

BY EMAIL

March 31, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth St., N.W.
Washington, D.C. 20549-0609

Re: File No. S7-19-03

Dear Mr. Katz:

This letter is submitted on behalf of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.7 trillion in annual revenues. The Business Roundtable appreciates the opportunity to comment further on the Commission's proposed "Election Contest" rules in light of the U.S. Securities and Exchange Commission's March 10 "Roundtable" on the proposal, and in view of the comments submitted by others in the rulemaking. Due to the important issues presented by this rulemaking, we are submitting more detailed comments in an attachment to this letter.

The Business Roundtable has long been a strong supporter of sound corporate governance. We share the Commission's belief that corporate boards and management must hold themselves to the highest standards of corporate governance. In this regard, the Business Roundtable has issued numerous statements regarding corporate governance, including *Principles of Corporate Governance* in May 2002; *Executive Compensation: Principles and Commentary* in November 2003; and most recently the *The Nominating Process and Corporate Governance: Principles and Commentary*. The Business Roundtable strongly supported enactment of the Sarbanes-Oxley Act of 2002, implementation of the Commission's rules related to the Sarbanes-Oxley Act, and revisions to the corporate governance listing standards of the New York Stock Exchange and NASDAQ Stock Market, Inc.

Although the Business Roundtable has supported these recent reforms, we must continue to oppose the proposed Election Contest rules for reasons set forth in the attached comments and in our earlier submissions. In brief, the Commission has failed to establish that it has the legal authority to issue the proposed rules, or that there is a need for rules of this nature. To the contrary, issuance of the proposed rules at this time is particularly inappropriate, given the sweeping changes in corporate governance already underway. The proposed rules would have widespread and harmful unintended consequences, enabling a small number of shareholders and advisory services to impose significant costs on all shareholders, often for reasons wholly unrelated to sound corporate governance or the welfare of the corporation. Indeed, the diversion of corporate attention and resources away from the day-to-day business of the corporation that would result from the proposed rules could have adverse implications for the economy as a

whole. Moreover, the rulemaking itself has been flawed in serious ways that would require re-proposal of any rule before it was finalized. For all of these reasons, we have no choice but to continue to oppose the Commission's proposed Election Contest rules.

Thank you for considering our comments on the proposed rules. We would be happy to discuss our concerns or any other matters that you believe would be helpful.

Sincerely,

A handwritten signature in black ink that reads "Steve Odland". The signature is written in a cursive, flowing style.

Steve Odland
Chairman, President & CEO
AutoZone, Inc.
Chairman – Corporate Governance Task Force
Business Roundtable

cc: Hon. William H. Donaldson, Chairman, Securities and Exchange Commission
Hon Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner
Giovanni P. Prezioso, General Counsel
Alan L. Beller, Division of Corporation Finance
Martin P. Dunn, Division of Corporation Finance

**Supplemental Detailed Comments
of
Business Roundtable
on
The “Proposed Election Contest Rules”
of the
U.S. Securities and Exchange Commission**

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BUSINESS ROUNDTABLE’S SUPPLEMENTAL DETAILED COMMENTS ON THE PROPOSED ELECTION CONTEST RULES

These comments are submitted on behalf of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and \$3.7 trillion in annual revenues. It is a supplement to the comments that we submitted to the Securities and Exchange Commission (“Commission”) on December 22, 2003.¹ The Business Roundtable appreciates the opportunity to comment further on the Commission’s rule proposal (“Proposed Election Contest Rules” or “Proposed Rules”) in light of the March 10, 2004, “Roundtable” on the proposal, and in light of the comments submitted by others in this rulemaking.

The March 10 Roundtable and the comments filed in this rulemaking confirm that the Proposed Election Contest Rules are fundamentally flawed. No convincing showing has been made of the need for these rules, or that the Commission has the authority to adopt them. The very purpose of this proposal remains uncertain—indeed, the proffered justifications for the rules have been so varied and inconsistent that, if the rules were to be finalized, they would first need to be repropose with a clear and consistent statement of purpose. That step should not be taken, however, because no rules should be adopted. Numerous well-respected and thoughtful observers—including many invited by the Commission to participate in the Roundtable—have attested to the widespread adverse effects that would result from the Proposed Rules. Based on the record before it, the Commission cannot adopt these rules consistent with its responsibilities under the Administrative Procedure Act.

The Business Roundtable has long been—and will continue to be—a strong supporter of good corporate governance. We have advocated corporate governance best practices for more than three decades, beginning in the 1970s with our first statement on corporate governance, and continuing through the 1980s and 1990s with numerous publications addressing corporate governance best practices. We strongly supported enactment of the Sarbanes-Oxley Act of 2002, implementation of the Commission’s rules related to the Sarbanes-Oxley Act, and revisions to the corporate governance listing standards of the New York Stock Exchange (“NYSE”) and NASDAQ Stock Market, Inc (“NASDAQ”). The Business Roundtable must, nonetheless, continue to oppose the Proposed Election Contest Rules for the reasons discussed in our earlier comments and for additional reasons set forth below.

These comments are divided into six sections. Section I discusses the Commission’s lack of legal authority to adopt the Proposed Rules. Section II demonstrates that the rulemaking process—from the Commission’s lack of consistent justification for the rulemaking to the Commission’s refusal to provide public access to data that it relied upon in the rulemaking—has

¹ Letter from Henry A. McKinnell, Ph.D., Chairman of the Board and Chief Executive Officer, Pfizer Inc, Chairman, Business Roundtable, to Jonathan G. Katz, U.S. Securities and Exchange Commission, including the Detailed Comments of Business Roundtable on the “Proposed Election Contest Rules” of the U.S. Securities and Exchange Commission (“Business Roundtable Detailed Comments”) and Appendix of Secondary Materials to Detailed Comments of Business Roundtable on the “Proposed Election Contest Rules” of the U.S. Securities and Exchange Commission.

been fatally flawed. Section III shows that, rather than establishing a need for the Proposed Rules, the rulemaking record confirms that they are unnecessary in light of recent reforms and improvements in corporate governance. Section IV discusses ways in which the Proposed Rules would lead to a host of harmful unintended consequences, perhaps the greatest of which would result from the vast powers bestowed on proxy advisory services and certain large institutional investors. Section V demonstrates that the Proposed Rules would result in great costs that the Commission has not considered adequately and that could have adverse implications for the economic vitality of the country as a whole. These include costs associated with increased election contests, changes in the functioning of boards of directors, and extensive complex changes to the proxy processing system that would be necessary for the Proposed Rules to function. Section VI emphasizes the Commission's legal obligation to consider adequately alternatives to the Proposed Rules. In full, these comments demonstrate that the Commission should not move forward with this rulemaking; but, in any event, it would be legally required to repropose the rules for comment before they could be adopted.

I. The Proposed Election Contest Rules Exceed The Commission's Legal Authority.

As discussed in detail in our earlier comments, the Commission lacks the legal authority to adopt the Proposed Election Contest Rules. Under the Proposed Rules, companies would for the first time be required to include shareholder nominees for director in company proxy materials. This radical transformation of corporate practice would occur not pursuant to the laws of the States—where such matters of corporate governance traditionally have been regulated—but through federal agency rulemaking. This attempted expansion of the Commission's authority has led the Chief Justice of the Supreme Court of Delaware to question “whether the Commission . . . *should* undertake to provide a substantive right in certain stockholders when the creation of that right by the Commission intrudes upon and may be in conflict with corporate internal affairs that are the province of state law.”²

Nothing that has emerged in the months since the issuance of the proposing release³ has changed the fact that the Commission lacks the legal authority to adopt the Proposed Rules.⁴ Indeed, it became clear during the Roundtable that rather than using its legal authority as a guidepost for proposing rules, the Commission has proposed rules outside the bounds of its legal authority—rules that create a substantive right rather than a right to disclosure or even a procedural right—and now is attempting to squeeze the rules within the parameters of its

² Letter from E. Norman Veasey, Chief Justice, Delaware Supreme Court, to Alan L. Beller, U.S. Securities and Exchange Commission at 1 (Mar. 11, 2004) (emphasis in original); *see also* CCH Washington Service Bureau, *Delaware Chief Justice Offers Alternative to SEC Rule Proposal*, SEC TODAY (Mar. 26, 2004) (reporting on the letter); E. Norman Veasey, Roundtable Transcript at 216 (stating that the Proposed Rules would grant shareholders a “substantive right”).

³ Security Holder Director Nominations, 68 Fed. Reg. 60,784 (Oct. 23, 2003) (“Proposing Release”).

⁴ During the Roundtable, Charles Elson also expressed the view that the Proposed Election Contest Rules implicate “federalism concerns.” *See* Charles M. Elson (Professor, University of Delaware), Roundtable Transcript at 3.

authority. Thus, one Roundtable panelist provided “practical advice” on how the Commission can “cast” the Proposed Election Contest Rules to create the appearance that they fall within the Commission’s authority. Professor John Coffee counseled the Commission:

Well I think just as a matter of sort of defensive advice . . . you are more safely within your bunker the more this *looks* like a procedural rule. . . . I think the more you make it *look* procedural, the more you’re in the narrow core of a series of concentric circles that might define your authority . . . the more you can *cast it* as a procedural rule, the safer it is.⁵

In fact, the Proposed Election Contest Rules are substantive, as demonstrated in our prior comments, and no amount of creative re-packaging can change that. Professor Coffee’s comments only further illustrate that the Proposed Rules exceed the Commission’s authority.

II. The Rulemaking Process Has Been Fatally Flawed.

In addition to lacking legal authority to adopt the Proposed Election Contest Rules, the Commission has conducted a rulemaking proceeding that is fatally flawed under the Administrative Procedure Act (“APA”).⁶ As even the Proposed Rules’ supporters have acknowledged, “[i]t’s going to be the strength of the rulemaking record and the Commission’s articulation of a need for this rule that ultimately is going to drive the outcome on whether the rule is upheld” in the face of a legal challenge.⁷ For the reasons discussed below, this rulemaking is deficient in both respects. Among other things, the Commission’s shifting justification for the Proposed Rules, and its failure to provide the public with data it has relied upon in the course of the rulemaking, will leave any final rule seriously vulnerable to legal challenge.

A. The Proposed Rules Are Based On An Unclear Objective That Has Shifted In The Course Of The Rulemaking.

In the less than six months since this rulemaking was initiated, the Commission has offered shifting justifications for the Proposed Rules. Rather than identify a clear objective and then shape a rule to fit that goal, it appears that the Commission has fashioned a rule for which it is now in perpetual search of legally-sustainable justifications. Should the Commission determine to adopt final rules—which it should not—this shift in objectives would require it to first republish those “final” rules for additional comment under the APA.

⁵ John C. Coffee, Jr. (Professor, Columbia University Law School), Roundtable Transcript at 214 (emphases added).

⁶ 5 U.S.C. § 551 *et seq.*

⁷ Donald C. Langevoort (Professor, Georgetown University Law Center), Roundtable Transcript at 212.

1. No Clear Objective For This Rulemaking Has Been Provided.

The APA requires an agency to articulate a purpose for a rulemaking,⁸ and prohibits rulemaking that is, among other things, “arbitrary and capricious.”⁹ Rulemaking is arbitrary and capricious where an agency fails to articulate a clear purpose or objective for the promulgation of a rule, or where an agency is unsure of the “effect its rule would have.”¹⁰ Courts will not invent a rationale for agency rulemaking, nor will they accept an agency’s “post hoc rationalization” for a rule.¹¹ Rather, courts adjudicate the permissibility and lawfulness of a rule “on the basis articulated by the agency itself.”¹² Failure to state a basis and purpose “has become the most frequent basis for judicial reversal of agency rules.”¹³

As was clear in the Proposing Release and became even clearer during the Roundtable, there is no fixed or defined rationale for this rulemaking. In the observation of one Commissioner shortly before the Roundtable, “defining the objective [of the Rules]—has proven more elusive than one would have hoped So what is the ultimate objective? What problem are we trying to solve? Several *possibilities* come to mind”¹⁴ Indeed, even those who have “read and re-read the proposing release and related literature very carefully and repeatedly . . . still can’t figure out what the specific reasons are for this initiative.”¹⁵ As the Commission

⁸ APA, 5 U.S.C. § 553(c). Section 1(b)(1) of Executive Order 12,866 similarly requires an agency to clearly identify the problem that it intends to address through rulemaking. Exec. Order 12,866, 58 Fed. Reg. 51,735 (Oct. 4, 1993), as amended by Exec. Order No. 13,258, 67 Fed. Reg. 9385 (Feb. 28, 2002) (“Executive Order 12,866”).

⁹ See *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983); see also 5 U.S.C. § 706(2)(A).

¹⁰ *ALLTEL Corp. v. FCC*, 838 F.2d 551, 562 (D.C. Cir. 1988) (finding a rule to be arbitrary and capricious where an agency first stated that its rule would apply only to two companies but later admitted that it would apply to several more companies); see also APA, 5 U.S.C. § 553(c) (requiring a clear statement of a rule’s basis and purpose).

¹¹ *Motor Vehicle Mfrs. Ass’n*, 463 U.S. at 50.

¹² *Id.*

¹³ 1 RICHARD J. PIERCE JR., ADMINISTRATIVE LAW TREATISE § 7.4, at 442 (4th ed. 2002).

¹⁴ Commissioner Cynthia A. Glassman, Speech by SEC Commissioner: American Enterprise Institute—Issues Surrounding the SEC’s Shareholder Access Proposal (Mar. 8, 2004) (emphasis added), available at <http://www.sec.gov/news/speech/spch030804cag.htm> (last visited Mar. 24, 2004).

¹⁵ Robert Todd Lang (Partner, Weil, Gotshal & Manges), Roundtable Transcript at 206 (stating that it would be “a good idea” for the Commission to tell the public “why these rules should be adopted,” which it so far has failed to do); see also Warren L. Batts (Retired Chief Executive Officer; National

belatedly searches for a clear objective for this rulemaking, it must recognize that adoption of a final rule under these circumstances would be arbitrary and capricious and violate the APA.

2. *The Stated Objective Has Shifted, Requiring The Commission To Republish Any Final Rule For Additional Comment.*

To the extent that the Commission articulated a purpose for this rulemaking in its Proposing Release, that purpose appears to have changed and continues to change as the rulemaking progresses. The Commission twice stated in its Proposing Release that the Proposed Rules would serve a limited purpose, applying only “in those instances where evidence suggests that the company has been *unresponsive* to security holder concerns as they relate to the proxy process.”¹⁶

As explained at length in our prior comments and observed by Steve Odland at the Roundtable, “the rules that have been proposed don’t quite match th[is] objective [].”¹⁷ One of the two triggers in the proposal bears no relation to a corporation’s historical responsiveness to shareholders—if a majority of shareholders vote for election contest procedures at even the most responsive of corporations, the Proposed Rules’ requirements are triggered at that company. The second trigger—a 35 percent withhold vote—would be tripped even though a majority of the shareholders voted in favor of a director’s election. A company is not “non-responsive” when it takes the course of action approved by a majority of shareholders. Moreover, the Commission’s 35 percent trigger makes no allowance for the company that does, in fact, respond to a high withhold vote by not renominating that director for election the following year.

Perhaps because the originally-stated objective was so inconsistent with the rules actually proposed, a host of alternative objectives have been offered in the course of this rulemaking. During the Roundtable, statements by several Commissioners suggested that the Proposed Rules are intended to serve the quite different and far broader purpose of fundamentally altering corporate voting practices that are viewed as “outdated,” without regard to whether a particular company governed by those practices is responsive to shareholder concerns. For example, the Chairman’s opening remarks at the Roundtable described a “central purpose” of the rulemaking as providing shareholders a “middle-ground” between selling a company’s stock on the one

Association of Corporate Directors), Roundtable Transcript at 130 (noting the Proposed Rules’ “ambiguity” on this point).

¹⁶ See 68 Fed. Reg. at 60,787; see also Commissioner Cynthia A. Glassman, Speech by SEC Commissioner: American Enterprise Institute—Issues Surrounding The SEC’s Shareholder Access Proposal (Mar. 8, 2004) (quoting the same), available at <http://www.sec.gov/news/speech/spch030804cag.htm> (last visited Mar. 24, 2004).

¹⁷ Steve Odland (Chairman, President & Chief Executive Officer of AutoZone; Chairman, Corporate Governance Task Force, Business Roundtable), Roundtable Transcript at 35; see also Peter J. Wallison (Resident Fellow and Co-director Financial Deregulation Project, American Enterprise Institute), Roundtable Transcript at 86 (“this rule would not accomplish what I think you hope the rule will accomplish”).

hand, and undertaking a proxy contest for control of the company on the other hand.¹⁸ Elaborating on this critique of corporate voting rules as a whole, the Chairman added: “[W]hat we are talking about here is the frustration of certain shareholders that they haven’t really been given an opportunity to vote.”¹⁹ Similarly, another Commissioner suggested that shareholders who are “dissatisfied” for whatever reason should be permitted to trigger the Proposed Election Contest Rules.²⁰

The broader objectives for the rulemaking indicated by these Commissioners during the Roundtable are similar to those put forward by various proponents of the Proposed Rules, who desire the Commission to act beyond its mandate and outside of its legal authority. Some proponents of the Proposed Rules, including the Council of Institutional Investors, support the proposal because they believe that proxy contests are too cumbersome and costly.²¹ Others, including CalPERS and the National Coalition for Corporate Reform, support additional election contest triggers that have nothing at all to do with company “responsiveness,” including triggers for material misstatements, Commission enforcement actions, economic underperformance, criminal indictments of directors and market delisting.²² Still others, including the North

¹⁸ Chairman William H. Donaldson, Speech by SEC Chairman: Opening Remarks at the Security Holder Director Nominations Roundtable (Mar. 10, 2004), *available at* <http://www.sec.gov/news/speech/spch031004whd.htm> (last visited Mar. 24, 2004); Chairman William H. Donaldson, Roundtable Transcript at 9-10; *see also* Chairman William H. Donaldson, Speech by SEC Chairman: Remarks to the Council of Institutional Investors (Mar. 25, 2004), *available at* <http://www.sec.gov/news/speech/spch032504whd.htm> (last visited Mar. 29, 2004).

¹⁹ Chairman William H. Donaldson, Roundtable Transcript at 155.

²⁰ *See* discussion between Commissioner Harvey J. Goldschmid and Peter J. Wallison, Roundtable Transcript at 89-91.

²¹ *See, e.g.*, Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors et al., to Jonathan G. Katz, U.S. Securities and Exchange Commission at 1-2 (Dec. 12, 2003); Ann Yerger (Deputy Director, Council of Institutional Directors), Roundtable Transcript at 57; Lucian Bebchuk (Professor, Harvard Law School), Roundtable Transcript at 57; *see also* Chairman William H. Donaldson, Speech by SEC Chairman: Opening Remarks at the Security Holder Director Nominations Roundtable (Mar. 10, 2004), *available at* <http://www.sec.gov/news/speech/spch031004whd.htm> (last visited Mar. 24, 2004) (discussing the expense of proxy contests); William H. Donaldson, Roundtable Transcript at 9 (same); Commissioner Harvey J. Goldschmid, Roundtable Transcript at 147 (noting that it is “extraordinary to have a proxy contest”).

²² Letter from Sean Harrigan, President, Board of Administration, CalPERS, to Jonathan G. Katz, U.S. Securities and Exchange Commission, Answer to Question C.1 (Dec. 5, 2003); *see also* Letter from National Coalition for Corporate Reform, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Dec. 18, 2003); Denise L. Nappier (Treasurer, State of Connecticut), Roundtable Transcript at 180; Letter from Lucian A. Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 9 (Dec. 22, 2003).

Carolina Treasurer, believe that rules are required because indexed funds are unable to “vote with their feet” to express dissatisfaction.²³ And, as will be discussed below, several institutional investors acknowledge that the Proposed Rules will provide them tremendous leverage to force a wide range of changes in the management and policies of American corporations. To these supporters of the Commission’s proposal, the value of the Proposed Rules lies not in concepts of corporate responsiveness to the proxy process, but rather in the Proposed Rules’ potential to reorder radically the relative roles of corporate shareholders, directors and management, a matter traditionally reserved to state law.

The perceived “problems” that are the proponents’ reason for championing this rulemaking are an inappropriate basis for regulation by the Commission. In addition to being contrary to the purpose of the rulemaking as stated in the Proposing Release, these objectives exceed the Commission’s authority and improperly intrude on the role of the States. The Commission’s authority to regulate the proxy process is not intended to be a means of fundamentally altering the relative roles of shareholders and boards of directors in the selection of nominees for boards of directors.²⁴ Unfortunately, as the rulemaking progresses and discussion of the Proposed Election Contest Rules continues, it appears that this has become the principal purpose of the rulemaking.

The APA limits an agency’s ability to change the scope of its rulemaking midstream.²⁵ Where an agency adopts a final rule that does not “follow logically” from the rule as proposed, it

In the Proposing Release, the Commission appeared to reject the use of such triggering mechanisms because the Proposed Election Contest Rules “relate to the proxy process in connection with the nomination of directors,” and, accordingly, “the nomination procedure triggering events should be tied closely to evidence of ineffectiveness or security holder dissatisfaction with a company’s proxy process.” 68 Fed. Reg. at 60,790. It now appears that the Commission itself is straying from this more limited concept of its objective and legal authority, as shown above.

²³ See Richard H. Moore (Treasurer, State of North Carolina), Roundtable Transcript at 25. Yet as observed by Peter Wallison during the Roundtable: “Now it is true that some shareholders may not be able to sell the[ir] shares, indexation, and so forth, would be one—at least one cited reason. But of course, you buy an index fund in part for the diversification. You take the good with the bad. The purpose is to spread your investment over the entire economy. And so, in the index, there are going to be companies with which you don’t necessarily agree.” Peter J. Wallison, Roundtable Transcript at 78.

²⁴ See 68 Fed. Reg. at 60,784 (conveying that the Proposed Election Contest Rules will apply only “in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process”).

²⁵ *MCI Telecomm. Corp. v. FCC*, 57 F.3d 1136, 1142 (D.C. Cir. 1995) (quoting *Florida Power & Light Co. v. United States*, 846 F.2d 765, 771 (D.C. Cir. 1988) (requiring an agency to “afford interested parties a reasonable opportunity to participate in the rulemaking process”).

is required to republish the revised rule to provide proper notice and opportunity for comment.²⁶ Because, regardless of its validity or necessity, undertaking this rulemaking with a primary objective of reforming director nomination and election processes generally does not “follow logically” from the Proposing Release, the Commission must republish for comment any rule that it intends to adopt for this new, broader, and far more intrusive purpose.²⁷ If it does not, any final rule will be subject to compelling legal challenge.

B. The Commission Has Improperly Refused To Make Available Data And Information That It Relied Upon In The Rulemaking.

The rulemaking process also is fundamentally flawed as a result of the Commission’s explicit refusal to provide the public with access to data and information relied upon by the Commission in the Proposing Release. The APA requires that interested parties be afforded the opportunity to provide “meaningful” comment on proposed rules.²⁸ As repeatedly has been communicated to the Commission, courts construing this requirement of the APA have consistently held that agencies must “disclose in detail the thinking that has animated the form of a proposed rule and the data upon which that rule is based.”²⁹ Indeed, “it is especially important for the agency to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules,” and “an agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary.”³⁰

As noted in our previous comments, the Business Roundtable, through counsel, asked the Commission as far back as November 13, 2003, to provide data and studies that it cited or relied upon in the Proposing Release and that otherwise are not publicly available.³¹ Yet, contrary to the APA’s mandate that it provide such data voluntarily and in a timely manner for use in the

²⁶ *Connecticut Light & Power Co. v. Nuclear Regulatory Comm’n*, 673 F.2d 525, 533 (D.C. Cir. 1982) (citing *Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1031 (D.C. Cir. 1978)); see also *Kollett v. Harris*, 619 F.2d 134 (1st Cir. 1980); *American Standards, Inc. v. United States*, 602 F.2d 256 (Ct. Cl. 1979); *American Iron & Steel Inst. v. EPA*, 568 F.2d 284 (3d Cir. 1977).

²⁷ *Connecticut Light & Power Co.*, 673 F.2d at 533; see also Donald C. Langevoort, Roundtable Transcript at 213 (stating that the Commission would “create a record problem in articulating the [Proposed Rules’] need” if it does not “tie [the] particular structure of the rule to the claim for its validity”).

²⁸ *Florida Power & Light Co.*, 846 F.2d at 771.

²⁹ *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977); see also *Nat’l Coalition Against the Misuse of Pesticides v. Thomas*, 809 F.2d 875, 884 n.10 (D.C. Cir. 1987).

³⁰ *Connecticut Light & Power Co.*, 673 F.2d at 531.

³¹ See Business Roundtable Detailed Comments at 36.

comment process, the Commission rejected that request.³² Accordingly, the Business Roundtable, again through counsel, promptly requested the data in expedited fashion under the Freedom of Information Act, with a copy of that request forwarded to the rulemaking file for purposes of ensuring access in connection with this rulemaking.³³

With the exception of a handful of pages only recently produced, and despite renewed reminders that the public is entitled to the requested data in connection with this rulemaking, the Commission has continued to deny access to the vast majority of the data and studies that it has relied upon. The importance of the information the Commission has refused to provide, and the rationale it has given for this refusal, both reflect a lack of appreciation for the Commission's obligations in this instance. The withheld information was cited by the Commission as the very premise for key thresholds and triggers in the Proposed Election Contest Rules—this is information that indisputably goes to the heart of the public's ability to effectively review and comment on the agency's decisionmaking. Moreover, the Commission's rationales for withholding the data indicate an inadequate understanding of one of the most basic principles of rulemaking: the Commission's letter denying access to the materials has asserted, among other things, that the Commission does not know what it relied upon in developing the Proposed Rules, and that the government may premise its decisionmaking on information provided by interested parties that the government can then choose not to disclose to other members of the public.³⁴

In sum, by refusing to provide data that it relied upon to promulgate the Proposed Rules, the Commission has prejudiced and violated the public's right to comment meaningfully in a manner that further compounds the already serious substantive and procedural errors of this rulemaking.

³² *See id.*

³³ *See* Letter from Ashley Wright, Gibson, Dunn & Crutcher LLP, to Jonathan G. Katz, U.S. Securities and Exchange Commission (Nov. 26, 2003), *available at* <http://www.sec.gov/rules/proposed/s71903/gibson112603.htm> (last visited Mar. 24, 2004). The Commission also has declined to afford expedited treatment to a more recent FOIA request submitted in an effort to obtain information for the explicit purpose of use during this comment period. *See* Letter from Ashley Wright, Gibson, Dunn & Crutcher LLP, to FOIA Office, U.S. Securities and Exchange Commission (Mar. 8, 2004); Letter from Celia Winter, FOIA/Privacy Act Officer, U.S. Securities and Exchange Commission, to Ashley Wright, Gibson, Dunn & Crutcher LLP (Mar. 12, 2004) (denying expedited review).

³⁴ Yet another request for the information identified in the November 26, 2003 FOIA request has been made to the Commission in the form of a recent appeal filed with the Office of General Counsel. A copy of the appeal letter, Request No. 2004-0835, which describes the full procedural history and the Commission's flawed bases for rejecting a valid request, was forwarded electronically to this rulemaking's comment file on March 19, 2004.

III. The Rulemaking Record Does Not Establish The Need For The Proposed Rules; To The Contrary, The Rules Are Unnecessary In Light Of Recent Corporate Governance Reforms.

In addition to conducting the rulemaking in a flawed manner under the APA, the Commission has failed to establish that there is a real need for the Proposed Election Contest Rules. Both the Commission's own data and current shareholder behavior demonstrate that there is no need for the Proposed Rules. In fact, the rulemaking record demonstrates that the Proposed Rules are unnecessary in light of recent reforms and improved corporate governance and shareholder communications. The Commission's apparent unwillingness to let recent reforms take hold before adopting a new layer of additional, unnecessary regulation falls short of the sound and reasonable agency decisionmaking required by the APA.

A. There Is No Established Need For The Proposed Rules.

In the Proposing Release, the Commission stated that the Proposed Rules would serve a limited purpose, applying only "in those instances where evidence suggests that the company has been *unresponsive* to security holder concerns as they relate to the proxy process."³⁵ Yet, the evidence evaluated in the course of the rulemaking has failed to establish the need for rules of this nature at this time. To the contrary, as numerous Roundtable panelists suggested, recent reforms should be permitted time to take hold before any further regulation along the lines of the Proposed Rules is adopted.³⁶ This is particularly the case because these earlier reforms are working and companies are enhancing their corporate governance in a variety of ways. Accordingly, the proposed regulation is unnecessary and would be "a serious mistake at this time."³⁷

As noted in our earlier comments, the Commission's own data indicate that there are not serious problems with the ability of the proxy process to produce nominees for corporate director positions that are supported by the majority of shareholders. The Commission has indicated its view that a principal measure of whether the proxy process is flawed at a particular company is

³⁵ See 68 Fed. Reg. at 60,784, 60,787 (emphasis added); see also Commissioner Cynthia A. Glassman, Speech by SEC Commissioner: American Enterprise Institute—Issues surrounding the SEC's Shareholder Access Proposal (Mar. 8, 2004), available at <http://www.sec.gov/news/speech/spch030804cag.htm> (last visited Mar. 24, 2004) (quoting the same).

³⁶ See, e.g., Martin Lipton (Partner, Wachtell, Lipton, Rosen & Katz), Roundtable Transcript at 15-17, 40; Randall S. Kroszner (Professor, University of Chicago), Roundtable Transcript at 20; Steve Odland, Roundtable Transcript at 36-38, 64-66; Thomas J. Donohue (President & Chief Executive Officer, U.S. Chamber of Commerce), Roundtable Transcript at 74; David S. Ruder (Former Commission Chairman; Professor, Northwestern University School of Law), Roundtable Transcript at 118; Susan Ellen Wolf (Staff Vice President Corporate Law, Schering-Plough), Roundtable Transcript at 141; Franklin D. Raines (Chairman & Chief Executive Officer, Fannie Mae; Co-Chairman, Business Roundtable), Roundtable Transcript at 139; J. Carter Beese, Jr. (Former SEC Commissioner; Center for Strategic & International Studies), Roundtable Transcript at 143.

³⁷ Martin Lipton, Roundtable Transcript at 38.

whether a substantial number of withhold votes have been cast against director nominees at the company—a withhold vote in excess of 35% has been made one of the triggers under the Proposed Rules.³⁸ Data from the Proposing Release indicates, however, that just 1.1% of companies experienced a withhold vote that large in the last two years.³⁹ A perceived problem affecting such a small percentage of companies hardly supports such a far-reaching and costly rule as the Commission has proposed.

The record developed in this rulemaking disproves another of the important assumptions underlying the Proposed Election Contest Rules: the claim that large investors currently are trying to influence director nominations but cannot. In fact, numerous Roundtable panelists reported that in their experience, institutional investors generally have not sought to nominate or help select directors, even when asked to do so by companies. For example, Steve Odland of AutoZone noted that despite company efforts to discuss corporate governance issues with institutional investors, these investors have only been interested in discussing “performance and . . . shareholder returns.”⁴⁰ David Katz and other panelists attested to the fact that despite invitations from companies to do so, institutional investors have seldom recommended director candidates in the past. Mr. Katz stated:

I can tell you that . . . people that are in proxy fights or are looking to avoid proxy fights or are simply looking to expand boards of directors have recently gone to a number of their institutional investors and asked them to suggest directors. And to this day, we have not been successful in getting an institution to designate a director, to make a suggestion about a director.⁴¹

Similarly, Warren Batts stated that in his 35 years serving on corporate boards, there has not been “a single incident of a responsible shareholder group proposing a candidate to stand for election to the board.”⁴²

Institutional investors currently have the ability to recommend director nominees by submitting their names to independent nominating committees; yet, they usually do not do so. In fact, on December 11, 2003, the Commission adopted rules requiring additional disclosure of the process for shareholders to submit director candidates.⁴³

³⁸ See 68 Fed. Reg. at 60,790.

³⁹ *Id.*

⁴⁰ Steve Odland, Roundtable Transcript at 37.

⁴¹ David A. Katz (Partner, Wachtell, Lipton, Rosen & Katz), Roundtable Transcript at 222.

⁴² Warren L. Batts, Roundtable Transcript at 129.

⁴³ See Disclosure Regarding Nominating Committee Functioning and Communications Between Security Holders and Boards of Directors; Final Rule; Republication, 68 Fed. Reg. 69,204 (Dec. 11, 2003).

Thus, as discussed below, support for the Proposed Rules is largely driven by the desire to use them as leverage to pursue special-interest agendas.

B. Additional Time Is Needed For Recent Reforms To Be Fully Implemented.

Numerous commenters—including Cendant, 3M, and J.P. Morgan Chase & Co., to name a few—have counseled the Commission that recent corporate governance reforms must be permitted time to work before the Commission considers adopting the added layer of regulation embodied in the Proposed Rules.⁴⁴ Rulemaking requirements compel the Commission to assess this approach—the approach of not regulating—in a serious, balanced manner.⁴⁵ To date, however, no convincing argument has been put forward that recent reforms are not working and that, given time to work fully, they would not be adequate.

There have been more corporate governance reforms in the last 24 months than in the prior four decades. Recent reforms, which have been strongly supported by the Business Roundtable, include the Sarbanes-Oxley Act of 2002, the Commission implementing regulations, and new NYSE and NASDAQ corporate governance listing standards and rules increasing disclosure regarding nominating committee functions and communications between shareholders and boards of directors. Many of the NYSE and NASDAQ corporate governance listing standards do not even go into effect until later this year. Similarly, the Commission only recently adopted new rules requiring enhanced disclosure about nominating committee processes and shareholder-director communications.

If the Commission adopts rules now without due consideration to recent reforms, it will be taking inappropriate and unjustified risks that “could set the economy on its ear.”⁴⁶ Recent reforms must be fully implemented, evaluated, and understood before the Commission can know whether more change is needed, and what form any additional change should take.⁴⁷ Indeed, as the Chairman stated during the Roundtable, “[i]t is [the Commission’s] hope that the transparency created by [recently adopted] standards . . . will help produce more communication

⁴⁴ See, e.g., Letter from Robert E. Nederlander, Director and Chairman of the Corporate Governance Committee, Cendant Corporation, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Nov. 17, 2003); Letter from W. James McNerney, Jr., Chairman of the Board and Chief Executive Officer, 3M, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 8 (Dec. 5, 2003); Letter from Anthony J. Horan, Corporate Secretary, J.P. Morgan Chase & Co., to Jonathan G. Katz, U.S. Securities and Exchange Commission at 1 (Jan. 5, 2004).

⁴⁵ See Executive Order 12,866, at § 1(b)(3) (requiring an agency to consider the alternative of not regulating).

⁴⁶ Steve Odland, Roundtable Transcript at 46.

⁴⁷ See *Motor Vehicle Mfrs. Ass’n*, 463 U.S. at 43 (requiring an agency to consider all important aspects when engaging in rulemaking); Executive Order 12,866, at § 1(b)(3) (requiring an agency to consider the alternative of not regulating at all); see also J. Carter Beese, Jr., Roundtable Transcript at 143 (“[W]e should at least understand what has changed before we move to the next generation. We don’t really know what has changed yet.”).

among management, directors, and shareholders generally, but especially with respect to the nomination of candidates for boards of directors.”⁴⁸ Precisely because it holds that hope—and has promulgated those new legal requirements on that premise—it is improper for the Commission to impose additional requirements at a time when the consequences of those earlier reforms cannot be known.⁴⁹ As stated during the Roundtable, without due consideration of recent reforms, the Commission will be “trying to drive the [rulemaking] car by looking [only] in the rearview mirror . . . rather than [also] looking through the windshield.”⁵⁰

C. Survey Data And Empirical Evidence Demonstrate Significant Continued Improvements In Corporate Governance.

Companies have made sweeping changes to strengthen their corporate governance, and the Commission should let the impact of those reforms be absorbed before adopting new, costly, and uncertain rules in this area. A recently-completed survey by the Business Roundtable indicates that in the past two years there has been a “sea change” in corporate governance practices at American companies, including greater board independence, more transparency and increased communications with shareholders.⁵¹ Many of these changes go well beyond the requirements of the Commission and self-regulatory organizations.⁵² Franklin Raines has observed that “[t]here is no doubt that corporate management and corporate governance have improved substantially.”⁵³

The Business Roundtable survey demonstrates the strong trend toward greater board independence and oversight, more transparency and increased communication with shareholders cited by several Roundtable panelists.⁵⁴ Among other things, the survey indicates that:

⁴⁸ Chairman William H. Donaldson, Roundtable Transcript at 7.

⁴⁹ See Robert Todd Lang, Roundtable Transcript at 205; see also David A. Katz, Roundtable Transcript at 222.

⁵⁰ Steve Odland, Roundtable Transcript at 36.

⁵¹ *Id.* at 37; see also, e.g., E. Norman Veasey, Roundtable Transcript at 219 (noting that there “has been an increased improvement in the behavior of corporations”).

⁵² See Press Release, Business Roundtable, New Business Roundtable CEO Survey Shows Continuing Improvements In Corporate Governance Practices (Mar. 9, 2004), available at <http://www.businessroundtable.org/newsroom/Document.aspx?qs=5626BF807822B0F13D3429167F75A70478252> (last visited Mar. 24, 2004).

⁵³ Franklin D. Raines, Roundtable Transcript at 139.

⁵⁴ Press Release, Business Roundtable, New Business Roundtable CEO Survey Shows Continuing Improvements In Corporate Governance Practices (Mar. 9, 2004), available at <http://www.businessroundtable.org/newsroom/Document.aspx?qs=5626BF807822B0F13D3429167F75A70478252> (last visited Mar. 24, 2004).

- 71% of companies have an independent chairman, lead director or presiding director, up from 55% last summer;
- 81% of companies have boards of directors that are at least 80% independent and nearly 40% of companies' boards are 100% independent, other than the chief executive officer;⁵⁵
- 87% of companies have established a procedure for shareholder communications with directors, up from 66% in a survey conducted last summer; an additional 7% currently are considering such a procedure;
- 23% of companies have established a policy for shareholder meetings with directors;
- 87% of company nominating committees have established qualifications and criteria for directors;
- 74% of company nominating committees have a process in place to accept and respond to shareholder nominations for director positions; and
- 98% of companies have a procedure in place to review or analyze incumbent directors before they are renominated.

Moreover, evidence suggests that companies are increasingly responding to shareholder proposals that receive a majority vote. For example, a November 2003 survey indicates that 100% of responding Business Roundtable companies that received a majority vote on a shareholder proposal reported that their boards considered whether to implement that proposal.⁵⁶

⁵⁵ The New York Stock Exchange listing requirements call for simply a majority of the board to be made up of independent directors. *See* Self-Regulatory Organizations: New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes, 68 Fed. Reg. 64,154 (Nov. 12, 2003).

⁵⁶ *See, e.g.*, Business Roundtable Appendix of Secondary Materials to Detailed Comments of Business Roundtable on the "Proposed Election Contest Rules" of the U.S. Securities and Exchange Commission, Tab 65. Examples of specific companies that have responded to majority-vote shareholder proposals abound. *See, e.g.*, News Release, Union Pacific Corporation, Union Pacific's Board of Directors Restricts Executive Severance (Oct. 3, 2003), *available at* http://www.uprr.com/notes/investor/2003/r1003_policy.shtml (last visited Mar. 17, 2004); News Release, Hewlett-Packard, HP Board Declares Regular Dividend, Adopts New Policies (July 21, 2003), *available at* <http://www.hp.com/hpinfo/newsroom/press/2003/030721b.html> (last visited Mar. 24, 2004); Press Release, Merck, Merck Board Elects New Director and Proposes Annual Election of Directors (Jan. 15, 2004), *available at* http://www.merck.com/newsroom/press_releases/corporate/2004_0115.html (last visited Mar. 24, 2004); Corporate Release, Circuit City Stores, Inc., Board of Directors Votes to Terminate Shareholder Rights Plan, *available at* http://investor.circuitcity.com/ireye/ir_site.zhtml?ticker=CC&script=412&layout=-6&item_id=496814 (last visited Mar. 24, 2004); Press Release, Eastman Kodak Company, Kodak Board of Directors Enhances Corporate

Furthermore, as the AFL-CIO has acknowledged, “[a]s a result of negotiation with shareholders,” companies increasingly are responding to the “underlying concerns” raised by shareholder proposals without the necessity of implementing the proposals.⁵⁷ Shareholders often withdraw proposals (leading companies to withdraw “no-action” letter requests to the Commission staff) after discussions with companies resolve their concerns.⁵⁸

As recent reforms continue to take hold and companies take continued steps to improve their corporate governance, the time simply is not right for adoption of the Proposed Election Contest Rules.

IV. The Proposed Rules Will Lead To Harmful, Unintended Consequences.

During the Roundtable, former Commissioner J. Carter Beese, Jr. aptly observed that the Proposed Election Contest Rules are “prone to th[e] law of unintended consequences.”⁵⁹ Indeed, it is the numerous harmful, unintended consequences that would arise under the Proposed Rules

Governance Guidelines (Feb. 18, 2004), available at <http://www.kodak.com/us/en/corp/pressReleases/pr20040218-02.shtml> (last visited Mar. 24, 2004).

The fact that shareholder proposals receiving a majority vote are not *always* adopted by boards of directors does not indicate that the system is broken. Under state law, a board has a duty to make its own determination whether implementation of a shareholder proposal is in the company’s and all of its shareholders’ best interests. Automatic compliance with the results of a shareholder vote—regardless of the level of support—would violate the board’s fiduciary obligations.

⁵⁷ Notably, the AFL-CIO has opposed an additional triggering event based on a company not implementing a shareholder proposal that received a majority shareholder vote. See Letter from

Richard L. Trumka, Secretary-Treasurer, AFL-CIO, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 7 (Dec. 19, 2003).

⁵⁸ See, e.g., Letter from William Zitelli, Vice President, Advisors’ Inner Circle Fund, to Gregory F. Pilcher, Senior Vice President, General Counsel and Secretary, Kerr-McGee Corporation (Jan. 23, 2004); Letter from Edward J. Durkin, Corporate Governance Advisor, United Brotherhood of Carpenters and Joiners of America, to Patricia A. Wilkerson, Vice President and Corporate Secretary, Dominion Resources, Inc. (Jan. 26, 2004); Letter from Susan A. Waxenberg, Assistant General Counsel and Assistant Secretary, Time Warner Inc., to Office of the Chief Counsel, Division of Corporation Finance, U.S. Securities and Exchange Commission (Feb. 12, 2004); Letter from Edward J. Durkin, Corporate Governance Advisor, United Brotherhood of Carpenters and Joiners of America, to Susan A. Waxenberg, Assistant General Counsel and Assistant Secretary, Time Warner Inc. (Feb. 9, 2004); Letter from W. Scott Klinger, Co-Director, Responsible Wealth, to James Killerlane III, Vice President, Lehman Brothers Inc. (Feb. 4, 2004); Letter from Rev. William Somplatsky-Jarman, Associate for Mission Responsibility Through Investment, to Karen Corrigan, Vice President, Office of the General Counsel, Lehman Brothers Inc. (Jan. 27, 2004); Letter from Adam Kanzer, General Counsel and Director of Shareholder Advocacy, and Kimberly Gladman, Shareholder Advocacy Associate, Domini Social Investments LLC, to Timothy R. Baer, Vice President, Target Corporation (Feb. 11, 2004).

⁵⁹ J. Carter Beese, Jr., Roundtable Transcript at 144.

that has left the Business Roundtable no choice but to urge that the proposal not be adopted. As commenters ranging from the United Brotherhood of Carpenters and Joiners of America to Professor Randall Kroszner have observed, the Proposed Election Contest Rules simply are the “wrong answer.”⁶⁰

Chief among the Proposed Rules’ unintended consequences is that they would cede a vast amount of power to some institutional investors and unregulated proxy advisory services. These entities could use these powers as leverage to pursue special-interest agendas. This in turn would impose extensive direct costs, and would divert the time and energies of corporate management from the business of running the company.⁶¹ The costs to all shareholders resulting from adoption of the Proposed Rules thus would be great, both as a result of institutional investors using the threat of a triggering event as leverage to extract concessions from companies, and from companies being forced to engage in expensive election contests. Companies and all their shareholders would incur great expense from such contests, as companies initially would endeavor to prevent the triggers from being tripped, and then exercise their fiduciary duty by campaigning to promote the candidacies of those nominees whom they believe would be the best directors for the company. Companies might be pressured to make significant, long-term concessions in collective bargaining with labor unions under the threat of an expensive and disruptive proxy contest.⁶²

A. The Proposed Rules Would Cede Vast Power To Proxy Advisory Services And Institutional Shareholders At Great Cost To Companies And All Shareholders.

As the United Brotherhood of Carpenters and Joiners of America has noted, the evolution of ownership activism should be facilitated through “new avenues for responsible activism,” not avenues subject to great abuse.⁶³ The Proposed Election Contest Rules are not “the next logical step” in the responsible promotion of ownership activism, because they are likely to “inhibit responsible shareholder activism that requires diligence, consistency, [and] a long-term ownership perspective” “to the ultimate detriment of the corporation and its committed long-term

⁶⁰ Letter from Edward J. Durkin, Director, Corporate Affairs Department, United Brotherhood of Carpenters, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 1 (Dec. 22, 2003); Randall S. Kroszner, Roundtable Transcript at 58. *See also* Peter J. Wallison, Roundtable Transcript at 84 (“I have grave doubts about whether any of these ideas would really work.”).

⁶¹ *See, e.g.*, Franklin D. Raines, Roundtable Transcript at 149-50.

⁶² *See* Mary Williams Walsh, *State Pension Officials Accuse Safeway Leaders of Conflict*, N.Y. TIMES, Mar. 25, 2004, at C11 (describing pension funds’ efforts at Safeway); Jonathan Peterson, *Boards Heeding Investor Activists*, L.A. TIMES, Mar. 29, 2004, at C1 (same).

⁶³ Letter from Edward J. Durkin, Director, Corporate Affairs Department, United Brotherhood of Carpenters, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Dec. 22, 2003).

shareholders.”⁶⁴ In particular, the Proposed Rules would cede enormous power to institutional investors and proxy advisory services such as Institutional Shareholder Services (“ISS”)—entities that have no fiduciary duty to act in the best interests of a company and all of its shareholders. Significantly, some institutional investors have acknowledged that the great powers afforded to them under the Proposed Rules are subject to abuse. Although Chairman Donaldson stated during the Roundtable that “the last thing that shareholders really want for the company’s future” is to “divert the company’s resources away from the business they’re building,” the Proposed Rules would do just that by requiring companies to expend large resources to address and combat abuse made possible by the Proposed Rules.⁶⁵ The Commission’s economic analysis of its proposal has given no consideration to these significant costs.

1. Institutional Investors And Proxy Advisory Services—Not Individual Shareholders—Are Given Vast, Unregulated Power Under The Proposed Rules.

As discussed in detail in our previous comments, the “triggers” in the Proposed Election Contest Rules would be tripped far more frequently than the Commission supposes, due in substantial part to the voting practices of institutional investors and proxy advisory services, and the narrow agendas likely to be pursued by some institutional investors.⁶⁶ As former Commission Chairman David Ruder made clear during the Roundtable, the Proposed Rules serve the interests of certain large institutional investors and proxy advisory services, not individual shareholders:

We’re not really talking about shareholders here. We’re talking about institutional investors, and what you have is a rule that is going to empower those institutional investors and I would, if I were examining this, pay close attention to the question of how the voting process will take place at the institutional investor level. Certainly, organizations like ISS and others who have the power to make recommendations regarding voting procedures, and this is particularly true for mutual funds these days, will become increasingly powerful⁶⁷

Andrew S. Grove, Chairman of Intel, similarly has noted that the “wholesale shift of voting authority to unregulated proxy voting organizations will create substantial unregulated and

⁶⁴ *Id.* at 2-3. As discussed below, the Proposed Rules would encourage some shareholders to use them to further narrow agendas that do not benefit all other shareholders. Shareholders’ use of the Proposed Rules in this manner thus would harm a company and all of its shareholders.

⁶⁵ Chairman William H. Donaldson, Roundtable Transcript at 9.

⁶⁶ Business Roundtable Detailed Comments at 27-40.

⁶⁷ David S. Ruder, Roundtable Transcript at 118; *see also* Steve Odland, Roundtable Transcript at 37.

inappropriate changes in U.S. corporate governance.”⁶⁸ Steve Odland stated during the Roundtable that “an issue here is that those people who are those proxy rating services will become more powerful in this process. They are unregulated private entities. They are businesses unto themselves, actually, trying to make a profit.”⁶⁹

Proxy advisory services already greatly influence the voting behavior of institutional investors.⁷⁰ A November 2003 survey conducted by the Business Roundtable indicates that, on average, 40% of our member companies’ shares currently are voted by institutional investors that follow ISS proxy voting guidelines.⁷¹ Many of these investors do not deviate from the ISS voting guidelines, regardless of the individual circumstances presented by a particular company. In the words of one newspaper: “ISS is a leading proxy-voting consultant and has its own set of voting guidelines, which virtually all [mutual] funds use as a reference. Some [funds] went so far as to strictly adhere to the ISS guidelines.”⁷² Simply, as another recent article put it, “certain index funds cede voting decisions to ISS.”⁷³ Quoting a proxy solicitor, the article explains:

Many institutions, notably mutual funds, will face more scrutiny on how they vote controversial shareholder issues than in the past. Some will rely on proxy services. Others will use them for cover . . . ‘The conflicts are just going to get greater and greater’ . . . ‘The easiest way to decide how to vote is putting the responsibility on ISS and Glass Lewis.’⁷⁴

At the Roundtable, Dean Jeffrey Sonnenfeld provided an example of ISS’s clout, stating: “[M]ost people in the room would certainly tend to agree that ISS had a hugely influential role in throwing the vote through their recommendation on the HP-Compaq merger. Had they gone the other way, I’d bet my life savings . . . that vote would have gone out differently.”⁷⁵

⁶⁸ *Open Elections?*, FORBES at 52 (Mar. 29, 2004).

⁶⁹ Steve Odland, Roundtable Transcript at 37; *see also* Franklin D. Raines, Roundtable Transcript at 135.

⁷⁰ Business Roundtable Detailed Comments at 28-31.

⁷¹ *See id.* at 28-29.

⁷² *See* Burton Rothberg & Ned Regan, A Seat at the Corporate Governance Table, WALL ST. J., Dec. 17, 2003, at A22.

⁷³ Matt Miller, *A difference of opinion makes the proxy fight*, CORPORATE CONTROL ALERT at 8 (Mar. 2004).

⁷⁴ *Id.* at 9.

⁷⁵ Jeffrey A. Sonnenfeld (Associate Dean, Yale School of Management), Roundtable Transcript at 124-25.

Proxy voting services already recommend withhold votes to “send a message,” and would be encouraged by the Proposed Rules’ triggers to do so with even greater frequency. As observed by Franklin Raines during the Roundtable, “it’s a foregone conclusion that there will be almost universal invocation, if possible, of the desire to be able to nominate directors.”⁷⁶ ISS and institutional investors are likely to support shareholder access proposals at *all* companies, if for no other reason than to ensure that access to company proxy materials is available in the future.⁷⁷ Indeed, it has been reported that union funds already plan withhold vote campaigns against up to another 18 individual directors during the 2004 proxy season to set the stage for several possible election contests in 2005.⁷⁸ A consequence of adoption of the Proposed Rules thus would be widespread investor voting patterns unrelated to what the Commission has said it seeks to accomplish—more effective proxy processes at “unresponsive” companies. Rather, as discussed below, among the Proposed Rules’ principal roles would be to function as a mechanism for pressuring corporations to make changes on matters wholly outside the Commission’s mandate.⁷⁹

2. *Institutional Investors Acknowledge That The Proposed Rules Are Subject To Abuse.*

Statements made by the Proposed Rules’ proponents since the preparation of our earlier written comments—some of them statements from institutional investors themselves—confirm that large institutional investors such as union and public employee pension funds, and others with special-interest agendas, would use the Proposed Rules not only to gain a seat in the boardroom, but also as leverage to further their own agendas. Even without seeking to include their nominees in company proxy materials, shareholders will be able to use the threat of tripping an election contest trigger to pursue special-interest agendas. As the Commission heard at the Roundtable, it would be “human nature” for certain shareholders to use the Proposed Election Contest Rules to further such agendas.⁸⁰

⁷⁶ Franklin D. Raines, Roundtable Transcript at 129. ISS has denied that this is likely to occur. *See* Jamie Heard (Chief Executive Officer, ISS), Roundtable Transcript at 241.

⁷⁷ *See* Jamie Heard, Roundtable Transcript at 233 (“I think up until now we’ve looked at withhold votes as being largely symbolic If you adopt this rule, I think a withhold vote does clearly become more consequential.”).

⁷⁸ *See* Amy Borrus, *Directors in the Crosshairs*, BUS. WEEK (Mar. 29, 2004).

⁷⁹ *See* 68 Fed. Reg. at 60,784 (conveying that the Proposed Election Contest Rules will apply only “in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process”).

⁸⁰ Robert Todd Lang, Roundtable Transcript at 205; *see also* Mary Williams Walsh, *State Pension Officials Accuse Safeway Leaders of Conflict*, N.Y. TIMES, Mar. 25, 2004, at C11 (describing an initiative by pension trustees at Safeway that has occurred at the same time as high profile labor disputes).

In its comment letter to the Commission, the California Public Employees' Retirement System ("CalPERS") acknowledges that the Proposed Rules give institutional shareholders powers that could be abused, but seeks to assure the Commission that "we intend to utilize the rule in a responsible manner."⁸¹ Taken at face value, CalPERS' assurance that it will use the Proposed Rules in a "responsible" manner does not overcome the special-interest problem inherent in the Proposed Rules. To the contrary, the mere fact that CalPERS saw a need for such a pledge confirms the potential for abuse. And whatever CalPERS' intentions, other institutional investors have not made this pledge. Nor would their assurances be adequate in any event, since even "responsible advocates" will not be able to resist the use of the Proposed Rules to further individual agendas.⁸² As Professor (and former Commissioner) Joseph Grundfest noted in his comments, "investors would have every incentive to provide *only* the most high-minded examples" to describe their intentions under the Proposed Rules.⁸³ The objectives they actually pursue must be expected to differ.

Like CalPERS, the Teachers Insurance and Annuity Association of America ("TIAA-CREF") acknowledges that the Proposed Election Contest Rules would be subject to abuse by institutional investors.⁸⁴ TIAA-CREF indicates that the current system discourages special interest nominations because the costs of waging a proxy contest are borne by the nominating shareholder (and not the company, as largely would be the case under the Proposed Rules).⁸⁵ As a suggested defense against an influx of frivolous nominations by special-interests under the Proposed Rules, TIAA-CREF and The Corporate Library have proposed that every shareholder nominee be required to certify that, "if elected, the nominee will represent the financial interests of all security holders."⁸⁶ Once again, this suggestion confirms that the Proposed Rules have the clear capacity to encourage institutional investors and their director nominees to pursue single- or special-interest agendas at the expense of other shareholders. And the certification itself is a wholly inadequate remedy to the problem: it would be difficult if not impossible to enforce, and even by its own terms, it would not prevent shareholders from using the election contest triggers as "leverage" to pursue special-interest agendas well before they seek the nomination of directors.

⁸¹ Letter from Sean Harrigan, President, Board of Administration, CalPERS, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 1 (Dec. 5, 2003).

⁸² Franklin D. Raines, Roundtable Transcript at 138.

⁸³ Letter from Joseph A. Grundfest, Former SEC Commissioner, The William A. Franke Professor of Law and Business, Stanford Law School, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Oct. 22, 2003) (emphasis added).

⁸⁴ Letter from Peter C. Clapman, Senior Vice President & Chief Counsel, Corporate Governance, TIAA-CREF, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 3 (Dec. 17, 2003).

⁸⁵ *Id.*

⁸⁶ *Id.*; Letter from Nell Minow and Beth Young, The Corporate Library, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Dec. 22, 2003).

The AFL-CIO's representative at the Roundtable was forthright about unions' "interests" in the Proposed Rules, stating that he "will stip[ulate] to the fact that there are multiple interests at this table. And the interest I represent is working people for whom corporate America not only produces profits and share appreciation, but jobs, goods, service, and the good things in life. The purpose of corporate governance is to forward all of these things."⁸⁷ Those "good things" often can be in conflict with the best interests of a company and shareholder value, yet would, as the AFL-CIO acknowledges, clearly guide union behavior if the Proposed Rules were adopted. Union-controlled pension funds are among the most active and influential institutional investors; the heads of these funds may determine (even if they state now that they would not) that their role as advocates for *their causes* or *their constituents* require them to use the threat of a trigger as leverage—as they have leveraged companies in the past through corporate campaigns—to extract concessions that do not necessarily inure to the benefit of all shareholders. As Thomas Donohue stated during the Roundtable:

It's very clear to those that have carefully looked at the matter, that unions that have been unable to deal with corporations on a whole series of issues see this as a great opportunity to leverage the corporations. They don't even believe that it'll happen that often, but they think they'll have the sword to hold over their heads. I suppose there are other interest groups, as well, that might do the same thing.⁸⁸

It is notable that institutional investors such as CalPERS and the North Carolina Treasurer have stated that, should the Commission not adopt the Proposed Election Contest Rules, they would more vigorously pursue "vote no" campaigns against directors. For example, CalPERS' comment letter stated that "it would like to pursue more vigorous vote no campaigns against . . . companies presently and regardless of this proposed rule," and the North Carolina Treasurer was recently quoted as saying that he "do[esn't] think they [companies] like the alternative that we have. If we don't get a decent rule on this, we are going to have to start picking 20 to 25 companies and going at them in a much harder way every year."⁸⁹ Statements such as these demonstrate that mechanisms to use director elections to initiate corporate actions

⁸⁷ Damon Silvers (Associate General Counsel, AFL-CIO), Roundtable Transcript at 27.

⁸⁸ Thomas J. Donohue, Roundtable Transcript at 73-74; *see also* Business Roundtable Detailed Comments at 41-42; Investor Responsibility Research Center, *Proxy Season 2004: Union Funds Lead The Charge on Executive Compensation*, IRRRC CORPORATE GOVERNANCE BULLETIN (December 2003-February 2004) (demonstrating that labor funds submitted more shareholder proposals than any other institutional investor in 2003).

⁸⁹ *See* Letter from Sean Harrigan, President, Board of Administration, CalPERS, to Jonathan G. Katz, U.S. Securities and Exchange Commission, Answer to Question M.6 (Dec. 5, 2003); Brendan Intindola, *States to try to unseat boards if access denied*, REUTERS (Feb. 18, 2004) (quoting North Carolina Treasurer Richard Moore).

already exist, and that adoption of the Proposed Rules is unnecessary. Indeed, withhold votes repeatedly have been used in precisely this manner in recent weeks.⁹⁰

The fact that institutional investors and proxy advisory services owe no fiduciary duty to a company and all of its shareholders makes the “special-interest” problem described above all the more real. As Todd Lang observed during the Roundtable:

no one ever talks about the fact that proponent stockholders are not fiduciaries and are not accountable as distinguished from directors. It seems to me if they’re going to have that kind of influence, there should be some level of accountability and some level of fiduciary responsibility. You can’t have it both ways. If the directors are responsible, it’s their proxy statement, they should be dealing with it.⁹¹

Indeed, Eric Roiter of Fidelity Management and Research Company confirmed during the Roundtable that, both as a matter of law and practice, institutional investors do not owe any fiduciary duty to shareholders generally but only to their “fund shareholders, and solely to [their] fund shareholders.”⁹² Roiter stated that “[t]here are not affirmative obligations that one minority shareholder . . . owes to another,” and provided an example of an action a fund could take with respect to a company that would benefit its shareholders to the possible detriment of all other shareholders.⁹³ In his comment letter to the Commission, Professor David Margotta offered yet another real-world example to demonstrate that the “perspectives and interests [of institutional investors] can be distinctly different from that of managements of the companies and, more important, different from the smaller non-institutional owners of the company’s stock.”⁹⁴ As Nell Minow stated during the Roundtable, “no individual shareholder . . . is going to be looking into the long-term best interest [of the company] all the time.”⁹⁵

Because institutional investors owe no fiduciary duty to fellow shareholders, the Commission should not adopt a rule that empowers them (or any shareholder) to trigger election contests or nominate directors. Candidates are currently nominated by corporate directors and

⁹⁰ See, e.g., Mary Williams Walsh, *State Pension Officials Accuse Safeway Leaders of Conflict*, N.Y. TIMES, Mar. 25, 2004, at C11 (discussing a “vote no” campaign at Safeway).

⁹¹ Robert Todd Lang, Roundtable Transcript at 204.

⁹² Eric Roiter (Senior Vice President & General Counsel, Fidelity Management & Research Company), Roundtable Transcript at 32, 59.

⁹³ *Id.* at 32-34 (providing an example of how active fund management could lead to actions that benefit fund shareholders but harm other shareholders economically).

⁹⁴ Letter from David G. Margotta, Associate Professor of Finance, Northeastern University, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Dec. 20, 2003).

⁹⁵ Nell Minow (Chairman, The Corporate Library), Roundtable Transcript at 47.

independent nominating committee members who do owe a fiduciary duty to the company and all of its shareholders. It would be a mistake to move from a system where the law requires each and every nominating decision to be made with the best interests of all shareholders in mind, to one where nominating decisions—initial or otherwise—could be made with the interests of only 1% or 5% of all shareholders in mind. Nor would it constitute reasoned decisionmaking for the Commission to adopt rules that it knows to be overwhelmingly subject to abuse. As John Wilcox stated during the Roundtable, the Commission, “as an agency, [has to] think about how this rule would work if it were used . . . aggressively by shareholders. I don’t think it’s right to create a rule and then hope that it’s going to slip through because it isn’t used very much.”⁹⁶

3. *Improper Use Of The Proposed Rules As “Leverage” Is Inevitable.*

A common response from proponents of the Proposed Rules is that the special-interest problems inherent in the Rules will never materialize because a special-interest nominee would not be elected to a board of directors without the majority support of all shareholders.⁹⁷ As an initial matter, the Proposed Rules would not require shareholder nominees to receive the majority vote of all shareholders to be elected.⁹⁸ More significantly, however, the proponents’ argument overlooks the damage that a single- or special-interest shareholder can cause on a company well before an election contest occurs or a trigger is even tripped. Quite arguably, “[t]he leverage point . . . is by far the most important point” and “will get out of control.”⁹⁹

As discussed by several Roundtable participants, the Proposed Rules would permit shareholders, even those with no inclination to actually nominate a director, to use the mere threat of a triggering event as “leverage” to extract corporate action on issues wholly unrelated to corporate responsiveness or matters of corporate governance. Professor Randall Kroszner noted that the Proposed Rules would change “the threat point” by making it easier for special-interest shareholders “to extract some concessions from a board or from a corporation that might not be

⁹⁶ John C. Wilcox (Vice Chairman, Geogeson Shareholder Communications), Roundtable Transcript at 242.

⁹⁷ *See, e.g.*, Commissioner Harvey J. Goldschmid, Roundtable Transcript at 42 (“You were talking about narrow shareholder groups taking advantage. How are they going to take advantage in a process where you need two majority votes, and the 35 withhold is roughly a majority, but you need a second majority vote before you can elect one minority director or two?”). *See also* Letter from Richard L. Trumka, Secretary-Treasurer, AFL-CIO, to Jonathan G. Katz, United States Securities and Exchange Commission at 7 (Dec. 19, 2003).

⁹⁸ The Proposed Election Contest Rules requires a majority of votes cast rather than votes outstanding, a point largely ignored by the Proposed Rules’ proponents during the Roundtable. *See* 68 Fed. Reg. at 60,791. Commissioner Glassman had to underscore this point at the Roundtable. Commissioner Cynthia A. Glassman, Roundtable Transcript at 151 (“The 50 percent [required to elect a shareholder nominee] is not 50% of all shareholders. It’s 50% of votes cast, which is not necessarily a majority of shareholders in any event.”).

⁹⁹ Franklin D. Raines, Roundtable Transcript at 132; Susan Ellen Wolf, Roundtable Transcript at 135.

consistent with shareholder value, even if they can't get someone on the board.”¹⁰⁰ Indeed, as observed by Franklin Raines at the Roundtable, “[n]o responsible advocate who seeks corporate action . . . will be able to resist the use of [the Proposed Rules] lever” to forward their special interests.¹⁰¹ The need for companies to respond to special-interest concerns in turn will divert their attention from serving the best interests of all shareholders to serving the interests of a handful of well-organized and vocal shareholders.

During the Roundtable, one Commissioner expressed skepticism about the “leverage” problem; if special-interest investors attempted to use the Proposed Rules as leverage to “blackmail” companies, he suggested, companies could easily dismiss the demands by averring, “we won’t accept such nonsense.”¹⁰² However, single- or special-interest concerns often are not so easily dismissed.¹⁰³ First, companies as a general matter are responsive to shareholder concerns and do not dismiss shareholder requests without first expending considerable time evaluating them. Second, when a large and influential shareholder vows an intense campaign against a particular influential director if a concession is not made on a certain matter of corporate policy, it will be the rare executive indeed who dismisses that threat as “nonsense” without a second thought to the campaign about to be waged against the director. And finally, the concerns of special interest organizations are not necessarily in themselves bad or repugnant ideas. Often they reflect reasonable societal concerns but are poor bases for corporate policy. As Franklin Raines indicated during the Roundtable, “[i]t’s not the people who come in with kooky ideas that’s the problem. It’s people who come in with ideas that on the surface are good ideas, but they are not good ideas *for your company*.”¹⁰⁴

Because passionate advocates will be urging what may be good ideas in the abstract (at least from their perspective)—while threatening to trigger an election contest if they are left dissatisfied—companies will be forced to spend time and resources making a case why the interest forwarded is not in the best interests of all shareholders. Alternatively, companies may be forced to compromise on an issue to avoid the even greater cost to shareholders that would result from an unnecessary election contest.¹⁰⁵ There is no avoiding the fact that shareholders’ use of the Proposed Election Contest Rules as leverage would be extremely costly—in time, distraction, and money—for companies and all other shareholders.

¹⁰⁰ Randall S. Kroszner, Roundtable Transcript at 63-64.

¹⁰¹ Franklin D. Raines, Roundtable Transcript at 138-39.

¹⁰² Commissioner Harvey J. Goldschmid, Roundtable Transcript at 146.

¹⁰³ Franklin D. Raines, Roundtable Transcript at 149-50.

¹⁰⁴ *Id.* at 150 (emphasis added).

¹⁰⁵ *Id.*

V. The Proposed Rules Would Impose Costs That The Commission Has Not Considered Adequately.

In addition to costs caused by the use of “leverage” discussed above, there are additional costs that would result from adoption of the Proposed Election Contest Rules that must be considered adequately by the Commission in this rulemaking. As Susan Ellen Wolf correctly noted during the Roundtable, “all shareholders bear the cost of implementing these rules.”¹⁰⁶

First, the Proposed Rules would cause corporate director elections to be treated as “contested” even when no shareholder nominee appears on the ballot. That is because companies would be forced to expend resources to ensure not merely that their nominees are elected, but that they do not receive more than 35% withhold votes to avoid the election contest trigger. Accordingly, virtually every election will be a contested election creating new costs—both monetary and otherwise—for companies and all shareholders. Second, the Proposed Rules would have the collateral costs of discouraging qualified nominees from seeking board seats, and impairing the ability of boards to function properly. Moreover, the Commission completely has overlooked the collateral costs to companies, their shareholders and the economy as a whole that would result from the Proposed Rules’ diversion of corporate attention and resources away from the day-to-day business of the corporation. Third, the Proposed Election Contest Rules would necessitate costly upgrades to voting systems and significant expenditures by the Commission to resolve disputes that would arise under the Proposed Rules.

A. Increased Election Contests Are Inevitable Under The Proposed Rules.

At the time of its Proposing Release, the Commission, acknowledging that its burden estimates are not “reliable,” estimated that the average cost of the Proposed Election Contest Rules for each affected company would be a mere \$4,200.¹⁰⁷ Included in the Commission’s estimate were what it believed to be costs for election contests under the Proposed Rules. The Commission asserted that there would be no new monies spent on election contests under the Proposed Rules as compared to what is spent currently.¹⁰⁸ To test the Commission’s \$4,200 cost estimate, the Business Roundtable conducted a survey of member firms that inquired about the Proposed Rules’ likely costs. The results of that survey indicate that the Proposed Election Contest Rules would on average cost each affected company more than \$700,000.¹⁰⁹ We are unaware of any studies or research that the Commission—or any party other than the Business Roundtable and American Society of Corporate Secretaries—has undertaken since the Proposing Release was published to determine the Proposed Rules’ true costs for companies and all shareholders.

¹⁰⁶ Susan Ellen Wolf, Roundtable Transcript at 134.

¹⁰⁷ See 68 Fed. Reg. at 60,814.

¹⁰⁸ *Id.*

¹⁰⁹ Business Roundtable Detailed Comments at 58.

Institutional investors such as CalPERS and TIAA-CREF have acknowledged that the Proposed Election Contest Rules would result in an increased number of withhold vote campaigns.¹¹⁰ Moreover, as noted above, labor funds already plan increased withhold vote campaigns this proxy season to set the stage for contested elections in 2005.¹¹¹ Yet, many of the same proponents of the Proposed Rules have contended that the costs of these election contests should not be considered a cost of the Proposed Rules, because the decision to incur costs in supporting the campaign of a director nominee is voluntary—it is “the choice of the company,” rather than a cost of the Proposed Rules.¹¹² That simply is not correct.

The notion that companies’ increased election-contest expenditures would be “voluntary” fails to take account of directors’ duties under state corporate law. Corporate directors and management have a fiduciary duty to act in the best interests of a company and all shareholders, including expending all necessary and permissible resources to secure the election of candidates whom they believe would be the best directors for the company. To the extent, moreover, that the Proposed Rules incentivize corporations to incur costs on shareholders and the economy that otherwise would not exist, it is immaterial that some element of individual discretion might precede the decision to incur these costs—the increased election contest expenditures are still a clear and inevitable result of the Proposed Rules, and must be included in the Commission’s cost analysis.¹¹³ As Franklin Raines observed at the Roundtable, it would “be a very odd world” where companies do not support their director nominees.¹¹⁴

¹¹⁰ Letter from Sean Harrigan, President, Board of Administration, CalPERS, to Jonathan G. Katz, U.S. Securities and Exchange Commission at Response to Question C.9. (Dec. 5, 2003) (noting that the Rules likely will lead to more frequent withhold campaigns); Amy Borrus, *Directors in the Crosshairs*, BUS. WEEK (Mar. 29, 2004) (quoting Peter C. Clapman of TIAA-CREF as stating: “We are going to [vote “no”] more than we did in the past, now that it [could be] more meaningful”); see also Letter from Peter C. Clapman, Senior Vice President & Chief Counsel, Corporate Governance, TIAA-CREF, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 3 (Dec. 17, 2003) (acknowledging, in the context of discussing proxy contests, that the Proposed Election Contest Rules could present “costs and risks to public companies and their shareholders”); Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 64 (November 2003) (noting that companies will spend substantial sums on campaigning when their nominees face a chance of losing).

¹¹¹ See Amy Borrus, *Directors in the Crosshairs*, BUS. WEEK (Mar. 29, 2004).

¹¹² Ted White, Roundtable Transcript at 126; see also Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors et al., to Jonathan G. Katz, U.S. Securities and Exchange Commission at 4 (Dec. 12, 2003); Alan L. Beller, Roundtable Transcript at 133.

¹¹³ See Business Roundtable Detailed Comments at 52-58.

¹¹⁴ Franklin D. Raines, Roundtable Transcript at 137. Moreover, the failure of companies to support their director nominees would create a disincentive for qualified people to seek election to corporate boards. As Raines stated: “I would expect companies to try to elect the board members that they’ve nominated. Indeed, I’m not quite sure who would stand for election in a company if the company said we’re going to nominate you but you’re sort of on your own here, we’re kind of indifferent as to whether you win, and we’ll just put you in the proxy like everybody else.” *Id.*

B. Significant Collateral Costs Also Are Inevitable Under The Proposed Rules.

Increased election contests also would impose significant collateral costs on companies and shareholders. The Commission is required to consider these costs as well when evaluating whether to adopt the Proposed Rules.¹¹⁵ Because the Proposed Election Contest Rules would effectively turn all corporate director elections into election contests, and because contentious boards could result if shareholder nominees are elected, qualified individuals would be less willing to serve on corporate boards. Stephen Sanger, Chairman and Chief Executive Officer of General Mills, Inc., recently stated that the Proposed Election Contest Rules give rise to “significant risks such as the loss of qualified director candidates who do not want to participate in contested elections.”¹¹⁶ This point was echoed by numerous Roundtable participants. For example, Martin Lipton stated that

[what directors] want to do is to act collegially to do what they believe to be in the best interest of the corporation, and they don’t want to be involved in a situation where they are facing a proxy contest, where they’re facing campaigns that disparage their independence or disparage their performance. And therefore, they say, ‘I’d rather not serve under these circumstances.’ I think that’s a factor that the proposal fails to take into account.¹¹⁷

Thomas Donohue stated that “some of the best of people that we want on . . . boards won’t run.”¹¹⁸ And (former Commissioner) J. Carter Beese Jr. stated, “I need to question why to still serve on boards in today’s environment.”¹¹⁹

As noted above, the Proposed Election Contest Rules would threaten the cohesiveness of company boards. Although board members must exercise objective independence and judgment, they also must function as a team, within a culture of trust and candor, if the board is to be effective. Franklin Raines stated during the Roundtable that he “is quite aware of companies where people have been on the board as special interest shareholders expressly, and it was a disaster.”¹²⁰ Moreover, C. Harley Booth noted in his comments, “true board conflicts will be the inevitable result of permitting shareholders to nominate just one or two director candidates.”¹²¹

¹¹⁵ See, e.g., *Motor Vehicle Mfrs. Ass’n*, 463 U.S. at 43.

¹¹⁶ *Open Elections?*, FORBES at 52 (Mar. 29, 2004).

¹¹⁷ Martin Lipton, Roundtable Transcript at 40-41.

¹¹⁸ Thomas J. Donohue, Roundtable Transcript at 73.

¹¹⁹ J. Carter Beese, Jr., Roundtable Transcript at 172.

¹²⁰ Franklin D. Raines, Roundtable Transcript at 170.

¹²¹ Letter from C. Harley Booth, Executive Director, Independent Corporate Directors Association, to Jonathan G. Katz, U.S. Securities and Exchange Commission at 2 (Dec. 22, 2003).

Todd Lang added during the Roundtable that it is unwise for the Commission to foster the idea that it is constructive to put people on the board who “are actively against the Board.”¹²² Joseph Grundfest emphasized that it is not a good thing to promote “head-to-head combat” among directors.¹²³

In sum, the Proposed Rules would create a whole host of collateral costs that the Commission has failed to consider adequately. Indeed, the Commission has completely ignored the ultimate cost of the Proposed Rules—the cost to the economy as a whole that will result from companies having to divert attention and resources away from maintaining and improving their businesses to the benefit of all consumers.

C. Costly Changes To the Proxy Processing System And The Creation Of Dispute Processes Would Be Necessary Under The Proposed Rules.

Other costs that would result from adoption of the Proposed Election Contest Rules include the expense of enhancing the proxy processing system, and the cost to the Commission of resolving disputes that undoubtedly would arise under the Proposed Rules.

As discussed during the Roundtable, the current proxy processing system is not capable of handling implementation of the Proposed Election Contest Rules. John Wilcox, Vice Chairman of Georgeson Shareholder Communications, Inc. stated:

Another concern I have [about the Proposed Rules] is if we have vote thresholds, a 35 percent threshold or a 50 percent threshold, a corporation and its legal counsel are going to want to be absolutely sure that the 35% vote is authentic, and it has, in fact, been achieved, particularly if it’s close, or the 50% vote. We cannot do that now.¹²⁴

Furthermore, Richard Daly, Co-President of Automated Data Processing, Inc., stated that without expensive enhancements to the current proxy processing system, it would not be possible to “implement these rules.”¹²⁵ “[R]ight now our system has just over 1,750 programs and just over 2 million lines of code to process the current system,” he explained.¹²⁶ “We would need to make changes to 29 percent of the mainframe programs and 40 percent of the internet related

¹²² Robert Todd Lang, Roundtable Transcript at 205.

¹²³ Joseph A. Grundfest, Roundtable Transcript at 100.

¹²⁴ John C. Wilcox, Roundtable Transcript at 245.

¹²⁵ Richard J. Daly (Group Co-President, Automatic Data Processing, Inc.), Roundtable Transcript at 249.

¹²⁶ *Id.*

activities.”¹²⁷ Daly estimates that these changes would require “just over 21,000 man hours, and it would require just over 60 of the 150 . . . systems professional[s] . . . that are employed to maintain and enhance the proxy processing system.”¹²⁸ He estimates that it would “be a six to seven-month effort” to complete the necessary changes.¹²⁹ Neither the burdens nor costs of enhancing the proxy processing system were addressed by the Commission in its Proposing Release.

Moreover, the Commission must consider the costs to it—and all taxpayers—of implementing the Proposed Election Contest Rules. Several commenters—including CalPERS and the Council of Institutional Investors—have noted that the Commission would need to create and implement processes that shareholders and companies could invoke when a dispute arises under the Proposed Rules.¹³⁰ The costs to the Commission of creating and maintaining such processes would be large. This expenditure of the Commission’s time and taxpayers’ dollars clearly is not justified in light of the Proposed Rules’ fundamental flaws. To date, the Commission has made no serious attempt to estimate these costs.

VI. Alternatives To The Proposed Election Contest Rules Must Receive Serious Consideration.

In addition to considering comments related to specific components of the Proposed Election Contest Rules, the Commission is required to adequately consider alternatives to the proposal.¹³¹ Numerous criticisms of the Commission’s proposal were voiced during the Roundtable. For example, Professor Charles Elson stated: “My quibble with the proposal is not the proposal itself and not the reason behind the proposal, but the approach, because I don’t think it answers the ultimate question here.”¹³² Moreover, Joseph Grundfest stated that “even if one agrees that there is a problem, and the problem needs to be resolved, its not at all clear that this is necessarily the best resolution.”¹³³ He referred to the Proposed Rules as “slow,” “complicated,”

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ See Letter from Sean Harrigan, President, Board of Administration, CalPERS, to Jonathan G. Katz, U.S. Securities and Exchange Commission, Answer to Question L.3.e (Dec. 5, 2003); Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors et al., to Jonathan G. Katz, U.S. Securities and Exchange Commission at 3 (Dec. 12, 2003).

¹³¹ See, e.g., *Int’l Ladies’ Garment Workers Union v. Donovan*, 722 F.2d 795, 814-20 (D.C. Cir. 1983) (vacating agency action under the APA because the decision was not rational in light of the agency’s failure to adequately consider alternatives).

¹³² Charles M. Elson, Roundtable Transcript at 93-94.

¹³³ Joseph A. Grundfest, Roundtable Transcript at 98.

“arbitrary,” and “confrontational—unnecessarily so”; the proposal would have “potentially unequal interstate impacts,” he predicted.¹³⁴ Notably, one former Chairman and two former Commissioners of the U.S. Securities and Exchange Commission referred to the Proposed Election Contest Rules during the Roundtable as a “Rube Goldberg” proposal; “it seems as though Rube Goldberg has visited corporate governance,” one former Commissioner observed.¹³⁵

At least seven different options to replace the Proposed Election Contest Rules recently have been proposed.¹³⁶ Four of these were discussed briefly during the Roundtable,¹³⁷ with several Roundtable participants endorsing an alternative approach to the one put forward in the Proposed Rules.¹³⁸

The Commission’s obligation with respect to alternatives is a serious one. As Professor Grundfest stated at the Roundtable, “as a matter of public policy, if you have a step that you can take that’s less intrusive and that might achieve everything you need,” as an alternative approach to the Proposed Rules might, “and you have a step that’s more intrusive and might create additional side effects that are unnecessary,” as would occur if the Proposed Rules were adopted, “it’s smart policy and good medicine to start with a lower dose.”¹³⁹ Moreover, the Commission has an obligation to design any regulation in the most cost-effective manner possible.¹⁴⁰

¹³⁴ *Id.* at 98-99; *see also* Warren L. Batts, Roundtable Transcript at 124 (referring to the proposal as “ambiguous”); Jill E. Fisch (Professor, Fordham University School of Law), Roundtable Transcript at 209 (“It’s very hard to predict the effect that proposed Rule 14(a)(11) is going to have.”).

¹³⁵ David S. Ruder, Roundtable Transcript at 118, 160; Joseph A. Grundfest, Roundtable Transcript at 99; J. Carter Beese, Jr., Roundtable Transcript at 144.

¹³⁶ Proposals have been put forward by the American Society of Corporate Secretaries; Chancellor William Chandler and Vice-Chancellor Leo Strine (Delaware Chancery Court); Edward J. Durkin on behalf of the United Brotherhood of Carpenters and Joiners of America (Director of Corporate Affairs); Professor Charles M. Elson; Professor (and former Commissioner) Joseph A. Grundfest; Professor Randall S. Kroszner; and Ira Millstein (Partner, Weil, Gotshal & Manges; National Association of Corporate Directors).

¹³⁷ Charles M. Elson, Roundtable Transcript at 94-95; Joseph A. Grundfest, Roundtable Transcript at 100-02; Randall S. Kroszner, Roundtable Transcript at 20-21; Ira Millstein, Roundtable Transcript at 104-06.

¹³⁸ *See id.*; *see also, e.g.*, Warren L. Batts, Roundtable Transcript at 130; David S. Ruder, Roundtable Transcript at 160; Susan Ellen Wolf, Roundtable Transcript at 142.

¹³⁹ Joseph A. Grundfest, Roundtable Transcript at 115.

¹⁴⁰ Executive Order No. 12,866, at § 1(b)(5).

Accordingly, the Commission must thoroughly analyze the proposed alternatives before adopting any rule.¹⁴¹

VII. Conclusion

For all of the reasons set forth in this letter and previously expressed by the Business Roundtable, it is clear that the Proposed Election Contest Rules exceed the Commission's authority and would be harmful to corporate governance; that this rulemaking process itself has been afflicted by significant procedural errors; and that the Proposed Rules would impose extensive costs on corporations and all their shareholders, which the Commission has not seriously addressed. Although we strongly supported enactment of the Sarbanes-Oxley Act and other recent corporate governance reforms, we are left with no choice but to respectfully urge that the Commission proceed no further with this rulemaking.

¹⁴¹ See Business Roundtable Detailed Comments at 48-50.

**SECONDARY MATERIALS TO
SUPPLEMENTAL DETAILED COMMENTS OF BUSINESS ROUNDTABLE**

(SUBMITTED AS SEPARATE APPENDIX)

TAB

SEC MATERIALS

Chairman William H. Donaldson, Speech by SEC Chairman: Opening Remarks at the Security Holder Director Nominations Roundtable (Mar. 10, 2004), available at <http://www.sec.gov/news/speech/spch031004whd.htm> (last visited Mar. 24, 2004) 1

Chairman William H. Donaldson, Speech by SEC Chairman: Remarks to the Council of Institutional Investors (Mar. 25, 2004), available at <http://www.sec.gov/news/speech/spch032504whd.htm> (last visited Mar. 29, 2004) 2

Commissioner Cynthia A. Glassman, Speech by SEC Commissioner: American Enterprise Institute—Issues Surrounding the SEC’s Shareholder Access Proposal (Mar. 8, 2004), available at <http://www.sec.gov/news/speech/spch030804cag.htm> (last visited Mar. 24, 2004) 3

LAW REVIEW, NEWSPAPER, AND MAGAZINE ARTICLES

Amy Borrus, *Directors in the Crosshairs*, BUS. WEEK (Mar. 29, 2004) 4

CCH Washington Service Bureau, *Delaware Chief Justice Offers Alternative to SEC Rule Proposal*, SEC TODAY (Mar. 26, 2004) 5

Brendan Intindola, *States to try to unseat boards if access denied*, REUTERS (Feb. 18, 2004) 6

Matt Miller, *A difference of opinion makes the proxy fight*, CORPORATE CONTROL ALERT (Mar. 2004) 7

Open Elections?, FORBES (Mar. 29, 2004) 8

Jonathan Peterson, *Boards Heeding Investor Activists*, L.A. TIMES, Mar. 29, 2004, at C1 9

Burton Rothberg & Ned Regan, *A Seat at the Corporate Governance Table*, WALL ST. J., Dec. 17, 2003, at A22 1

Mary Williams Walsh, *State Pension Officials Accuse Safeway Leaders of Conflict*, N.Y. TIMES, Mar. 25, 2004, at C11 1

MISCELLANEOUS

Corporate Release, Circuit City Stores, Inc., Board of Directors Votes to Terminate Shareholder Rights Plan, *available at* http://investor.circuitcity.com/ireye/ir_site.zhtml?ticker=CC&script=412&layout=-6&item_id=496814 (last visited Mar. 24, 2004) 1

Letter from Edward J. Durkin, Corporate Governance Advisor, United Brotherhood of Carpenters and Joiners of America, to Patricia A. Wilkerson, Vice President and Corporate Secretary, Dominion Resources, Inc. (Jan. 26, 2004) 1

Letter from Edward J. Durkin, Corporate Governance Advisor, United Brotherhood of Carpenters and Joiners of America, to Susan A. Waxenberg, Assistant General Counsel and Assistant Secretary, Time Warner Inc. (Feb. 9, 2004) 1

Letter from Rev. William Somplatsky-Jarman, Associate for Mission Responsibility Through Investment, to Karen Corrigan, Vice President, Office of the General Counsel, Lehman Brothers Inc. (Jan. 27, 2004) 1

Letter from Adam Kanzer, General Counsel and Director of Shareholder Advocacy, and Kimberly Gladman, Shareholder Advocacy Associate, Domini Social Investments LLC, to Timothy R. Baer, Vice President, Target Corporation (Feb. 11, 2004) 1

Letter from W. Scott Klinger, Co-Director, Responsible Wealth, to James Killerlane III, Vice President, Lehman Brothers Inc. (Feb. 4, 2004) 1

Letter from Linda C. Sayler, Senior Corporate Counsel, Safeway, Inc., to Kenneth B. Sylvester, Assistant Comptroller for Pension Policy, The City of New York (Jan. 16, 2004) 1

Letter from Eugene Scalia, Gibson, Dunn & Crutcher LLP, to FOIA/Privacy Act Officer, U.S. Securities and Exchange Commission (Mar. 19, 2004) 1

- Letter from Susan A. Waxenberg, Assistant General Counsel and Assistant Secretary, Time Warner Inc., to Office of the Chief Counsel, Division of Corporation Finance, U.S. Securities and Exchange Commission (Feb. 12, 2004) 2
- Letter from Celia Winter, FOIA/Privacy Act Officer, U.S. Securities and Exchange Commission, to Ashley Wright, Gibson, Dunn & Crutcher LLP (Mar. 12, 2004) 2
- Letter from Ashley Wright, Gibson, Dunn & Crutcher LLP, to FOIA Office, U.S. Securities and Exchange Commission (Mar. 8, 2004) 2
- Letter from William Zitelli, Vice President, Advisors' Inner Circle Fund, to Gregory F. Pilcher, Senior Vice President, General Counsel and Secretary, Kerr-McGee Corporation (Jan. 23, 2004) 2
- News Release, Hewlett-Packard, HP Board Declares Regular Dividend, Adopts New Policies (July 21, 2003), *available at* (<http://www.hp.com/hpinfo/newsroom/press/2003/030721b.html>) (last visited Mar. 24, 2004) 2
- News Release, Union Pacific Corporation, Union Pacific's Board of Directors Restricts Executive Severance (Oct. 3, 2003), *available at* (http://www.uprr.com/notes/investor/2003/r1003_policy.shtml) (last visited Mar. 17, 2004) 2
- Press Release, Business Roundtable, New Business Roundtable CEO Survey Shows Continuing Improvements In Corporate Governance Practices (Mar. 9, 2004), *available at* (<http://www.businessroundtable.org/newsroom/Document.aspx?qs=5626BF807822B0F13D3429167F75A70478252>) (last visited Mar. 24, 2004) 2
- Press Release, Eastman Kodak Company, Kodak Board of Directors Enhances Corporate Governance Guidelines (Feb. 18, 2004), *available at* (<http://www.kodak.com/us/en/corp/pressReleases/pr20040218-02.shtml>) (last visited Mar. 24, 2004) 2
- Press Release, Merck, Merck Board Elects New Director and Proposes Annual Election of Directors (Jan. 15, 2004), *available at* (http://www.merck.com/newsroom/press_releases/corporate/2004_0115.html) (last visited Mar. 24, 2004) 2

Proxy Season 2004: Union funds Lead the Charge on Executive Compensation, Investor Responsibility Research Center, IRRC CORPORATE GOVERNANCE BULLETIN (December 2003-February 2004) 2

BOOK

1 RICHARD J. PIERCE JR., ADMINISTRATIVE LAW TREATISE § 7.4, at 442 (4th ed. 2002) 3