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March 30, 2004

Via e-mail: rule-comments@sec.gov

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attention: Jonathan G. Katz, Secretary

Re: Security Holder Director Nominations
(Release No. 34-48626; IC-26206; File No. S7-19-03; RIN 3235-AI93)
(the "Proposing Release")

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law (the "Committee"). It was prepared by the Committee's Task Force on Shareholder Proposals and is supplementary to our comment letter submitted on January 7, 2004 with respect to the Proposing Release. The purpose of this letter is to comment on specific items which arose in the discussion held at the Security Holder Director Nominations Roundtable convened by the Commission on March 10, 2004 (the "Roundtable"). We appreciate the opportunity to have participated in the Roundtable.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, they do not represent the official position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committee.

Our comments concern two primary matters addressed at the Roundtable: (I) the goals of the proposed access rule and possible alternatives for improving the director selection process and (II) the proper role and authority of the Commission in regulating the director selection process.

I. GOALS AND ALTERNATIVES

We commend the Commission for conducting the Roundtable on this important subject. The Roundtable identified or emphasized several important matters that warrant further consideration by the Commission. The overriding issue raised by the Commission's Proposing Release is no less than the continued effective governance of U.S. corporations as vital economic business units. Our economy has thrived under a governance model that carefully balances the role of shareholders with the responsibility of directors to manage the corporation's affairs subject to compliance with fiduciary duties. As several commentators at the Roundtable noted, the effects of the proposed rule on the corporate governance system are likely to be significant and entail substantial uncertainty and, in our judgment, the rule as proposed threatens to alter the balance in the respective roles of directors and shareholders.

As discussed in our earlier comment letter and noted repeatedly at the Roundtable, significant changes in corporate governance have recently been adopted and there has been no opportunity to see their full impact on our governance system. These include the enhanced role of independent directors in the nominating process and mandated transparency with respect to the nomination process. A number of alternatives have been suggested for modifying the director selection process without the complexities and uncertainties involved in the access proposals discussed in the Proposing Release.

There have also been several recent examples of shareholder activity that suggest possible uses of the proposed access mechanisms for purposes that differ from those relating to the shareholder participation in the director nomination process. These include campaigns by some institutional investors to withhold votes from the nominees of some boards' audit committee members because they have approved the rendering of non-audit services by the company's auditors. We do not address the wisdom of these efforts or of a shareholder focus on such specific directorial judgments, but do question whether it is appropriate for the Commission to reward such action as it would do by the proposed rule. Clearly, the decision whether to use a company's auditor for a non-audit service (particularly given the narrow scope of permitted non-audit services under the Commission's recently adopted rules) has traditionally been one for the company's directors (subject to compliance with overall auditor independence standards), a position the Commission confirmed in implementing the auditor independence requirements of the Sarbanes-Oxley Act. However, the proposed rule would give additional import to a decision of shareholders to withhold votes on such grounds, even if that withholding results from application of mechanical standards unrelated to the overall effectiveness of the director nomination or selection process.

Another example is the recent prominent proxy campaigns against reelection of certain management and other directors. We do not comment on the merits of such campaigns but they do demonstrate to us that shareholders already have the capability to mount such campaigns and influence corporate affairs without the need for an access rule. They also demonstrate that the Commission's proposed triggering event

can be satisfied without necessarily being tied to any unresponsiveness of a company's board during the nomination process, particularly when the Commission's proposal does not make provision for remedial action being taken in response to the triggering event. For example, in a notable instance following a significant withheld vote the board promptly separated the position of chairman of the board and chief executive and indicated a willingness to meet with major investors regarding their concerns about company strategy. Notably, another company recently agreed, in response to a shareholder proposal, to nominate as a director a candidate nominated by four institutional investors. These illustrate the leverage institutional investors already have and are willing to exercise without new access rules.

The Commission should recognize that the withholding of votes for one or only a few directors does not necessarily indicate the type of dissatisfaction with management of the corporation or the director selection process that justifies imposing a shareholder nomination access regime. At the very least, the board should be given the opportunity to respond to the expression of shareholder will with respect to a particular director. Thus, for example, if the requisite percentage of votes was withheld from a director, the board should be able to negate the consequences of that withheld vote by taking appropriate action, which might include obtaining that director's resignation or agreement to resign or electing to treat that director as not being independent.

We believe that the developments discussed above and the reforms of the director nomination process already adopted by the SROs and the Commission demonstrate that a significant evolution in the director nomination and selection process is already underway. This supports the view that the Commission should carefully reassess the necessity of intervening at this time in this sensitive area, risking disruption to our corporate governance system. The substantial risks which the proposed rules would run of diminishing the ability of companies to recruit good directors and of generating repeated election contests and attendant disruption of corporate affairs have been noted repeatedly at the Roundtable and in previous submissions regarding the Proposing Release.

Furthermore, the proposed rule would give special rights to institutional holders, premised on the assumptions that they are in fact representative of the shareholder interest in general and their activism is essentially the passive exercise of the shareholder franchise. These are questionable assumptions and have at times been shown not to be the case. As we have seen, institutional investors sometimes have special interests or may be politically motivated in their voting policies. In addition, they themselves may be unrepresentative of and unresponsive to their own beneficiaries, who in virtually every case are effectively disenfranchised from decisionmaking. Moreover, some institutional investors vote automatically in accordance with self-imposed voting policies without a case-by-case review of the specific proposal or in accordance with recommendations of a limited number of proxy analysis organizations, who themselves are not beneficial owners and may owe no fiduciary duty to the institutions or those for whom the institutions purport to act. While the actions of these institutional investors and proxy analysis organizations are often well-meaning, this nevertheless is a precarious

foundation upon which to build a new corporate governance regime, as the proposed rule would tend to do. It certainly indicates that significant attention should be given to the activities of these parties and the need for transparency respecting these matters, particularly joint institutional activities relating to the access rights that would be furthered by the proposed rule.

In considering the impact of the activities of institutional shareholders and their advisors in this area, we believe the Commission should consider triggering mechanisms that affect the director selection process only on the same basis that other fundamental corporate governance changes can be made under governing law. That is, require shareholder approval at the level required for other organic changes in corporate governance processes such as charter and bylaw amendments. Ordinarily, under state law, charter amendments require approval of at least a majority of the outstanding shares entitled to vote. A by-law amendment may require a similar approval or approval of a majority of the shares voted. This approach would also mitigate the authority considerations discussed below.

Finally, in light of the various alternatives for evolution in this area raised during the Roundtable, we reiterate the view expressed in our comment letter that the Commission should defer action on its proposed rule in favor of a study of the alternatives proposed and the related areas pertinent to the directors selection process identified above

II. AUTHORITY

During the discussion concerning authority at the Roundtable, some expressed the view that the Commission's authority to mandate shareholder access to company proxy statements can be derived from the Exchange Act's broad statutory standards regarding the public interest and the protection of investors or the implied goal of fair corporate suffrage. All of these were found in the Business Roundtable decision to be too broad or vague in nature and, consistent with the intent of Congress, too tenuous to serve as a grant to the Commission of authority to regulate the internal governance matters of a corporation. The internal governance of corporations has historically been regulated by state -- not federal -- law. In Business Roundtable, the impermissible intrusion into state law involved the reallocation of voting rights among shareholders. With respect to the proposed access rule, the intrusion into state law involves other fundamental elements of internal governance, which we discuss below.

In the Proposing Release, the Commission primarily rested its claim of authority on its broad powers to regulate disclosure under the proxy rules. This contention was augmented by certain panelists who suggested that the Commission's power was derived from its authority over voting procedures. Indeed, one panelist suggested to the Commission that, when it adopted an access rule, it should to the extent possible rely primarily on its authority over procedural matters.

We believe that the proposed rule, if adopted, would involve matters of substance and not come within the Commission's authority with respect to disclosure or proxy solicitation procedures as those terms are ordinarily understood and have been defined and interpreted. In making this analysis, we follow the Business Roundtable premise that the Commission requires actual, as distinguished from interpretative or constructive, authority from the Congress to preempt state law with respect to internal corporate affairs traditionally regulated by the states.

The Business Roundtable decision concluded that the central concern of the Congress in adopting Section 14 of the Exchange Act was disclosure. The court stated "That proxy regulation bears almost exclusively on disclosure stems as a matter of necessity from the nature of proxies." The court did also recognize that disclosure is not necessarily the sole subject of the proxy rules and that the Commission had some authority under the proxy rules with respect to voting procedures.

Our reasons as to why the proposed rule involves substantive internal corporate law matters are briefly as follows:

1. Although state law generally affords shareholders a right to nominate directors, it does not establish a right of access to the corporation's proxy statement by shareholders for this purpose. Generally, shareholders have no right to act for or bind the corporation except their power to adopt by-law amendments with respect to limited subject matter. Indeed, there is a serious question regarding whether a bylaw amendment adopted by stockholders providing access to corporate proxy statements for nominees not endorsed by the board of directors would be valid because of the impinging effect it may have on the duties and responsibilities assigned to the board of directors by statute. Thus, the proposed right of access would be derived solely from a federal rule uniformly applicable to thousands of corporations which we believe would be preemptive of the state law allocations of rights and responsibilities between directors and stockholders.

The construct of the proposed rule is that shareholders by minimal action prescribed by the Commission can either opt into access or trigger the access right by withholding votes. In either case, this is stockholder action that would be inadequate under state law to establish in shareholders a right to access. In other words, the Commission's proposed rule would independently confer authority with respect to access on certain shareholders and make access virtually an organic requirement through the biannual renewal mechanism. This grant of authority would apply to all public companies that are subject to the proxy rules, regardless of the vote required to change the corporation's bylaws under state law. Under the proposed rule, the board of directors would be accorded no role in this process.

It is particularly noteworthy that the proposed rule enables certain shareholders to avoid the independent nominating committee process which the principal securities markets now -- with Commission approval and support -- require. Presumably, the purpose of independent nominating committees and the Commission's related

disclosure rules is to enable shareholders, both institutional and others, to submit candidates for bona fide consideration by the nominating committee and the board on a transparent basis. This is intended to remedy the claim of some shareholders that the nomination process has been closed to them. Under the proposed rule, a category of shareholders seemingly would not be bound by or subject to the newly-established nominating committee procedures. This intrudes on the ability of the board of directors and its nominating committee to act in this crucial area of corporate governance and impairs the nominating committee process. Moreover, the proposed rule would establish, by federal action, special rights in the same crucial area of corporate governance for certain shareholders and not others, a development not authorized under state law.

2. Under the state statutory scheme, the directors act as fiduciaries for all the stockholders. The stockholders have no accountability or fiduciary responsibility. Therefore, the proposed rule would enable stockholders to use the company's proxy materials to pursue their own interests without accountability and without check by anybody capable of acting in the best interests of the shareholders as a whole. This is a fundamental federal intrusion into the established corporate governance structure and does not protect the interests of investors. So long as there is a federal-state system of corporate regulation in the United States, SEC rulemaking should not, and in our judgment is not authorized, to extend this far.

3. Access is not a simple mechanical provision; it has substantive effects and must be evaluated on the basis of its consequences to the corporate governance of each corporation. We believe significant negative consequences are likely to follow the adoption of this rule. Proxy contests are likely to increase not only with respect to the initial access votes and attendant contested elections but also biannually when the same shareholders again have the right to seek and vote upon renewal of access. This will provoke divisiveness on boards of directors, particularly since some proponents of access believe that their candidates' mission on the board if elected would be to challenge the board. Special interests may be promoted through this process.

4. The history of limited shareholder access to company proxy materials for proposals under Rule 14a-8 does not support treating the proposed rule as a mere additional procedural regulation as part of the proxy process. In our letter of January 7, 2004 we discuss the pertinent purposes, history and effect of Rule 14a-8, which concern disclosure and shareholder communications. By its terms, Rule 14a-8 has had no applicability to director elections or to matters which are not permissible actions for shareholders under state law. This has been the governing practice for almost 60 years. In contrast to the proposed rule, Rule 14a-8 does not intrude on the board of directors' exercise of its fiduciary role in carrying out one of its core functions – providing continuity in corporate affairs by nominating directors – nor do proposals under Rule 14a-8 impose on companies the costs and risks of disruption to corporate affairs normally attendant on director election contests. A federal rule mandating that any insurgent candidate must be included on the proxy solicited by its board of directors would not be a “procedural” refinement of the proxy solicitation process. It would cross the threshold into substantive regulation of the director selection process, reallocating the

respective roles of directors and shareholders. It would be the same as a Commission requirement, even if labeled “procedural”, that a reporting company bears an insurgent’s proxy solicitation expenses or that an insurgent seeking control can use the company’s proxy statement for its own solicitation purposes. These would be expansions of the Commission’s authority under the proxy rules far beyond any application to voting procedures ever intended by Congress, as confirmed by Business Roundtable.

The proposed rule in effect would supplant or preempt the substantive requirements and structure of state law and particularly the mandated duties and responsibilities of directors in contrast to the narrow and in many cases non-existent shareholder power to require particular corporate action.

5. In the Proposing Release, the Commission does not provide specific reasons why this initiative has been undertaken. There is reference to shareholder dissatisfaction with the electoral process as a basis for defining triggering events, but this is not a substantiation of the reasons the proposed rule should be adopted. If the purpose for adoption of the proposed rule is to provide shareholders access in order to enhance their role in managing corporate affairs, that intrudes on the state statutory scheme and impedes -- and in some respects eliminates -- the ability of the directors to act as fiduciaries for the corporate interest. If the Commission has other reasons, we suggest that they be identified, since many of the arguments in favor of access that have been raised in discussion are properly matters of state law and not within the prescribed authority of the Commission. Clarity in the Commission’s goals is crucial. We have grave concern as to the unintended consequences of adoption of this rule, with its potential to produce a significant change in corporate governance -- shifting influence from boards to certain shareholders -- without accountability and with limited, if any, transparency.

CONCLUSION

We urge the Commission to consider the potential consequences of adoption of the proposed rule and seek a more collaborative mechanism to deal with this subject – and the asserted “problems” – which the Commission has already identified as involving a wide divergence of opinion. It is evident from the commentary at the Roundtable that many of the participants question the reliability of the rule and suggest alternative means be considered instead. This can only be achieved by further Commission initiatives dealing with alternative means. We hope that these comments will be helpful to the Commission and its Staff. We would be pleased to discuss with the Commission or its Staff any aspect of this letter. Questions may be directed to Robert Todd Lang (212) 310-8200, Charles Nathan (212) 906-1730 or Dixie Johnson (202) 639-7269.

Respectfully submitted,

Dixie Johnson, Chair,
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