimate that the amendments will, in total, affect approximately 855 small entities.<sup>216</sup>

We requested comment on the number of small entities that would be impacted by our proposals, including any available empirical data. We received no responses to this request.

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

The amendments are expected to result in some additional costs to comply with the disclosure requirements. Because the current rules already require a company to collect and disclose information about the composition, functions, policies and procedures of its nominating committee, the disclosure should not impose significant new costs for the collection of information. Thus, the task of complying with the nominating committee disclosure could be performed by the same person or group of persons responsible for compliance under the current rules at a minimal incremental cost. Moreover, if a small entity were to maintain a process for security holders to send communications to its board of directors, company personnel would be aware of such procedures and the disclosure burden also would be minimal. If a small entity does not maintain such a process, then the disclosure will consist of a statement that the board does not have a communications process and a statement of the specific basis for the view of the board of directors that it is appropriate for the company not to have such a communications process.

To the extent that the new rules influence corporate behavior, however, the costs will extend beyond a disclosure burden. For example, companies may incur additional costs in instituting more responsive policies and procedures regarding director nominations and security holder communications. The new disclosure

<sup>215</sup> This estimate is based on the proportion of small entities that are reporting companies (2,500) to the total domestic companies quoted on the OTCBB or the Pink Sheets (7,317). We derived the latter figure from individuals within the organization called <http://www.pinksheets.com> and from the OTCBB Web site at <http://www.otcbb.com>.

<sup>216</sup> The calculation for the total number of small entities is as follows: 225 listed operating companies + 25 listed investment companies + 580 non-listed operating companies + 25 non-listed investment companies = 855.

<sup>209</sup> *Id.*

<sup>210</sup> We estimate that 20% of all proxy and information statements do not include disclosure about directors, and therefore would not include the disclosure required by the amendments. This estimate is based on the proportion of preliminary proxy statements to definitive proxy statements filed in our 2002 fiscal year (2,555/8,692=29%), which has been adjusted downward by 9% to reflect the fact that some preliminary proxy statements contain disclosure about directors. This estimate is based on the rationale that preliminary proxy statements are less likely to contain disclosure about directors because registrants do not file preliminary proxy statements for security holder meetings where the matters to be acted upon involve only the election of directors or other specified matters. See Exchange Act Rule 14a-6.

<sup>211</sup> We derived this estimate from the database provided by the Center for Research in Securities Prices at the University of Chicago, the Standard & Poors Research Insight Compustat Database ("Compustat"), and SEC Form 1392.

<sup>212</sup> See, e.g., Rule 302.00 of NYSE listing standards and Rule 4350(e) of Nasdaq listing standards.

<sup>213</sup> Data obtained from Compustat indicates that there are less than 225 listed operating companies that are small entities. Information compiled by the Commission staff indicates that there are less than 25 listed investment companies that are small entities.

<sup>214</sup> 6,536-5,257=1,697.

<sup>204</sup> See *id.*

<sup>205</sup> See *id.*

<sup>206</sup> See Stoecklein.

<sup>207</sup> See *id.*

<sup>208</sup> 17 CFR 240.0-10(a).

requirements, however, do not mandate any specific procedures.

For purposes of the PRA, we estimated that it will take an average of approximately 3 hours per year for companies, large and small, to comply with the new disclosure requirements. We estimated that 75% of the compliance burden will be carried by the company internally and that 25% of the compliance burden will be carried by outside professionals retained by the company. Thus, we estimate the annual incremental paperwork burden for a company subject to the proxy rules will be 2.4 hours per company, which translates into an estimated cost of \$204 per company,<sup>217</sup> and a cost of approximately \$240 per company for the services of outside professionals.<sup>218</sup> A cost of \$444 per small entity may not, however, constitute a significant economic impact. That conclusion is based on our analysis of 1,245 small entities available on the Compustat database. We found that the average revenue of those small entities is \$2.07 million per company. Therefore, on average, the estimated \$444 compliance expense will constitute approximately .02% of a small entity's revenues, based on the Compustat data.

*E. Agency Action To Minimize Effect on Small Entities*

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposals, we considered the following alternatives:

- (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities;
- (b) The clarification, consolidation, or simplification of disclosure for small entities;
- (c) The use of performance rather than design standards; and
- (d) An exemption for small entities from coverage under the proposals.

The Commission has considered a variety of reforms to achieve its regulatory objectives. As one possible approach, we considered requiring companies to include the security holder's proxy card and materials in the

company mailing. Alternatively, we considered amending or reinterpreting Exchange Act Rule 14a-8(i)(8)<sup>219</sup> to allow security holder proposals requesting access to the company's proxy card for the purpose of making nominations. We believe that the current disclosure requirements are the most cost-effective approach to address specific concerns related to small entities because the proposals build on existing disclosure requirements.

We have drafted the new disclosure rules to require clear and straightforward disclosure of a company's policies and procedures regarding the nomination of directors and security holder communications. Separate disclosure requirements for small entities would not yield the disclosure that we believe to be necessary to achieve our objectives. In addition, the informational needs of investors in small entities are typically as great as the needs of investors in larger companies. Therefore, it did not seem appropriate to develop separate requirements for small entities involving clarification, consolidation, or simplification of the disclosure.

We have used design rather than performance standards in connection with the new requirements for two reasons. First, based on our past experience, we believe the disclosure will be more useful to investors if there are enumerated informational requirements. The mandated disclosures may be likely to result in a more focused and comprehensive discussion. Second, more precise disclosure requirements will promote more consistent disclosure among a cross-section of public companies because they will have greater certainty as to the required disclosure. In addition, more precise disclosure requirements will improve our ability to enforce the rules. Therefore, adding to the disclosure requirements in existing proxy and information statements appears to be the most effective method of eliciting the disclosure.

**VII. Statutory Basis and Text of Amendments**

The amendments are being adopted pursuant to sections 2,<sup>220</sup> 6,<sup>221</sup> 7,<sup>222</sup> 10,<sup>223</sup> and 19<sup>224</sup> of the Securities Act, sections 3(b),<sup>225</sup> 12, 13,<sup>226</sup> 14, 15,

23(a)<sup>227</sup> and 36<sup>228</sup> of the Exchange Act, as amended, and sections 8,<sup>229</sup> 20(a),<sup>230</sup> 30,<sup>231</sup> 31,<sup>232</sup> and 38<sup>233</sup> of the Investment Company Act, as amended.

**List of Subjects**

17 CFR Parts 228, 229, 240 and 249

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

**Text of the Amendments**

■ In accordance with the foregoing, the Securities and Exchange Commission amends Title 17, chapter II of the Code of Federal Regulations as follows:

**PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS**

■ 1. The general authority citation for Part 228 is revised to read as follows:

**Authority:** 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350.  
\* \* \* \* \*

■ 2. Amend § 228.401 by adding paragraph (g) to read as follows:

**§ 228.401 (Item 401) Directors, Executive Officers, Promoters and Control Persons.**

\* \* \* \* \*

(g) Describe any material changes to the procedures by which security holders may recommend nominees to the registrant's board of directors, where those changes were implemented after the registrant last provided disclosure in response to the requirements of Item 7(d)(2)(ii)(G) of Schedule 14A (§ 240.14a-101), or this Item.

*Instructions to paragraph (g) of Item 401:*

1. The disclosure required in paragraph (g) need only be provided in a registrant's quarterly or annual reports.

2. For purposes of paragraph (g), adoption of procedures by which security holders may recommend nominees to the registrant's board of directors, where the registrant's most recent disclosure in response to the requirements of Item 7(d)(2)(ii)(G) of Schedule 14A (§ 240.14a-101), or this Item, indicated that the registrant did not have in place such procedures, will constitute a material change.

<sup>217</sup> We estimate the average hourly cost of in-house personnel to be \$85. This cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry* (October 2001).

<sup>218</sup> In connection with other recent rulemakings, we have had discussions with several private law firms to estimate an hourly rate of \$300 as the cost of outside professionals that assist companies in preparing these disclosures.

<sup>219</sup> 17 CFR 240.14a-8(i)(8).

<sup>220</sup> 15 U.S.C. 77b.

<sup>221</sup> 15 U.S.C. 77f.

<sup>222</sup> 15 U.S.C. 77g.

<sup>223</sup> 15 U.S.C. 77j.

<sup>224</sup> 15 U.S.C. 77s.

<sup>225</sup> 15 U.S.C. 78c(b).

<sup>226</sup> 15 U.S.C. 78m.

<sup>227</sup> 15 U.S.C. 78w(a).

<sup>228</sup> 15 U.S.C. 78mm.

<sup>229</sup> 15 U.S.C. 80a-8.

<sup>230</sup> 15 U.S.C. 80a-20(a).

<sup>231</sup> 15 U.S.C. 80a-29.

<sup>232</sup> 15 U.S.C. 80a-30.

<sup>233</sup> 15 U.S.C. 80a-37.

**PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATIONS ACT OF 1975—REGULATION S-K**

■ 3. The general authority citation for Part 229 is revised to read as follows:

**Authority:** 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 79e, 79j, 79n, 79t, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

■ 4. Amend § 229.401 by adding paragraph (j) to read as follows:

**§ 229.401 (Item 401) Directors, executive officers, promoters and control persons.**

\* \* \* \* \*

(j) Describe any material changes to the procedures by which security holders may recommend nominees to the registrant's board of directors, where those changes were implemented after the registrant last provided disclosure in response to the requirements of Item 7(d)(2)(ii)(G) of Schedule 14A (§ 240.14a-101), or this Item.

*Instructions to paragraph (j) of Item 401:*

1. The disclosure required in paragraph (j) need only be provided in a registrant's quarterly or annual reports.

2. For purposes of paragraph (j), adoption of procedures by which security holders may recommend nominees to the registrant's board of directors, where the registrant's most recent disclosure in response to the requirements of Item 7(d)(2)(ii)(G) of Schedule 14A (§ 240.14a-101), or this Item, indicated that the registrant did not have in place such procedures, will constitute a material change.

**PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

■ 5. The general authority citation for part 240 is revised to read as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

■ 6. Amend § 240.14a-101 by:

■ a. Revising paragraph (d)(2) of Item 7;  
 ■ b. Revising the reference "paragraphs (a) through (d)(2)" in paragraph (e) of Item 7 to read "paragraphs (a) through (d)(1) and (d)(2)(ii)(D)";

■ c. Adding paragraph (h) to Item 7;  
 ■ d. Revising the reference "paragraphs (d)(3), (f) and (g)" in the introductory text of paragraph (b) of Item 22 to read "paragraphs (d)(2) (other than (d)(2)(ii)(D)), (d)(3), (f), (g), and (h)";  
 ■ e. Revising the last sentence of the introductory text of paragraph (b)(14) of Item 22;

■ f. Revising paragraph (b)(14)(ii) of Item 22;

■ g. Removing the semi-colon and "and" from the end of paragraph (b)(14)(iii) of Item 22 and in their place adding a period;

■ h. Removing paragraph (b)(14)(iv) of Item 22; and

■ i. Adding an Instruction directly after paragraph (b)(14)(iii) of Item 22.

The additions and revisions read as follows:

**§ 240.14a-101 Schedule 14A. Information required in proxy statement.**

**Schedule 14A Information**

\* \* \* \* \*

*Item 7. Directors and executive officers.*

\* \* \* \* \*

(d)(1) \* \* \*

(2)(i) If the registrant does not have a standing nominating committee or committee performing similar functions, state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a committee and identify each director who participates in the consideration of director nominees;

(ii) Provide the following information regarding the registrant's director nomination process:

(A) If the nominating committee has a charter, disclose whether a current copy of the charter is available to security holders on the registrant's Web site. If the nominating committee has a charter and a current copy of the charter is available to security holders on the registrant's Web site, provide the registrant's Web site address. If the nominating committee has a charter and a current copy of the charter is not available to security holders on the registrant's Web site, include a copy of the charter as an appendix to the registrant's proxy statement at least once every three fiscal years. If a current copy of the charter is not available to security holders on the registrant's Web site, and is not included as an appendix to the registrant's proxy statement, identify in which of the prior fiscal years the charter was so included in satisfaction of this requirement;

(B) If the nominating committee does not have a charter, state that fact;

(C) If the registrant is a listed issuer (as defined in § 240.10A-3) whose securities are listed on a national securities exchange registered pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or in an automated inter-dealer quotation system of a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78o-3(a)) that has independence requirements for nominating committee members, disclose

whether the members of the nominating committee are independent, as independence for nominating committee members is defined in the listing standards applicable to the listed issuer;

(D) If the registrant is not a listed issuer (as defined in § 240.10A-3), disclose whether each of the members of the nominating committee is independent. In determining whether a member is independent, the registrant must use a definition of independence of a national securities exchange registered pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78o-3(a)) that has been approved by the Commission (as that definition may be modified or supplemented), and state which definition it used. Whatever definition the registrant chooses, it must apply that definition consistently to all members of the nominating committee and use the independence standards of the same national securities exchange or national securities association for purposes of nominating committee disclosure under this requirement and audit committee disclosure required under paragraph (d)(3)(iv) of Item 7 of Schedule 14A (§ 240.14a-101);

(E) If the nominating committee has a policy with regard to the consideration of any director candidates recommended by security holders, provide a description of the material elements of that policy, which shall include, but need not be limited to, a statement as to whether the committee will consider director candidates recommended by security holders;

(F) If the nominating committee does not have a policy with regard to the consideration of any director candidates recommended by security holders, state that fact and state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a policy;

(G) If the nominating committee will consider candidates recommended by security holders, describe the procedures to be followed by security holders in submitting such recommendations;

(H) Describe any specific, minimum qualifications that the nominating committee believes must be met by a nominating committee-recommended nominee for a position on the registrant's board of directors, and describe any specific qualities or skills that the nominating committee believes are necessary for one or more of the registrant's directors to possess;

(I) Describe the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether the nominee is recommended by a security holder;

(J) With regard to each nominee approved by the nominating committee for inclusion on the registrant's proxy card (other than nominees who are executive officers or who are directors standing for re-election), state which one or more of the following categories of persons or entities recommended that nominee: security holder,

non-management director, chief executive officer, other executive officer, third-party search firm, or other, specified source. With regard to each such nominee approved by a nominating committee of an investment company, state which one or more of the following additional categories of persons or entities recommended that nominee: security holder, director, chief executive officer, other executive officer, or employee of the investment company's investment adviser, principal underwriter, or any affiliated person of the investment adviser or principal underwriter;

(K) If the registrant pays a fee to any third party or parties to identify or evaluate or assist in identifying or evaluating potential nominees, disclose the function performed by each such third party; and

(L) If the registrant's nominating committee received, by a date not later than the 120th calendar day before the date of the registrant's proxy statement released to security holders in connection with the previous year's annual meeting, a recommended nominee from a security holder that beneficially owned more than 5% of the registrant's voting common stock for at least one year as of the date the recommendation was made, or from a group of security holders that beneficially owned, in the aggregate, more than 5% of the registrant's voting common stock, with each of the securities used to calculate that ownership held for at least one year as of the date the recommendation was made, identify the candidate and the security holder or security holder group that recommended the candidate and disclose whether the nominating committee chose to nominate the candidate, provided, however, that no such identification or disclosure is required without the written consent of both the security holder or security holder group and the candidate to be so identified.

*Instructions to paragraph (d)(2)(ii)(L):*

1. For purposes of Item 7(d)(2)(ii)(L), the percentage of securities held by a nominating security holder may be determined using information set forth in the registrant's most recent quarterly or annual report, and any current report subsequent thereto, filed with the Commission pursuant to this Act (or, in the case of a registrant that is an investment company registered under the Investment Company Act of 1940, the registrant's most recent report on Form N-CSR (§§ 249.331 and 274.128)), unless the party relying on such report knows or has reason to believe that the information contained therein is inaccurate.

2. For purposes of the registrant's obligation to provide the disclosure specified in Item 7(d)(2)(ii)(L), where the date of the annual meeting has been changed by more than 30 days from the date of the previous year's meeting, the obligation under that Item will arise where the registrant receives the security holder recommendation a reasonable time before the registrant begins to print and mail its proxy materials.

3. For purposes of Item 7(d)(2)(ii)(L), the percentage of securities held by a recommending security holder, as well as the holding period of those securities, may be determined by the registrant if the security

holder is the registered holder of the securities. If the security holder is not the registered owner of the securities, he or she can submit one of the following to the registrant to evidence the required ownership percentage and holding period:

A. A written statement from the "record" holder of the securities (usually a broker or bank) verifying that, at the time the security holder made the recommendation, he or she had held the required securities for at least one year; or

B. If the security holder has filed a Schedule 13D (§ 240.13d-101), Schedule 13G (§ 240.13d-102), Form 3 (§ 249.103), Form 4 (§ 249.104), and/or Form 5 (§ 249.105), or amendments to those documents or updated forms, reflecting ownership of the securities as of or before the date of the recommendation, a copy of the schedule and/or form, and any subsequent amendments reporting a change in ownership level, as well as a written statement that the security holder continuously held the securities for the one-year period as of the date of the recommendation.

4. For purposes of the registrant's obligation to provide the disclosure specified in Item 7(d)(2)(ii)(L), the security holder or group must have provided to the registrant, at the time of the recommendation, the written consent of all parties to be identified and, where the security holder or group members are not registered holders, proof that the security holder or group satisfied the required ownership percentage and holding period as of the date of the recommendation.

*Instruction to paragraph (d)(2)(ii):* For purposes of Item 7(d)(2)(ii), the term "nominating committee" refers not only to nominating committees and committees performing similar functions, but also to groups of directors fulfilling the role of a nominating committee, including the entire board of directors.

(h)(1) State whether or not the registrant's board of directors provides a process for security holders to send communications to the board of directors and, if the registrant does not have such a process for security holders to send communications to the board of directors, state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a process;

(2) If the registrant has a process for security holders to send communications to the board of directors:

(i) Describe the manner in which security holders can send communications to the board and, if applicable, to specified individual directors; and

(ii) If all security holder communications are not sent directly to board members, describe the registrant's process for determining which communications will be relayed to board members; and

*Instruction to paragraph (h)(2)(ii):* For purposes of the disclosure required by this paragraph, a registrant's process for collecting and organizing security holder communications, as well as similar or related activities, need not be disclosed provided that the registrant's process is approved by a majority of the independent directors or, in the case of a registrant that is an investment

company, a majority of the directors who are not "interested persons" of the investment company as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)).

(3) Describe the registrant's policy, if any, with regard to board members' attendance at annual meetings and state the number of board members who attended the prior year's annual meeting.

*Instruction to paragraphs (h)(2) and (h)(3):* In lieu of providing the information required by paragraphs (h)(2) and (h)(3) in the proxy statement, the registrant may instead provide the registrant's Website address where such information appears.

*Instructions to paragraph (h):*

1. For purposes of this paragraph, communications from an officer or director of the registrant will not be viewed as "security holder communications." Communications from an employee or agent of the registrant will be viewed as "security holder communications" for purposes of this paragraph only if those communications are made solely in such employee's or agent's capacity as a security holder.

2. For purposes of this paragraph, security holder proposals submitted pursuant to § 240.14a-8, and communications made in connection with such proposals, will not be viewed as "security holder communications."

\* \* \* \* \*

*Item 22. Information required in investment company proxy statement.*

\* \* \* \* \*

(b) \* \* \*

(14) \* \* \* Identify the other standing committees of the Fund's board of directors, and provide the following information about each committee, including any separately designated audit committee and any nominating committee:

\* \* \* \* \*

(ii) The members of the committee and, in the case of a nominating committee, whether or not the members of the committee are "interested persons" of the Fund as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)); and

\* \* \* \* \*

*Instruction to paragraph (b)(14):* For purposes of Item 22(b)(14), the term "nominating committee" refers not only to nominating committees and committees performing similar functions, but also to groups of directors fulfilling the role of a nominating committee, including the entire board of directors.

\* \* \* \* \*

**PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934**

■ 7. The general authority citation for Part 249 is revised to read as follows:

**Authority:** 15 U.S.C. 78a *et seq.* and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

- 8. Amend Form 10-Q (referenced in § 249.308a), Item 5 of Part II—Other Information by:
  - a. Designating the existing text in Item 5 as paragraph (a);
  - b. Removing the period at the end of newly designated paragraph (a) and in its place adding “; and”; and
  - c. Adding paragraph (b).

The addition reads as follows:

**Note:** The text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-Q

\* \* \* \* \*

Part II—Other Information

\* \* \* \* \*

Item 5. Other Information.

\* \* \* \* \*

(b) Furnish the information required by Item 401(j) of Regulation S-K (§ 229.401).

\* \* \* \* \*

- 9. Amend Form 10-QSB (referenced in § 249.308b), Item 5 to Part II—Other Information by:

- a. Designating the existing text in Item 5 as paragraph (a);
- b. Removing the period at the end of newly designated paragraph (a) and in its place adding “; and”; and
- c. Adding paragraph (b).

The addition reads as follows:

**Note:** The text of Form 10-QSB does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-QSB

\* \* \* \* \*

Part II—Other Information

\* \* \* \* \*

Item 5. Other Information.

\* \* \* \* \*

(b) Furnish the information required by Item 401(g) of Regulation S-B (§ 228.401).

\* \* \* \* \*

**PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940**

- 10. The authority citation for part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

- 11. Amend § 270.30a-2 by:

- a. Revising the reference “Item 10(a)(2)” in paragraph (a) to read “Item 11(a)(2)”; and
- b. Revising the reference “Item 10(b)” in paragraph (b) to read “Item 11(b).”

**PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934**

**PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940**

- 12. The authority citation for Part 274 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

\* \* \* \* \*

- 13. Amend Form N-CSR (referenced in §§ 249.331 and 274.128) by:

- a. Revising the reference “10(a)(1)” in General Instruction D and paragraphs (c) and (f)(1) of Item 2 to read “11(a)(1)”;

- b. Redesignating Items 9 and 10 as Items 10 and 11;

- c. Adding new Item 9; and

- d. Revising the reference “Item 10” in the heading of the Instruction to newly redesignated Item 11 to read “Item 11.”

The addition reads as follows:

**Note:** The text of Form N-CSR does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-CSR

\* \* \* \* \*

Item 9. Submission of Matters to a Vote of Security Holders.

Describe any material changes to the procedures by which shareholders may recommend nominees to the registrant’s board of directors, where those changes were implemented after the registrant last provided disclosure in response to the requirements of Item 7(d)(2)(ii)(G) of Schedule 14A (17 CFR 240.14a-101), or this Item.

*Instruction:* For purposes of this Item, adoption of procedures by which shareholders may recommend nominees to the registrant’s board of directors, where the registrant’s most recent disclosure in response to the requirements of Item 7(d)(2)(ii)(G) of Schedule 14A (17 CFR 240.14a-101), or this Item, indicated that the registrant did not have in place such procedures, will constitute a material change.

\* \* \* \* \*

By the Commission.

Dated: November 24, 2003.

**Jill M. Peterson,**

*Assistant Secretary.*

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