

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 DETAILED COMMENTS ON THE PROPOSED ELECTION CONTEST RULES

These comments are divided into three sections. Section I demonstrates that the Proposed Election Contest Rules exceed the statutory authority of the Commission and tread impermissibly on the authority of the states with respect to the roles and responsibilities of shareholders, directors, and corporate management. Section II demonstrates that this rulemaking is substantively and procedurally flawed in violation of the Administrative Procedure Act and numerous other constraints on agency rulemaking. Although the clear import of Sections I and II is that the Commission should abandon this rulemaking as an improper and ill-conceived exercise of its rulemaking authority, Section III discusses some of the substantial revisions that would need to be made if the Commission were to finalize election contest rules of the nature proposed here.

I. The Proposed Election Contest Rules Exceed The Commission’s Statutory Authority.

This section demonstrates that the Commission lacks the statutory authority to adopt the Proposed Election Contest Rules. As discussed throughout these comments, the Proposed Election Contest Rules would work a fundamental change in American corporate governance. Yet, neither Section 14(a) of the Securities Exchange Act of 1934 (the “Exchange Act”) nor the miscellaneous other statutory provisions cited in the proposing release authorizes the Commission to regulate corporate governance. Not only does the Commission lack the requisite express grant of authority from Congress, but this is an area that the Supreme Court and lower courts have made clear is traditionally reserved to the states.¹

For the first time, corporations would be required to include shareholder nominees in their proxy materials. Under these Proposed Rules, this radical transformation of corporate practice would occur not under the laws of the jurisdictions in which companies are incorporated, but by federal agency rulemaking. The Commission itself has acknowledged that “[p]roposals to require the company to include shareholder nominees in the company’s proxy statement would represent a substantial change in the Commission’s proxy rules.”² Yet the proposing release includes virtually no analysis of the Commission’s statutory authority to impose these sweeping changes.³

¹ See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977), and the discussion below at pages 11-15.

² Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,786 (Oct. 23, 2003) (quoting Release No. 34-31326 (Oct. 16, 1992)).

³ Indeed, of the hundreds of questions posed in the proposing release, only one even refers (albeit obliquely) to the Commission’s authority to promulgate the Proposed Election Contest Rules: “Would adoption of this procedure conflict with any state law, Federal law, or rule of a national securities exchange or national securities association?” 68 Fed. Reg. at 70,789. The proposing release also requests comment on whether the Proposed Election Contest Rules reflect “a proper balance between federal and state law.” *Id.*

Significantly, the July 15, 2003 Staff Report (the “Staff Report”) noted that “some commenters . . . questioned the Commission’s authority to adopt [election contest] rules under Exchange Act Section 14(a).”⁴ Apparently in response to these comments, the Staff Report expressly raised the issue of the Commission’s statutory authority: “Is [an election contest] rule consistent with Congressional intent regarding Exchange Act Section 14(a)?”⁵ Commissioner Atkins has similarly queried, “What authority does the SEC have to regulate the nomination and selection of corporate directors in this way?” Commissioner Atkins noted that “this is not a disclosure provision.”⁶

Notwithstanding the reservations of the Commission staff and Commissioner Atkins regarding the Commission’s authority to adopt the Proposed Election Contest Rules, the proposing release is virtually silent on the question of statutory authority. It states, “we believe that today’s proposals further the goals of Section 14,” apparently because (in the Commission’s view) “the proposed procedure involves disclosure and other requirements concerning proxy materials.”⁷ The proposing release also asserts that the Proposed Election Contest Rules have “a similar underlying purpose as Exchange Act Rule 14a-8” in that “the proposal would establish a procedure pursuant to which a company would have to provide specified information regarding [a shareholder] nomination in its proxy materials.”⁸ Based on no other legal analysis, the proposing release states that the Proposed Election Contest Rules are authorized by “Sections 3(b), 10, 13, 14, 15, 16, 23(a) and 36 of the Securities Exchange Act of 1934” and corresponding provisions of the Investment Company Act of 1940.⁹

⁴ SECURITIES AND EXCHANGE COMMISSION DIVISION OF CORPORATION FINANCE, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS at 6 (July 15, 2003).

⁵ *Id.* at 16.

⁶ Commissioner Paul S. Atkins, Remarks at Open Meeting of the Securities and Exchange Commission (Oct. 8, 2003).

⁷ 68 Fed. Reg. at 60,786-87.

⁸ *Id.* at 60,788.

⁹ *Id.* at 60,816. The Commission’s assessment of its own authority is not entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). *See, e.g., United Transp. Union-Illinois Legislative Bd. v. Surface Transp. Bd.*, 169 F.3d 474, 477 (7th Cir. 1999) (“We have indeed held that an administrative agency’s determination about the scope of its own jurisdiction, ‘a matter within the peculiar expertise of the courts,’ does not receive *Chevron* deference but is reviewed *de novo*.”) (citing *Midland Coal Co. v. OWCP*, 149 F.3d 558, 561 (7th Cir. 1998)).

Regulations must be based on more than a mere assertion that they would further the aims of federal law. The Commission maintains that its rulemaking authority is “sweeping.”¹⁰ But it is not unlimited, and the invocation of “underlying purposes” cannot be used to override those limits. The Supreme Court repeatedly has made this clear. “The 1934 Act cannot be read ‘more broadly than its language and the statutory scheme permit,’” the Court explained in *Chiarella v. United States* in rejecting an argument to extend insider trading liability.¹¹ More recently, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, the Court observed, “[t]he issue . . . is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting *is covered by the statute.*”¹² Put differently, “[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law.”¹³ “Rather, it is ‘the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.’ . . . [The scope of the rule] cannot exceed the power granted the Commission by Congress.”¹⁴ Thus, in *American Bankers Association v. SEC*, the D.C. Circuit invalidated a rule of the Commission that it found improperly had redefined the term “bank” in the Exchange Act: “The SEC cannot use its definitional authority to expand its own jurisdiction and to invade the jurisdiction” of others, the court explained, particularly where the agency interpretation is in direct conflict with the language of the Exchange Act.¹⁵

Neither Section 14(a) nor any other provision of the Exchange Act authorizes the Commission to regulate the internal affairs of corporations. Yet the Proposed Election Contest

¹⁰ 68 Fed. Reg. at 60,786 n.47 (quoting *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 671 (D.C. Cir. 1970), *vacated*, 404 U.S. 403 (1972), for the proposition that “[t]hrough section 14 of the Act, Congress has invested the Securities and Exchange Commission with sweeping authority to regulate the solicitation of corporate proxies”).

¹¹ 445 U.S. 222, 234 (1980) (citing *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (quoting *SEC v. Sloan*, 436 U.S. 103, 116 (1978))).

¹² 511 U.S. 164, 177 (1994) (emphasis added). *See also Dirks v. SEC*, 463 U.S. 646, 657 n.16 (1983) (finding a lack of statutory authority for Commission to prosecute officer of broker-dealer firm for disclosing information during a securities-fraud investigation of a publicly-traded company).

¹³ *Santa Fe Indus.*, 430 U.S. at 472.

¹⁴ *Id.* at 472-3 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976) (alterations in original)). The Supreme Court has repeatedly made clear that agency authority will not be implied when it is not expressly authorized by statute. *See, e.g., MCI Telecommunications Corp. v. AT&T Co.*, 512 U.S. 218, 231 (1994) (finding it “highly unlikely that Congress would leave the determination of whether an industry will be entirely, or even substantially, rate-regulated to agency discretion”); *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160 (2000) (“[W]e are confident that Congress could not have intended to delegate a decision of such economic and political significance to an agency in so cryptic a fashion.”).

¹⁵ 804 F.2d 739, 755 (D.C. Cir. 1986).

Rules would do exactly that.¹⁶ Although presented in the guise of amendments to the proxy rules, the Proposed Election Contest Rules would directly affect corporate governance. Indeed, affecting corporate governance—by setting the qualifications of directors who may be nominated by shareholders and giving shareholders greater ability to change the makeup of boards of directors—is the very purpose of the Proposed Election Contest Rules. As shown below, the Commission lacks statutory authority to regulate in this area, which has traditionally been reserved to the states.¹⁷

A. Section 14(a) Does Not Authorize The Commission To Interfere With The Internal Affairs Of Corporations.

Section 14(a) of the Exchange Act makes it “unlawful for any person, . . . in contravention of such rules and regulations as the Commission may prescribe . . . , to solicit . . . any proxy”¹⁸ Thus, as the Supreme Court has explained, Section 14(a) “authorizes the [SEC] to adopt rules for the solicitation of proxies, and prohibits their violation.”¹⁹

Section 14(a) expressly limits the Commission’s rulemaking authority to the proxy solicitation process. As such, it limits the Commission’s authority to regulating the *disclosures* made, and the procedures followed, in connection with proxy solicitations. The statute and rules thereunder “prevent management or others from obtaining authorization for corporate action by

¹⁶ At least one former Commissioner has questioned the Commission’s authority to promulgate the Proposed Election Contest Rules. See Roberta S. Karmel, *Shareholder Nominations: Increased Access to Proxy Card?*, N.Y.L.J., Dec. 18, 2003, at 7.

¹⁷ Not only is the Commission without statutory authority to promulgate the Proposed Election Contest Rules, but the proposal implicates several constitutional provisions and doctrines. For example, Congress may not delegate legislative authority to administrative agencies absent a “clear mandate in the [enabling] Act,” *Industrial Union Dep’t, AFL-CIO v. American Petroleum Inst.*, 448 U.S. 607, 645 (1980) (plurality opinion). In the absence of such a mandate, the non-delegation doctrine is violated and the agency action is invalid. See, e.g., *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935). The Commission has no clear mandate under the Exchange Act to promulgate the Proposed Election Contest Rules.

A final version of the Proposed Election Contest Rules may also violate specific provisions of the U.S. Constitution and principles of federalism embodied therein. For example, depending on its details and language, the final version of the Proposed Rules may violate the First Amendment, the Fifth Amendment and Equal Protection. See, e.g., *United States v. United Foods, Inc.*, 533 U.S. 405, 410 (2001) (“Just as the First Amendment may prevent the government from prohibiting speech, the Amendment may prevent the government from compelling individuals to express certain views.”) (internal citations omitted); *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency*, 535 U.S. 302, 326 (2002) (endorsing “[Justice] Holmes’ observation that ‘if regulation goes too far it will be recognized as a taking’”) (citing *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922)).

¹⁸ 15 U.S.C. § 78n(a).

¹⁹ *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1086 (1991).

means of deceptive or inadequate disclosure in proxy solicitation.”²⁰ While Section 14(a) empowers the Commission to ensure that shareholders receive full and accurate disclosure in connection with proposed corporate action, it has never been construed—by the courts or by the Commission itself—to allow the Commission to regulate corporate action directly. “In fact, although § 14(a) broadly bars use of the mails (and other means) ‘to solicit . . . any proxy’ in contravention of Commission rules and regulations, it is not seriously disputed that Congress’s central concern was with disclosure.”²¹

The distinction between disclosure (and corresponding procedural) requirements and direct regulation of corporate governance is critical, as the District of Columbia Circuit has made clear in invalidating a previous rulemaking where the Commission overstepped its authority. In *Business Roundtable v. SEC*, the challenge was to Rule 19c-4, which barred self-regulatory organizations from listing stock of a corporation “that takes any corporate action to nullify, restrict or disparately reduce the per share voting rights” of existing common stockholders.²² The court held the rule to be beyond the Commission’s authority because it “directly” controlled “the substantive allocation of powers among classes of shareholders.”²³

In the *Business Roundtable* litigation, “[t]he Commission support[ed] Rule 19c-4 as advancing the purposes of . . . § 14’s grant of power to regulate the proxy process.”²⁴ The court explained that “the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure (such as are regulated under § 14 of the Act), . . . and that is concededly a part of corporate governance traditionally left to the states.”²⁵ In reaching that conclusion—and ultimately invalidating the rule—the court considered and rejected a number of arguments that the Commission repeats almost verbatim in its attempt to support the Proposed Election Contest Rules.

²⁰ *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964); see also, e.g., *SEC v. Kalvex, Inc.*, 425 F. Supp. 310, 314 (S.D.N.Y. 1975) (Section 14(a) serves to “ensure that full and fair disclosure would be made to stockholders whose proxies are being solicited so that an informed and meaningful consideration of the alternatives can be made”).

²¹ *Business Roundtable v. SEC*, 905 F.2d 406, 410 (D.C. Cir. 1990) (citing *Borak*, 377 U.S. at 431) (alterations in original). See also *id.* (“Proxy solicitations are, after all, only *communications* with potential absentee voters.”).

²² Voting Rights Listing Standards; Disenfranchisement Rule, 53 Fed. Reg. 26,376, 26,394 (1988) (codified at 17 C.F.R. § 240.19c-4).

²³ 905 F.2d at 407.

²⁴ *Id.* at 410.

²⁵ *Id.* at 408.

The Commission argued in the *Business Roundtable* case that Rule 19c-4 advanced the statutory purpose of promoting “fair corporate suffrage.”²⁶ It makes the same contention in the proposing release: “Section 14(a) ‘stemmed from the congressional belief that “fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange.”’”²⁷ As the D.C. Circuit has explained, the *means* by which Congress authorized the Commission to advance “corporate suffrage”—*i.e.*, oversight of the proxy solicitation process—limits the scope of the Commission’s regulations to disclosure and concomitant procedures:

While the House Report indeed speaks of fair corporate suffrage, it also plainly identifies Congress’s target—the solicitation of proxies by well informed insiders “without fairly informing the stockholders of the purposes for which the proxies are to be used.” The Senate Report contains no vague language about “corporate suffrage,” but rather explains the purpose of the proxy protections as ensuring that stockholders have “adequate knowledge” about the “financial condition of the corporation . . . [and] the major questions of policy, which are decided at stockholders’ meetings.” Finally, both reports agree on the power that the proxy sections gave the Commission—“power to control the conditions under which proxies may be solicited.”²⁸

Thus, Section 14(a) does not authorize the Commission to regulate “corporate suffrage” in the abstract. Rather, the Commission is authorized to ensure the adequacy of *disclosures* made in the proxy process to ensure that shareholder votes are meaningful. As the Supreme Court has explained, Section 14(a) was “intended to promote the free exercise of the voting rights of stockholders by ensuring that proxies would be solicited with explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.”²⁹ It was *not* intended to allow the Commission to dictate the matters on which stockholders would vote.³⁰

In the *Business Roundtable* case, the Commission also attempted to rely on its authority to “protect investors and the public interest.”³¹ It takes the same tack in the proposing release: “Section 14(a) authorizes the Commission to prescribe proxy solicitation rules that are

²⁶ *Id.* at 410.

²⁷ 68 Fed. Reg. at 60,786 (quoting *Borak*, 377 U.S. at 431 (quoting H.R. REP. NO. 73-1383, at 13-14) (“1934 House Report”)).

²⁸ 905 F.2d at 410 (internal citations omitted) (alterations in original).

²⁹ *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970) (internal quotations omitted).

³⁰ Section 14(a) was not created “to regulate the stockholders’ choices.” *Business Roundtable*, 905 F.2d at 411.

³¹ *Id.* at 413 (internal quotations omitted).

‘necessary or appropriate in the public interest or for the protection of investors.’”³² As the D.C. Circuit explained, however, “a vague ‘public interest’ standard cannot be interpreted without some confining principle.”³³ Here, the statute itself provides the confining principle: The Commission’s rules must relate to *proxy solicitation*. And it “stems as a matter of necessity from the nature of proxies” that “proxy regulation bears almost exclusively on disclosure.”³⁴ The Commission thus is authorized to regulate proxy disclosures, including concomitant procedures, to protect investors and the public interest, but its authorization extends no further.

The proposing release asserts that “the proposed procedure involves disclosure and other requirements concerning proxy materials.”³⁵ But it is those “other requirements” that are the heart of the Proposed Election Contest Rules, and the Commission lacks authority to impose them. In particular, the Proposed Election Contest Rules would require companies under some circumstances to facilitate shareholder nomination of director candidates and include such candidates in company proxy materials. The Commission tries to cast this requirement in the language of disclosure—the proposing release states that the Proposed Election Contest Rules would “require companies to place security holder nominees for director in company proxy materials”³⁶—but in the absence of a right to include the shareholder nomination in the company’s proxy material, there would be no such nominees to disclose. The fundamental change wrought by the Proposed Election Contest Rules is not requiring the proxy materials to include information about nominees, but rather the antecedent (and largely unmentioned) determination that companies must allow shareholder nominees to be included in the company proxy materials.

The Commission attempts to analogize the Proposed Election Contest Rules to other proxy rules promulgated under the Exchange Act.³⁷ The Commission made a similar argument in attempting to defend Rule 19c-4 by analogizing it to Rule 14a-4(b)(2), which requires a proxy to provide some mechanism to allow a shareholder to withhold a vote for individual director

³² 68 Fed. Reg. at 60,786 (quoting 15 U.S.C. § 78n(a)).

³³ 905 F.2d at 414.

³⁴ *Id.* at 410.

³⁵ 68 Fed. Reg. at 60,787.

³⁶ *Id.*

³⁷ The Commission’s proxy rules generally “bar the use of proxy statements that are false or misleading with respect to the presentation or omission of material facts.” *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 440 (1976). Thus, Rule 14a-3 controls what information is to be furnished to security holders; Rule 14a-4 describes the form of proxies; Rule 14a-6 sets forth filing requirements; and Rule 14a-9 proscribes the use of false or misleading statements in proxy materials. Unlike the Proposed Election Contest Rules, existing proxy rules regulate the *disclosure* of information (and corresponding procedures) in the proxy process.

nominees.³⁸ The *Business Roundtable* court noted that Rule 14a-4(b)(2) “lie[s] in a murky area between substance and procedure,” but “*may* be supportable as a control over management’s power to set the voting agenda, or, slightly more broadly, voting procedures.”³⁹ In contrast, the court explained, Rule 19c-4 “much more directly interferes with the substance of what shareholders may enact.”⁴⁰ Similarly, here, the Commission is attempting to interfere with the director nomination and election processes by regulating substance—the nomination and election of directors—rather than procedure.

In this instance, the Commission analogizes the Proposed Election Contest Rules to Exchange Act Rule 14a-8, which requires corporations in specified circumstances to include shareholder proposals in their proxy materials. Assuming *arguendo* that Rule 14a-8—which, like Rule 14a-4(b)(2), lies in the “murky area between substance and procedure”—is within the Commission’s Exchange Act authority (a question not presented in the context of the Proposed Election Contest Rules), it does not establish a statutory foundation for the Proposed Election Contest Rules. There is a significant difference between Rule 14a-8 and the Proposed Election Contest Rules: Rule 14a-8 merely requires companies under certain circumstances to include shareholder proposals—which can be made under state law at the annual meeting—in the proxy materials. It thus extended the processes of the existing annual meeting to the proxy solicitation process.

The Proposed Election Contest Rules, by contrast, would establish a new federal right in the absence of any corresponding state privilege—the right of shareholders to gain access to company proxy materials to nominate directors. (The Proposed Election Contest Rules not only establish a new federal right, they also would put the Commission in the position of determining how that right is allocated, by defining which shareholders or groups of shareholders may nominate director candidates in a company’s proxy materials. That is an impermissible exercise of the Commission’s authority and, indeed, may directly conflict with corporate law in some states that prohibit shares of the same class from being treated disparately.⁴¹) The authority embodied in this proposed new right, moreover, would be mandatory and binding. If a shareholder nominee receives the requisite vote, that nominee must be seated as a director. By contrast, Rule 14a-8 proposals are precatory, unless state law permits binding shareholder action without director involvement, meaning that the Rule generally does not require that shareholder proposals be implemented even if they do receive the requisite vote.

³⁸ 17 C.F.R. § 240.14a-4(b)(2).

³⁹ 905 F.2d at 411 (emphasis added).

⁴⁰ *Id.*

⁴¹ See Andrew R. Brownstein & Igor Kirman, *Shareholder Access Proposals Conflict with Federal Proxy Rules and State Law*, 6 M&A LAWYER 8 (2003).

The distinction between mandatory and precatory proposals is critical, as the Commission has long recognized. In a 1976 release regarding Rule 14a-8, for instance, the Commission explained that “proposals by security holders that *mandate or direct* the board to take certain action *may constitute an unlawful intrusion* on the board’s discretionary authority under the typical [state] statute.”⁴² By contrast, the release stated, “proposals that *merely recommend or request* that the board take certain action would not appear to be contrary to the typical state statute, since such proposals are merely advisory in nature and would not be binding on the board even if adopted by a majority of the security holders.”⁴³

This proposal would step over that line for the first time to institute three types of binding shareholder votes. One would be the binding vote for director nominees proposed by shareholders in a company’s proxy statement rather than by the company. The second would be the binding vote to implement a shareholder’s proposal to hold an election contest (the first “trigger”). The third, for all practical purposes, would be the binding obligation to hold an election contest in instances where withhold votes in excess of 35 percent of the votes cast were cast against a company’s nominee (the second “trigger”). (Sophisticated institutional shareholders would recognize that often the simplest way of winning the ability to use the company proxy for their own nominees will be through withhold votes—in that manner, an election contest can be compelled by the votes of scarcely more than a third (35 percent) of shares, rather than a majority.)

It is immaterial that the proposed rules treat these latter two binding votes as “triggers” for an obligation imposed by the Commission, rather than as binding of their own force. An agency cannot use the regulatory authority that it does possess to impose requirements that otherwise are beyond its authority.⁴⁴ In this instance, the Commission does not have the authority to require companies to implement shareholder proposals. That being the case, even supposing the Commission had the authority to require companies to include shareholder director nominees in company proxy statements, it cannot use that authority as *leverage* to require companies to implement binding shareholder proposals, such as a proposal to have an election contest under the first “trigger.”

In requiring companies to include *binding* shareholder proposals in their proxy cards, the Commission would not only exceed its Section 14(a) authority to regulate *disclosures and certain procedures* in the proxy process, it also would alter the nature of proxies themselves so

⁴² Release No. 34-12999, 1976 SEC LEXIS 326, at *20 (Nov. 22, 1976) (emphasis added). *See also* Note to Rule 14a-8(i)(1) (“Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders.”).

⁴³ Release No. 34-12999, 1976 SEC LEXIS 326, at *20-21 (Nov. 22, 1976) (emphasis added).

⁴⁴ *See MD/DC/DE Broadcasters Ass’n v. FCC*, 236 F.3d 13, 19 (D.C. Cir. 2001) (Federal Communications Commission may not use authority to investigate broadcasters to “pressure” them into recruiting practices that cannot legally be required); *Chamber of Commerce v. United States Dep’t of Labor*, 174 F.3d 206, 210 (D.C. Cir. 1999) (OSHA may not use authority to inspect workplaces to compel conduct that may not be required).

fundamentally as to transgress the bounds of Section 14(a). The proxy process functions, to be sure, as a means of communicating with shareholders. But fundamentally and primarily, a proxy card is “an authority given by the holder of the stock who has the right to vote it to another to exercise his voting rights.”⁴⁵ To “give one’s proxy” to another is to give that person control of one’s vote. A proxy solicitation is by definition a request that a shareholder authorize another to vote his shares a certain way,⁴⁶ and a proxy contest, accordingly, is a contest in which rival groups compete to see who will receive shareholders’ proxies to be able to vote those proxies as they see fit.⁴⁷ Under these Proposed Election Contest Rules, however, in soliciting what the Commission calls “proxies” a company would in fact be soliciting *binding votes against itself*. That is not a “proxy,” as made clear above and, as the D.C. Circuit held in *American Bankers*, the Commission cannot expand its jurisdiction by issuing rules that interpret the terms of the Exchange Act so broadly as to violate the terms’ plain meaning.⁴⁸ That is what would occur here.

That the Commission cannot convert proxies to binding general “ballots” is evident in the *structure* of the Act, as well as in the plain meaning of the statutory terms. The Act already recognizes a mechanism for shareholders to cast binding votes against companies’ nominees for director—by giving their proxy to someone else to vote for a different slate. To force companies to “solicit” binding votes against themselves is so fundamentally at odds with that process that it would violate the Exchange Act and improperly intrude on matters that Congress left to regulation by the states.⁴⁹

⁴⁵ 18A AM. JUR. 2D *Corporations* § 1069 (1985). See also BLACK’S LAW DICTIONARY 1214 (7th ed. 1999) (defining proxy as “1. One who is authorized to act as a substitute for another, esp., in corporate law, a person who is authorized to vote another’s stock shares. 2. The grant of authority by which a person is so authorized. 3. The document granting this authority”); MERRIAM WEBSTER’S COLLEGIATE DICTIONARY 941 (10th ed. 1996) (defining proxy as: “1. the agency, function, or office of a deputy who acts as a substitute for another; 2a. authority or power to act for another; 2b. a document giving such authority . . . ; 3. a person authorized to act for another”).

⁴⁶ See 15 U.S.C. § 78n(a) (“It shall be unlawful . . . to solicit any proxy or *consent* or *authorization*. . .”) (emphases added); Rule 14a-1 (defining “proxy” as including “every *proxy, consent or authorization* within the meaning of section 14(a) of the Act”) (emphasis added). See also BLACK’S LAW DICTIONARY 1214 (7th ed. 1999) (defining proxy solicitation as “a request that a corporate shareholder authorize another person to cast the shareholder’s vote at a corporate meeting”).

⁴⁷ A proxy contest is “a dispute between groups attempting to retain or gain control of the board of directors of a company by using the proxy device to gather sufficient voting support.” 5 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2052.80 (perm. ed., rev. vol. 2003).

⁴⁸ See *American Bankers*, 804 F.2d at 755.

⁴⁹ In this sense, too, the Proposed Rules go farther than Rule 14a-8, which does not use the proxy to force a company to “solicit” binding votes against itself. Rule 14a-8 uses the proxy to serve a communicative function—to communicate shareholder approval for a proposal that is not binding. The proposed rules step

[Footnote continued on next page]

B. In Exceeding The Commission’s Authority Under Section 14(a), The Proposed Rules Improperly Intrude On Matters Left To Regulation By The States.

Even if the interpretation of Section 14(a) advocated by the Commission were not precluded by the plain language of the Securities Exchange Act as shown above, it would be barred as an improper intrusion on matters “traditionally relegated to state law.”⁵⁰

As the Supreme Court has observed, “Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”⁵¹ The D.C. Circuit relied on this principle in *Business Roundtable*, explaining that “state corporate law . . . regulates the distribution of powers among the various players in the process of corporate governance,” and that the Commission accordingly lacks statutory authority to “leap beyond disclosure”—as it attempts with the Proposed Rules—to engage in “just that sort of regulation.”⁵² As examples of such impermissible regulation of the corporate governance process, the D.C. Circuit offered “requirements for independent directors, independent audit committees, shareholder quorums, shareholder approval for certain major corporate transactions, and other major issues traditionally governed by state law.”⁵³ The nomination of director candidates, and the establishment of qualifications for those who may be nominated, follows *a fortiori* from this list.⁵⁴

[Footnote continued from previous page]

over the line between using the proxy to communicate, and using it to bind in precisely the manner of a general binding “ballot.”

⁵⁰ *Santa Fe Indus.*, 430 U.S. at 479 (internal quotations omitted).

⁵¹ *Id.*

⁵² 905 F.2d at 411-12. *See also Santa Fe Indus.*, 430 U.S. at 477-78 (emphasizing the Exchange Act’s “philosophy of full disclosure” and dismissing the terms of the underlying transaction in that case as “at most a tangential concern of the statute” once full and fair disclosure has occurred).

⁵³ 905 F.2d. at 412.

⁵⁴ The *Business Roundtable* decision was issued before the Sarbanes-Oxley Act, P.L. 107-204 (2002), was enacted. Sarbanes-Oxley expressly authorizes the Commission to make rules affecting some aspects of corporate governance, including directing national securities exchanges and associations to require “independent” audit committees, but did not address the question of director nominations. Tellingly, the proposing release does not cite the Sarbanes-Oxley Act as authority for the Proposed Election Contest Rules. In this context, the Sarbanes-Oxley Act serves to confirm that, in the absence of *express* congressional authorization, the Commission lacks statutory authority to regulate corporate governance.

Nothing in the Exchange Act purports to authorize the Commission to regulate the nomination and election of corporate directors. As the legislative history confirms, that silence speaks volumes.

The legislative history of the Exchange Act indicates that its intent was not “to regiment business in any way.”⁵⁵ Representative Rayburn, one of the sponsors of the Exchange Act, expanded on this point on the floor:

[T]here seems to be a fear running around that the Government is going to regiment business. If any gentleman on the floor of this House during the consideration of this bill . . . can demonstrate to the membership of this committee on either side of the House that there is regimentation of business in this bill, we are willing to take it out.⁵⁶

The Senate Report similarly notes that the bill “furnish[ed] no justification” for a concern that the Commission would have the “power to interfere in the management of corporations.”⁵⁷ Indeed, the House deleted as unnecessary a provision that would have explicitly stated that the Commission could not “interfere with the management of the affairs of an issuer.”⁵⁸ Clearly, requiring companies to include shareholder nominees in their proxy materials would be “interference” with corporate governance, as set forth at greater length in Section II below. As the D.C. Circuit noted in analogous circumstances, “[w]ith its step beyond control of voting procedure and into the distribution of voting power, the Commission would assume an authority that the Exchange Act’s proponents disclaimed any intent to grant.”⁵⁹ That is legally forbidden.

The reason that the Exchange Act does not authorize the Commission to “regiment business” is that corporate governance is a matter of internal corporate management that has traditionally and, for the most part, exclusively, been reserved to the states.⁶⁰ State corporate law governs the director nomination and election process.⁶¹ The Proposed Election Contest Rules would supplant state law in this regard, creating a wholly unprecedented regime of federal

⁵⁵ 1934 House Report at 3.

⁵⁶ 78 Cong. Rec. 7697. The statements of Representative Rayburn are particularly instructive because he was one of the sponsors of the Exchange Act. *See, e.g., N. Haven Bd. of Educ. v. Bell*, 456 U.S. 512, 526-27 (1982).

⁵⁷ S. REP. NO. 73-792, at 10 (1934) (“1934 Senate Report”).

⁵⁸ *Id.* at 35.

⁵⁹ *Business Roundtable*, 905 F.2d at 411.

⁶⁰ *Santa Fe Indus.*, 430 U.S. at 479.

⁶¹ *See, e.g., DEL. CODE ANN. tit. 3, §§ 8510, 8521* (2003) (governing nomination and election of directors).

intrusion into and control over the direction of state-chartered corporations. Again as the D.C. Circuit has explained in analogous circumstances, “the SEC’s assertion of authority directly invades the ‘firmly established’ state jurisdiction over corporate governance and shareholder voting.”⁶² Fundamental principles of federalism—not to mention the Tenth Amendment to the Constitution—preclude this type of arrogation of power by federal authorities, at least in the absence of an explicit congressional directive.

The proposing release attempts to avoid the conflict with state law by asserting that the Proposed Election Contest Rules “are conditioned on the existence of such a right under state law.”⁶³ But the proposing release concedes that the Commission has no idea whether *any* state law permits shareholders to nominate directors at the annual meeting.⁶⁴ Instead, the proposing release turns the relevant inquiry on its head, asserting that the Proposed Election Contest Rules would apply “unless applicable state law *prohibits* the company’s security holders from nominating a candidate or candidates for election as a director.”⁶⁵ Thus, in contrast to Rule 14a-8, the Proposed Election Contest Rules would recognize a new federal practice that would apply in the absence of conflicting state law.⁶⁶ This runs directly counter to the notions of federalism that animated the Exchange Act and that heretofore have guided the Commission’s implementation of Section 14(a).

Rule 14a-8 requires that shareholder proposals be included in proxy materials, but generally does *not* require that companies implement even those proposals that receive a majority vote. Boards of directors retain their state-law discretion to determine, in the exercise of their business judgment, whether any particular proposal would be in the best interests of their companies and the shareholders. The Proposed Election Contest Rules, by contrast, contemplate that a company would be *required* to seat a shareholder nominee who receives the requisite vote.⁶⁷ This crosses the line from providing *information* to proxy voters regarding the issues to be addressed at the annual meeting to dictating the *results* of corporate elections. It would supplant the fiduciary duty of directors to manage the business and affairs of corporations

⁶² *Business Roundtable*, 905 F.2d at 413 (quoting *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 89 (1987)).

⁶³ 68 Fed. Reg. at 60,787.

⁶⁴ See 68 Fed. Reg. at 60,808 (“We request comment and supporting empirical data . . . on any existing, applicable state law provisions that would prohibit security holders or security holder groups from nominating a candidate or candidates for election as director.”).

⁶⁵ 68 Fed. Reg. at 60,787 (emphasis added).

⁶⁶ In this regard, it is telling that Rule 14a-8 authorizes companies to *exclude* shareholder proposals “relat[ing] to an election for membership on the company’s board of directors or analogous governing body.” 17 C.F.R. § 240.14a-8(i)(8) (2003). This is an implicit recognition that existing state law does *not* authorize shareholders to propose nominees at the annual meeting.

⁶⁷ See 68 Fed. Reg. at 60,800.

pursuant to state law. The Proposed Election Contest Rules are no more supported by existing Rule 14a-8 than was Rule 19c-4, which the D.C. Circuit invalidated as exceeding the Commission’s statutory authority.

The *Business Roundtable* court explained that “[i]n 1934 Congress acted on the premise that shareholder voting could work, so long as investors secured enough information and, perhaps, the benefit of other procedural protections. *It did not seek to regulate the stockholders’ choices.*”⁶⁸ The Proposed Election Contest Rules clearly would regulate the shareholders’ choices, in two ways: First, by giving shareholders access—unprecedented as a matter of state or federal law—to the company’s proxy materials to nominate directors; and second, by interaction with state law, they would require changes in boards of directors based on the shareholder vote. The Proposed Election Contest Rules thus would intrude on existing directors’ fiduciary duties to manage the affairs of their corporations; invade state law, which regulates such matters of corporate governance; and, ultimately, exceed the Commission’s authority to regulate the proxy process pursuant to Section 14(a) of the Exchange Act.

In *Santa Fe Industries*, the Supreme Court rejected an interpretation of the Exchange Act that would “bring within the Rule a wide variety of corporate conduct traditionally left to state regulation.”⁶⁹ In the Court’s judgment, there was sufficient reason to reject the proffered interpretation where it was an “extension of the federal securities laws” that “would overlap and *possibly* interfere with state corporate law.”⁷⁰ In this instance, the overlap and intrusion on matters traditionally left to the states are not merely “possible,” they are clear and practically acknowledged by the Commission. Simply, the Proposed Election Contest Rules exceed the Commission’s lawful authority and should not be adopted.

C. The Other Statutory Provisions Cited Do Not Authorize The Proposed Election Contest Rules.

Although the Commission primarily relies on Section 14(a) in its attempt to justify the Proposed Election Contest Rules,⁷¹ the proposing release also cites various other Exchange Act provisions as ostensible justification for the Proposed Election Contest Rules.⁷² Like Section 14(a), however, those provisions ultimately provide no support for the Commission’s

⁶⁸ 905 F.2d at 411 (emphasis added).

⁶⁹ 430 U.S. at 478.

⁷⁰ *Id.* at 478-79 (emphasis added).

⁷¹ See General Counsel Giovanni P. Prezioso, Remarks at Open Meeting of the Securities and Exchange Commission (Oct. 8, 2003).

⁷² See 68 Fed. Reg. at 60,816. The proposing release also cites certain provisions of the Investment Company Act (*id.*), which simply parallel the cited provisions of the Exchange Act and add nothing to the statutory authorization question.

unwarranted and unprecedented attempt to intrude upon corporate governance issues that are the provenance of state law.

1. Section 3(b)

Section 3(b) vests the Commission with the authority to define certain terms used in the Exchange Act.⁷³ This Section does not confer on the Commission any authority to require that shareholders be permitted to include their nominees in company proxy materials. Indeed, the legislative record makes no mention of Section 3(b) other than to say that it gives the Commission the “power to define accounting, technical, and trade terms.”⁷⁴ This is clearly not the type of broad authority that would allow the promulgation of the Proposed Election Contest Rules.

2. Section 10

The Commission can regulate “manipulative and deceptive devices” under Section 10. Section 10, however, does not give the Commission the authority to promulgate the Proposed Election Contest Rules. Section 10 has two subsections. Subsection (a) makes it illegal to “effect a short sale, or to use or employ any stop-loss order” in connection with the purchase or sale of securities “in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”⁷⁵ Subsection (b) makes it illegal to use “manipulative or deceptive device[s] or contrivance[s] in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”⁷⁶

The statute states that the Commission will have authority to promulgate rules dealing with conduct that is made illegal by the statute; however, nothing in the statute grants to the Commission the authority to implement the Proposed Election Contest Rules. Indeed, Section 10 has absolutely nothing to do with the election of board members or with access to proxy materials. The Senate Report that discussed Section 10 when the Exchange Act was being enacted stated that the Section’s scope “is confined to transactions effected by the use of the mails, the instrumentalities of interstate commerce, and the facilities of a national securities

⁷³ 15 U.S.C. § 78c(b) (2003) (“The Commission . . . shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this title, consistently with the provisions and purposes of this title.”). However, any exercise of such authority may not conflict with other provisions of the Exchange Act. *See American Bankers*, 804 F.2d at 754-55.

⁷⁴ 1934 House Report at 18.

⁷⁵ 15 U.S.C. § 78j(a).

⁷⁶ *See id.* § 78j(b).

exchange.”⁷⁷ Further, subsection (b) only “authorizes the Commission . . . to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the investor.” In this respect, while the Supreme Court has said that Section 10 is a catchall provision, what it catches must be fraud;⁷⁸ neither Section 10 nor its legislative history makes any mention of requiring that shareholders be permitted to include their nominees in company proxy materials. The Commission, therefore, does not have the authority to promulgate the Proposed Election Contest Rules pursuant to Section 10 of the Exchange Act.

3. *Section 13*

Section 13, entitled “Periodicals and Other Reports,” has been adjudged to be procedural in nature: “[Section 13’s purpose is] to insure that investors receive adequate periodic reports concerning the operation and financial condition of corporations.”⁷⁹ This is particularly evident with respect to Section 13(a), which concerns periodic reporting and disclosure requirements for public companies. The other provisions of Section 13 also do not vest the Commission with authority to adopt the Proposed Election Contest Rules. For example, Section 13(b) includes books-and-records and internal accounting controls provisions added by the Foreign Corrupt Practices Act of 1977.⁸⁰ Other subsections of Section 13 added over time include: (1) Sections 13(d) and 13(g), which establish filing requirements of certain beneficial ownership reports upon the acquisition of a certain percentage of a company’s equity securities;⁸¹ (2) Section 13(e), which imposes restrictions on certain stock repurchases by companies;⁸² (3) Section 13(f), which requires institutional investment managers to file certain reports on their holdings and transactions in registered equity securities;⁸³ and (4) Sections 13(i), (j), (k) and (l), which require that public company financial statements reflect all material correcting adjustments, vest the Commission with authority to adopt rules regarding disclosure of material off-balance sheet transactions, prohibit personal loans to executives, and require timely disclosure of material

⁷⁷ 1934 Senate Report at 18.

⁷⁸ *Chiarella*, 445 U.S. at 234-35 (stating that “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud”). *See also Dirks v. SEC*, 463 U.S. 646 (1983).

⁷⁹ *Kalvex*, 425 F. Supp. at 316.

⁸⁰ 15 U.S.C. § 78m(b).

⁸¹ 15 U.S.C. § 78m(d); 15 U.S.C. § 78m(g).

⁸² 15 U.S.C. § 78m(e).

⁸³ 15 U.S.C. § 78m(f).

changes in the financial condition or company operations as specified by Commission rulemaking.⁸⁴

In sum, despite amendments spanning thirty-eight years, Section 13 remains concerned with issues wholly unrelated to requiring public companies to allow shareholders' director nominees to be placed in the companies' proxy materials.⁸⁵ The Section does not vest the Commission with the authority to promulgate the Proposed Election Contest Rules.

4. Section 15

Section 15 addresses the registration and regulation of brokers and dealers and includes filing requirements for certain public companies, limitations on penny stock transactions and restrictions on rulemaking regarding certain hybrid products.⁸⁶ Moreover, Section 15 authorizes the Commission to prescribe rules that address the requirements for the registration, standards and conduct of brokers and dealers.⁸⁷ Section 15 also requires certain public companies to file supplementary and periodic information, documents, and reports⁸⁸ and requires certain disclosures with respect to transactions in penny stocks.⁸⁹ The Section, however, does not even remotely address proxy matters or the nomination of director candidates.

5. Section 16

For directors, officers and principal shareholders of public companies, Section 16 imposes certain trading restrictions, prohibits short sales of stock and requires disclosures regarding transactions.⁹⁰ This Section grants the Commission limited rulemaking authority with respect to (i) the time of filing of beneficial ownership statements required under Section 16(a)(1); (ii) exempting certain transactions from the recovery of short-swing profits

⁸⁴ 15 U.S.C. § 78m(i)-(l). These sections were added in 2002 as part of the Sarbanes-Oxley Act.

⁸⁵ Amendments were adopted between 1964 and 2002. *See* Pub. L. No. 88-467, § 4, 78 Stat. 569 (1964); Pub. L. No. 107-204, tit. I, § 109(h), tit. IV, §§ 401(a), 402(a), 409, 116 Stat. 771, 785, 787, 791 (2002).

⁸⁶ 15 U.S.C. § 78o. Section 15(d) also addresses reporting requirements, which, for the same reasons discussed in connection with Section 13, would not provide the Commission with authority to promulgate the Proposed Election Contest Rules.

⁸⁷ *See id.* § 78o(b)(1).

⁸⁸ *See id.* § 78o(d).

⁸⁹ *See id.* § 78o(g).

⁹⁰ 15 U.S.C. § 78p.

under Section 16(b); and (iii) defining certain terms and conditions.⁹¹ As with the other statutory provisions cited in the proposing release, Section 16 makes no mention of the election of board directors or shareholders' access to companies' proxy materials for that purpose.

6. *Section 23(a)*

Section 23(a) vests the Commission with the “power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which [it is] responsible or for the execution of the functions vested in [it] by this title.”⁹² This language clearly limits the Commission’s authority to making rules that “implement the provisions of this title or for the execution of the functions vested in them by this title.”⁹³ There is no provision in the Exchange Act requiring companies to permit shareholders to include their nominees in company proxy materials, and indeed, as stated above, such interference into corporate governance was never contemplated by Congress to be encompassed within the Exchange Act.⁹⁴ As the Proposed Election Contest Rules do not implement any section in the Exchange Act, they cannot be properly authorized rules under Section 23(a). This Section, therefore, does not authorize the Commission to promulgate the Proposed Election Contest Rules.

7. *Section 36*

Section 36 vests the Commission with authority to exempt certain companies from Commission rules and requirements. This Section was not enacted in the original Exchange Act, but was added by amendment in 1996.⁹⁵ Section 36 has two subparts. Subsection (a) authorizes the Commission to exempt any person or securities from any provision in the Exchange Act “to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors” and to promulgate procedures for such exemptions.⁹⁶ Subsection (b) prohibits the Commission from exempting anyone from the definitions in paragraphs (42), (43), (44) and (45) of Section 3(a)⁹⁷. The legislative history of this Section is clear that Section 36 was enacted to allow the SEC to *exempt* people and securities from

⁹¹ *Id.* § 78p(a)(1), (b), (d).

⁹² 15 U.S.C. § 78w(a)(1). Section 23 also exempts from liability any entity that acted in good faith pursuant to a rule that was later amended or judged to be invalid. *See id.*

⁹³ *Id.*

⁹⁴ *See, e.g.*, 1934 Senate Report at 10; 1934 House Report at 3.

⁹⁵ Pub. L. 104-290, Title I, § 105(b), 110 Stat. 3424 (Oct. 11, 1996).

⁹⁶ 15 U.S.C. § 78mm(a).

⁹⁷ *Id.* at § 78mm(b).

Commission laws and rules, not to provide rulemaking authority.⁹⁸ There is nothing either in the Exchange Act or in the legislative history that would permit the Commission to promulgate a rule requiring companies to permit shareholders to include their nominees in company proxy materials. Like the other statutory provisions cited in the proposing release, Section 36 thus provides no support to the Commission’s proposition that the Proposed Election Contest Rules are authorized.

II. The Proposed Election Contest Rules Are Unreasonable, Would Not Achieve The Commission’s Objectives, And Have Been Issued Pursuant To Procedures That Violate Governing Rulemaking Requirements.

Section I of these comments has demonstrated that the Commission lacks the legal authority to promulgate the Proposed Election Contest Rules. In the section that follows, it will be shown that even if the Commission did possess authority to issue rules of this nature, the particular rules proposed—and the rulemaking by which they have been promulgated—are so fundamentally flawed as to violate the Administrative Procedure Act (“APA”) and other important constraints with respect to the Commission’s rulemaking responsibilities.

A. The Governing Rulemaking Standards.

Among the numerous laws and orders that govern the Commission’s rulemaking, three warrant particular attention: the APA,⁹⁹ the Exchange Act¹⁰⁰ and Executive Order 12,866.¹⁰¹

Administrative Procedure Act: The APA prohibits agency action that is, *inter alia*, “arbitrary and capricious.”¹⁰² In the context of rulemaking, the Supreme Court has

⁹⁸ H.R. REP. NO. 104-622, at 38 (1996).

⁹⁹ See APA, 5 U.S.C. § 551 *et seq.*

¹⁰⁰ See the Exchange Act, 15 U.S.C. § 78 *et seq.*

¹⁰¹ See Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (1993), as amended by Exec. Order No. 13,258, 67 Fed. Reg. 9385 (2002) (“Exec. Order No. 12,866”).

Other laws and/or provisions implicated by the Proposed Election Contest Rules include the Paperwork Reduction Act of 1995, 44 U.S.C. § 3501 *et seq.*; the Regulatory Flexibility Act of 1980, 5 U.S.C. § 601 *et seq.*; Small Business Regulatory Enforcement Act of 1996, P.L. 104-121, tit. II, 110 Stat. 857 (1996); Exec. Order No. 13,272, 67 Fed. Reg. 53,461 (2002); and Exec. Order 12,988, 61 Fed. Reg. 4,729 (1996). As described in detail in a November 21, 2003 comment letter submitted to the Office of Management and Budget (“OMB”) (and copied to the Commission) by the Business Roundtable regarding the Proposed Election Contest Rules, the proposing release clearly does not satisfy the requirements of the Paperwork Reduction Act. All of the comments contained in that letter are incorporated herein by reference.

said, this means that an agency “must examine the relevant data and articulate a satisfactory explanation for its actions including a ‘rational connection between the facts found and the choices made.’”¹⁰³ The Court elaborated:

Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.¹⁰⁴

The prohibition on arbitrary and capricious agency action requires an adequate evidentiary basis for agency decisions: “[S]peculation is an inadequate replacement for the agency’s duty to undertake an examination of the relevant data and reasoned analysis.”¹⁰⁵ And, even where an agency does have “substantial evidence” to support its findings, it may not indulge inferences from those facts that are themselves arbitrary—no matter how substantial the support for those facts.¹⁰⁶ Moreover, courts will not supply a rationale for agency action, or accept “counsel’s *post hoc* rationalizations for agency action.”¹⁰⁷

[Footnote continued from previous page]

¹⁰² See 5 U.S.C. § 706(2)(A) (reviewing courts shall “hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law”).

¹⁰³ *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (finding an agency order to be arbitrary and capricious because of inadequate agency analysis, including, but not limited to, the agency’s failure to consider relevant factors and alternative approaches).

¹⁰⁴ *Id.* at 43. See also 1 RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 7.4, at 442 (4th ed. 2002) (noting that an agency “must set forth the basis and purpose of the rule in a detailed statement, often several hundred pages long, in which the agency refers to the evidentiary basis for all factual predicates, explains its method of reasoning from factual predicates to the expected effects of the rule, relates the factual predicates and expected effects of the rule to each of the statutory goals or purposes the agency is required to further or to consider, responds to all major criticisms contained in the comments on its proposed rule, and explains why it has rejected at least some of the most plausible alternatives to the rule it has adopted”).

¹⁰⁵ *Horsehead Resource Dev. Co. v. Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994) (emphasis added).

¹⁰⁶ See *Bowman Transp., Inc. v. Arkansas Best Freight Sys., Inc.*, 419 U.S. 281, 284 (1974); *Midtech Paper Corp. v. United States*, 857 F.2d 1487, 1498 (D.C. Cir. 1988).

¹⁰⁷ *Motor Vehicle Mfrs. Ass’n*, 463 U.S. at 50. See also *Alltel Corp. v. FCC*, 838 F.2d 551, 562 (D.C. Cir. 1988) (rejecting agency rationale offered for the first time in a legal brief).

Central to the APA’s constraints on agency rulemaking is the requirement that agencies “afford interested parties a reasonable opportunity to participate in the rulemaking process.”¹⁰⁸ This requirement is designed “both (1) ‘to reintroduce public participation and fairness to affected parties after governmental authority has been delegated to unrepresentative agencies’; and (2) to ensure that the ‘agency will have before it the facts and information relevant to a particular administrative problem.’”¹⁰⁹ Providing a comment period of adequate length is one of the most basic components of assuring an adequate opportunity for public participation.¹¹⁰

Securities Exchange Act of 1934: The Exchange Act requires that Commission rulemakings consider whether the agency’s proposed actions will promote efficiency, competition, and capital formation, and whether they will improperly burden competition.¹¹¹ This requires a thorough and substantive analysis of the economic and competitive consequences of a proposed rule prior to its adoption.¹¹² Thus, for instance, the report of the Commerce Committee of the House of Representatives on the National Securities Markets Improvement Act of 1996 indicates that Congress expects the Commission to weigh the costs and benefits of any rulemaking initiative, including, whenever practicable, undertaking a specific analysis of such costs and benefits. In the report, the Commerce Committee states that it “expects that the Commission will engage in *rigorous* analysis pursuant to [Section 3(f)]” and that “[s]uch analysis [would] be necessary to the Congress in connection with the Congress’ review of major rules pursuant to the terms of the Small Business Regulatory Enforcement Fairness Act of 1996.”¹¹³

Executive Order 12,866: The White House has advised all agencies to comply with Executive Order 12,866, which represents the current policy of the Administration and generally accepted principles of good government.¹¹⁴ Executive Order 12,866

¹⁰⁸ *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)).

¹⁰⁹ *MCI*, 57 F.3d at 1141 (quoting *Nat’l Ass’n of Home Health Agencies v. Schweiker*, 690 F.2d 932, 949 (D.C. Cir. 1982)).

¹¹⁰ *Florida Power*, 846 F.2d at 771.

¹¹¹ See Exchange Act, § 3(f), 15 U.S.C. § 78c(f); Exchange Act, § 23(a)(2), 15 U.S.C. § 78w(a)(2).

¹¹² See H.R. Rep. No. 104-622 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3901.

¹¹³ *Id.*

¹¹⁴ By memorandum dated January 20, 2001, President Bush’s Chief of Staff Andrew Card wrote to heads of all federal executive departments and agencies advising that those agencies should continue to comply with the

[Footnote continued on next page]

provides that when a federal agency engages in a rulemaking, it must first determine whether rules are necessary by: identifying the problem that it intends to address; demonstrating the significance of that problem; demonstrating the failure of private or public institutions to address the problem;¹¹⁵ and adopting rules only where there exists a “compelling public need, such as material failures of private markets to protect or improve the health and public safety of the public, the environment, or the well-being of the American people.”¹¹⁶

If an agency determines that rules are necessary, it then must assess available alternatives to regulation, including the alternatives of (a) not regulating, and (b) providing information to the public that allows it to make choices among options.¹¹⁷ If an agency determines that direct regulation is preferable to other approaches, it must: assess both the costs and benefits of the proposed regulation, “proposing or adopting a regulation only upon a reasoned determination that the benefits of the intended program justify its costs”;¹¹⁸ base its decisions on the best data available;¹¹⁹ design its regulations in the most cost-effective manner possible;¹²⁰ and, where possible, “specify performance objectives, rather than . . . the behavior or manner of compliance that regulated entities must adopt.”¹²¹

Furthermore, agencies should seek the views of appropriate state officials “before imposing regulatory requirements that might significantly or uniquely affect those governmental entities.”¹²²

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requirements of Executive Order 12,866. The text of this memorandum is available at <http://www.whitehouse.gov/news/releases/20010123-4.html> (last visited Dec. 17, 2003).

¹¹⁵ See Exec. Order No. 12,866, at § 1(b)(1). Congress has recognized in other contexts the value of turning to the private sector to assess and attempt to resolve public issues. For example, the National Technology Transfer and Advancement Act, P.L. 104-113 (Mar. 7, 1996), directs agencies to rely upon standards developed by voluntary, private sector consensus bodies in lieu of government-based standards. See OMB, Circular No. A-119 (Feb. 10, 1998).

¹¹⁶ Exec. Order No. 12,866, at § 1(a).

¹¹⁷ See *id.* § 1(b)(3).

¹¹⁸ *Id.* § 1(b)(6).

¹¹⁹ See *id.* § 1(b)(7).

¹²⁰ See *id.* § 1(b)(5).

¹²¹ *Id.* § 1(b)(8).

¹²² *Id.* § 1(b)(9).

As demonstrated below, the Proposed Election Contest Rules fall short of these statutory and regulatory requirements in basic respects. To address a perceived problem that it scarcely identifies and that may not exist at all, the Commission has proposed rules that would not achieve its avowed objectives and, instead, would fundamentally alter corporate governance in ways that the Commission fails to discern, with potentially severe consequences for American companies, the shareholders the Commission seeks to protect, and quite possibly for the American economy as a whole. The important substantive errors of this rulemaking are accompanied by serious transgressions of the procedural constraints on agency rulemaking established by statute, the courts, and presidential Executive Orders. In short, for a problem that has not been established, the Commission has proposed a solution that does not work. The rulemaking should be abandoned.

B. The Commission Has Not Established The Need For A Rule And Has Proposed A Flawed Rule That Would Have Broad-Ranging, Adverse Consequences For Corporations And Their Shareholders Without Achieving The Commission’s Stated Objective.

The Commission has demonstrated no clear need for the Proposed Election Contest Rules; indeed, it has scarcely articulated any reason why this rulemaking is necessary at this time. And while the Commission’s stated objective is to enhance shareholder participation in the proxy process where there are objective indications that the process has been ineffective, the proposed rules would inaugurate sweeping, harmful changes in corporate governance and practices without even achieving the more modest aim identified by the Commission.

1. *The Commission Has Not Demonstrated A Need For Rulemaking.*

For a significant regulatory change to be made, there should be a significant need. Among the most striking aspects of the Commission’s Proposed Election Contest Rules is that while the rules’ consequences would be sweeping, the Commission’s statement of the need for the rules is surprisingly slim. The Commission cites general claims by commenters that including shareholder nominees in company proxy materials would give shareholders a more effective role in the proxy process and, in turn, would “make corporate boards more responsive and accountable.”¹²³ But scant evidence is given that shareholders are in fact denied meaningful participation in the proxy process under the current rules.

Substantial evidence in the record, in fact, suggests the opposite. The Commission views a substantial number of “withhold” votes as indicative of the sort of ineffective proxy process that purportedly warrants the Proposed Election Contest Rules. Thus, in the proposed rules, withhold votes in excess of 35 percent are made one of two “triggers” for application of the rules

¹²³ 68 Fed. Reg. at 60,786. It should be noted that the Commission did not issue an advance notice of proposed rulemaking or formally solicit comment on this issue. Instead, it issued a general release in May 2003 in response to which it received several hundred form letters.

to individual companies. And yet, according to the Commission's own data, this supposedly tell-tale sign of a dysfunctional proxy process occurred, over the last two years, at just *1.1 percent* of companies.¹²⁴ It is extraordinary for rules as significant as these to be premised on a purported problem that occurs at such a small segment of the entities to be regulated.¹²⁵

Even for the 1 percent of companies that did have withhold votes over 35 percent in the past two years, the Commission has not established that this in fact indicates a “problem” warranting government intervention. If 35 percent of shareholders opposed a candidate, but 65 percent supported him or her, the proxy process was not flawed. Even more importantly, government intervention in private enterprise is not appropriate unless, among other things, the conduct to be addressed would remain uncorrected in the absence of government intervention. For that to be the case here, the Commission must establish that the companies with high withhold votes *did not themselves take some action in light of the vote*. Perhaps, for instance, a substantial percentage of the companies whose directors received high withhold votes determined not to re-nominate the candidate who drew significant opposition. Or perhaps the high withhold vote was due to some concern with company practices unrelated to the director candidate, and the company addressed that concern and the next year the director was re-nominated and drew minimal opposition. Simply, even supposing that withhold votes in excess of 35 percent indicate a serious problem, the Commission cannot justify federal intervention without showing that the problem recurs in consecutive years at specific companies. It has no such evidence, and, accordingly, may well be proposing to “correct,” at great cost, a situation that companies already correct themselves.

In supposing that election contest rules are needed, the Commission also fails to consider adequately the other means by which any flaws in the proxy process can be corrected without government intervention. Shareholders who believe that a corporate board is under-performing have a variety of options for pressuring the board to improve. For instance, they may effect a change in the composition of the board by nominating alternative director candidates at the annual meeting (subject to compliance with applicable state-law requirements and company bylaws).¹²⁶ Or they may submit director candidates to the board's independent nominating committee, which has a fiduciary duty to consider candidates in the best interests of the company and all of its shareholders. They can take their concerns public and communicate with other shareholders, or—even easier, in many cases—they can “vote with their feet” by selling the

¹²⁴ See 68 Fed. Reg. at 60,790.

¹²⁵ Even the accuracy of this data is unclear. Although the APA requires agencies to make available the data upon which they rely in rulemaking, the Commission on November 18, 2003 refused our counsel's request to provide the data underlying this 1-percent figure. A formal request for the data currently is pending under the Freedom of Information Act.

¹²⁶ See SECURITIES AND EXCHANGE COMMISSION DIVISION OF CORPORATION FINANCE, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS at 5 (July 15, 2003).

company's stock.¹²⁷ Indeed, by making their initial investments, shareholders already have "voted" for the existing directors, who are entrusted with making decisions in the best interests of the corporation and its shareholders. The purest form of corporate suffrage takes place in the capital markets, not through regulatory action.¹²⁸

And of course, if shareholders are dissatisfied with the directors of a company in which they have invested (and choose to remain invested), the Commission's existing rules provide procedures for shareholders to prepare and disseminate their own proxy materials in support of alternative director candidates.¹²⁹ (In contrast, the Proposed Election Contest Rules would require companies to include shareholder nominees in *company* proxy materials.)

In fact, shareholders have used the Commission's existing rules to launch election contests on numerous occasions. For example, in 1998, the Teachers Insurance and Annuity Association–College Retirement Equities Fund ("TIAA-CREF") successfully ran a seven-person slate to replace the entire board of directors at Furr's/Bishop's.¹³⁰ And in 2001 and 2002, shareholders nominated and elected dissident directors at a number of companies, including United Industrial, ICN Pharmaceuticals, Lone Star Steakhouse & Saloon, Hercules and Liquid Auto.¹³¹ Thus, there is simply no evidence that the existing measures, including traditional election contests, are ineffective for the thousands of companies the Commission seeks to regulate.

¹²⁷ See, e.g., Mark Klock, *Lighthouse or Hidden Reef? Navigating the Fiduciary Duty of Delaware Corporations' Directors in the Wake of Malone*, 6 STAN. J. L., BUS. & FIN. 1, 10 (Fall 2000) (stating that "[t]he market can sometimes be a disciplining mechanism for enforcing [directors'] duties because if the directors make choices which investors dislike, the directors can be removed in a variety of ways: regular election, removal, or hostile takeover through a tender offer if shareholders vote with their feet"); Rachel Weber, *Why Local Economic Development Incentives Don't Create Jobs: The Role of Corporate Governance*, 32 URB. LAW. 97, 113 (Winter 2000) (stating that "[i]n addition to exercising 'voice' to influence management, shareholders have another powerful and more commonly used control tool at their disposal: exit. If shareholders are not pleased with management's performance, they will 'vote with their feet,' sell their stock, and force share values down"). See also David Marcus, *The Great Motivator*, THE DEAL, Oct. 20, 2003, at 31 (citing Robert Pozen, former vice chairman of Fidelity Investments, for the premise that "money managers usually respond to a company's poor performance by selling its stock, not by campaigning for corporate reform").

¹²⁸ In this regard, election of corporate directors is really quite different from the American political process. In the political jurisdiction in which each voter resides, there are only a small number of leadership positions to be voted on (one President, two Senators, one Congressman, one Mayor, and so on). By contrast, there are many thousands of public companies in which those same voters may choose to invest their capital. A citizen unhappy with the town council is unlikely to move for that reason alone, but an investor dissatisfied with a corporation's board of directors easily can redirect his or her capital to a preferred alternative.

¹²⁹ See 17 C.F.R. § 240.14a-4.

¹³⁰ See John Waggoner, *Largest Pension Fund Unseats Board*, USA TODAY, May 29, 1998, at 1B.

¹³¹ See AMY L. GOODMAN & JOHN F. OLSON, A PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES § 11-12.3 (2003 Supp.).

In discussing the catalyst for the Proposed Election Contest Rules, it is appropriate to address the current environment of great change in the regulation of corporate practices in this country. This environment is likely part of the reason—perhaps a large part of the reason—the Commission is considering implementing, suddenly, a broad change that, in the prior 60 years under the Exchange Act, it periodically considered and tabled.¹³² It is this very environment, however, that makes the Commission’s proposal particularly ill-timed.

The past two years have seen more corporate governance reform than the previous twenty. The sweeping reforms enacted by Congress (in the Sarbanes-Oxley Act of 2002), the Commission and the exchanges have yet to be fully implemented. In fact, the NYSE and NASDAQ corporate governance listing standards, which will enhance the role and independence of board nominating committees by requiring that nomination decisions be made solely by independent directors and that nominating committee responsibilities be addressed in a formal written charter, among other things, generally will not go into effect until next spring.¹³³ In addition, the Commission only recently adopted new rules requiring disclosure about nominating committee processes and shareholder-director communications.¹³⁴ These rules mandate discussion in a company’s proxy materials of, among other things: (1) whether the company has a standing nominating committee; (2) whether that committee has a charter and where that charter is available; (3) whether members of the nominating committee are independent; (4) whether the company considers candidates for director put forward by shareholders (and, if so, the material elements of its process for considering such candidates); (5) the procedures for shareholders to submit candidates for director; (6) any minimum qualifications that the company seeks for director nominees; (7) the company’s process for identifying and evaluating candidates to be nominated for director; (8) a statement regarding the category of person(s) who recommended each new nominee approved by the nominating committee; (9) whether the company pays third parties a fee to assist in the nominations process; and (10) whether the company has rejected director candidates put forward by certain large shareholders.¹³⁵ These rules were adopted less than one month ago (November 24, 2003) and will first affect companies’ disclosures in the 2004 proxy season.

Until these changes are fully implemented and their benefits—and costs—fully realized, the Commission is not in a position to determine whether additional changes in corporate governance are needed and, if so, what changes in particular are demanded. Similarly, because

¹³² See SECURITIES AND EXCHANGE COMMISSION DIVISION OF CORPORATION FINANCE, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS at 2-4 (July 15, 2003).

¹³³ 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).

¹³⁴ See Final Rule: Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Release No. 33-8340, 68 Fed. Reg. 66,992 (Nov. 28, 2003).

¹³⁵ See *id.*

these recent changes are expected to alter corporate conduct, the Commission lacks a stable evidentiary basis from which it may ascertain what problems in corporate conduct exist currently and require additional correction. The Commission's reliance on data from just two years ago will in many instances be unwarranted (and arbitrary and capricious) given the recent reforms aimed at corporate behavior. Survey data collected from our members in July 2003 (the "July 2003 Survey") indicates that, in fact, there have been real, positive changes in corporate boardrooms over the past two years.¹³⁶ Specifically:

- 8 in 10 companies reported that their boards of directors were at least 75 percent independent, and 9 in 10 reported that at least two-thirds of their directors were independent;
- the outside directors of 97 percent of companies were meeting in executive session at least once each year, and 55 percent expected to do so at least five times this year;
- over 70 percent of companies performed director evaluations in 2003, compared to 44 percent in 2002;
- in the absence of a legal requirement, 55 percent of companies had (or indicated that they would have by the end of 2003) an independent chairman, independent lead director or presiding outside director;
- 90 percent of companies encouraged, required or had in place director education programs for new, and in some cases all, directors; and
- two-thirds of companies reported that their nominating committees had a process in place to communicate with shareholders and respond to shareholder nominations of board candidates.

Given this pace of change in corporate governance, now would be a particularly inopportune time for the Commission to unleash the great changes in corporate governance that would result from its Proposed Election Contest Rules.

2. *The Triggers In The Proposed Rules Would Have Sweeping Consequences And Would Be Tripped Far More Frequently Than The Commission Suggests.*

The Commission's proposing release does not recognize the sweeping consequences this proposal would have for corporate conduct in general and director elections in particular. The Proposed Election Contest Rules would be triggered far more often than the Commission supposes. The Commission has not adequately considered the influence of proxy advisory services and institutional investors, many of whom rarely engage in the kind of company-by-

¹³⁶ See Press Release, The Business Roundtable Corporate Governance Survey Highlights (July 15, 2003), available at <http://www.businessroundtable.org/document.cfm/969> (last visited Dec. 17, 2003).

company analysis that the Commission contemplates and who may use the rules as leverage for advancing special-interest causes. Finally, the proposed triggering events would not accomplish the Commission's stated objective: enhancing shareholders' ability to participate in the proxy process where there is objective evidence indicating that such process has been ineffective.¹³⁷ For all of these reasons, it would be error for the Commission to proceed with its Proposed Election Contest Rules.

Before addressing the particular components of the proposed rules, comment is appropriate on the Commission's failure throughout the proposing release to recognize two important aspects of the proxy process that would have a great impact on the proposed rules. The first is the role of proxy voting guidelines in determining the voting practices of many institutional investors; the second is the collateral objectives of certain large institutional investors, among them state pension funds, unions and corporate raiders.

The proposing release appears to envision individual investors making particularized decisions about the "responsiveness" of specific companies to the proxy process, and determining on that basis whether to seek to trigger the Election Contest procedure at the company at issue. For the majority of institutional investors, however, this is not how the rules would function.

Employee benefit plans, for instance, are among the most significant current investors in the securities markets. These plans have total holdings valued at close to \$5 trillion. As a consequence of positions taken by the Department of Labor, managers of these plans regard the ability to vote proxies as a plan "asset" that they are required to exercise by virtue of their duties as plan fiduciaries.¹³⁸ For plans to vote proxies on all matters submitted to shareholders of the companies in which they are invested, however, is an enormous undertaking—tens of thousands of matters are submitted every year to shareholders of public companies. And because most public companies are calendar-year companies whose annual meetings generally are held in a six- to eight-week period in the spring of each year, these benefit plans would need to evaluate thousands of proposals in a very short time period. Therefore, for most institutional investors, the close examination of the individual matters to be voted on in company proxy materials contemplated by the proposing release is simply impracticable.

Instead, most institutional investors adopt voting guidelines, either independently or by using the guidelines of Institutional Shareholder Services ("ISS") or another proxy advisory service. (Some plans also hire proxy advisors to vote on their behalf.) In November 2003, surveys of members of the Business Roundtable and the American Society of Corporate Secretaries (the "November 2003 Surveys") found that, on average, 40 percent of a public company's shares are cast by institutional investors (including ERISA plans) that follow ISS

¹³⁷ 68 Fed Reg. at 60,816.

¹³⁸ See, e.g., Letter from Alan Lebowitz, Deputy Assistant Secretary, U.S. Department of Labor, to Avon Products, Inc. (Feb. 23, 1988).

proxy voting guidelines.¹³⁹ Indeed, ISS has been described as having a “pervasive influence” in the area of corporate governance.¹⁴⁰

Benefit plans and other institutional investors rely heavily on these proxy voting guidelines, often refusing even to *discuss* the merits of particular proposals with management. These investors typically do not review individual shareholder proposals on a company-by-company basis and do not consider the effectiveness or ineffectiveness of a company’s proxy process when casting their vote. In fact, they seldom deviate from ISS or other voting guidelines regardless of a company’s position, circumstances, or responsiveness to shareholders. According to Georgeson Shareholder Communications, Inc. (“Georgeson”), a large proxy solicitation firm, standardization of shareholder proposals and “automatic voting” by institutions “mean that certain proposals are certain to achieve majority support whenever the company’s ownership is dominated by institutions that have adopted a policy to support the issue in question. In these cases, it does not matter how much attention the company has paid to governance excellence.”¹⁴¹

As one corporate respondent told us in answering the November 2003 Surveys, “A majority of our institutional investors decline to discuss voting issues with us because they follow ISS voting guidelines without deviation.” Other respondents answered similarly:

- “We have noted that most institutional investors vote according to their own guidelines, and that it is very difficult to make a case for an exception.”
- “When we contacted several institutional holders regarding a . . . proposal, some of them blindly followed ISS recommendations and stated that no amount of accommodation would change their vote.”
- “Several institutional investors with whom we have spoken have told us that they follow ISS voting guidelines without exception and would not discuss any issues concerning proxy voting with us.”

¹³⁹ At some companies, a majority of shares follow ISS proxy voting guidelines. For example, approximately 50 percent of 3M Corporation’s shares outstanding follow ISS guidelines. See Letter from W. James McNerney, Jr., Chairman of the Board and CEO, 3M Corp., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 5, 2003).

¹⁴⁰ See Burton Rothberg & Ned Regan, *A Seat at the Corporate Governance Table*, WALL ST. J., Dec. 17, 2003, at A22. As the authors explain, “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.”

¹⁴¹ Georgeson Shareholder Communications, Inc., *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests* iii (2003). Georgeson also notes that this “situation is exacerbated by Department of Labor rules that encourage voting consistency rather than case-by-case decision-making.” *Id.*

- “Institutions have refused to speak to us because they follow ISS.”
- “Some institutional investors have indicated that they are bound by ISS voting guidelines even if they are persuaded by the merits of [the] company position.”
- “Several were unwilling to consider arguments against ISS voting guidelines. They said if they voted against ISS guidelines they had to explain their position to their constituents.”¹⁴²

It is notable as well that the guidelines of ISS and institutional investors tend to be based on a variety of factors that often are unrelated to the “responsiveness” of a company to the proxy process. ISS, for instance, has a more demanding definition of director independence than do the securities markets. When a director nominee fails to meet ISS’s standards, ISS recommends a withhold vote regardless of the responsiveness, or performance, of the company if the director serves on the audit, nominating or compensation committee. Many of the institutional investors relying on ISS, in turn, follow its recommendation without any further deliberation.¹⁴³ Under the Proposed Election Contest Rules, this dynamic would result in investor voting patterns unrelated to what the Commission is purporting to regulate—the proxy process—thereby rendering the rules a mechanism for pressuring corporate change on matters wholly outside the Commission’s regulatory mandate.

It is for reasons such as these that ISS itself has predicted that the Proposed Contest Election Rules would have a “dramatic impact” on corporate governance.¹⁴⁴

The second important factor overlooked by the Commission is the collateral agenda that certain institutional investors would bring to particular companies. State and labor union pension funds are among the principal advocates of the Proposed Election Contest Rules, and stand to be among the rules’ principal beneficiaries. Thus, for instance, the website of the AFL-CIO advises investors “what they can do to ensure that the [Commission] adopts” a final election contest rule,

¹⁴² Additional responses included: “In soliciting institutional shareholder support for positions of the [company] regarding various shareholder proposals, numerous institutional holders of our stock that utilize ISS voting guidelines have summarily dismissed our efforts to engage in meaningful discussion or to seriously consider an alternative to the recommendations of ISS.” “Many of our top institutional investors refuse to talk because they follow ISS voting guidelines. The investors who would talk, still said ISS would be a big factor.” “People who vote, vote only with respect to guidelines (internal or external). They do not know the company or the issues. They vote largely in a vacuum.” “Our company spoke to our large investors and they supported our position until they discovered their internal policy was to follow ISS’s recommendation, in which case they changed their position to vote in accordance with ISS’s recommendation.” “The recommendations of ISS are followed without consideration.”

¹⁴³ See Rothberg & Regan, *supra* note 140.

¹⁴⁴ See Institutional Shareholder Services, *SEC Shareholder Access Proposal*, ISS VIEWPOINT (Dec. 12, 2003), available at <http://www.issproxy.com/pdf/ISS%20Viewpoint%20SH%20access.pdf> (last visited Dec. 17, 2003).

and claims that “165 unions, pension funds, institutional investors and institutional investor associations . . . sent supporting comments to the [Commission] as part of its recent review of the proxy rules governing director nominations and elections.”¹⁴⁵

While there is no doubting the important role that unions, state pension funds and other institutional investors play in our economic life, some of these groups act for reasons not primarily related to the best interests of the corporations in which they are invested. A spokesman for the United Brotherhood of Carpenters Pension Fund recently acknowledged, for instance, that the primary purpose of a shareholder proposal the Fund submitted to Fluor Corporation was to “send a signal to political and business leaders, as well as the [Financial Accounting Standards Board], that it’s time for action on an accounting standard requiring option expensing.”¹⁴⁶ The best interests of Fluor and its shareholders were not even mentioned. Increasingly, unions are using their pension fund holdings to pressure the companies in which they are invested on such traditional labor concerns as wages, unionization, and benefits.¹⁴⁷ The Service Employees International Union reportedly has used its pension fund holdings to aid in union organizing drives, and the AFL-CIO pension fund is using its holdings to press for health-care benefits for its members.¹⁴⁸ State pension funds, among them the California Public Employees Retirement System (“CalPERS”), also have used their holdings to press for “social” reform.¹⁴⁹ For example, over the objections of even its own professional staff, CalPERS trustees, “many with close ties to unions,” voted to divest tobacco stocks (which subsequently outperformed the market) and lobbied “U.S. firms that reincorporated overseas to ‘come home to America’ even if that meant paying more taxes.”¹⁵⁰

Certain groups supporting the Proposed Election Contest Rules have, in fact, practically acknowledged that they would use Election Contest shareholder proposals as leverage to advance special interests of their own that are unrelated to the openness of the proxy process. Herb Denton, president of Providence Capital, Inc. (a large investor with a history of participating in proxy contests) has stated that “the very fact of a shareholder being able to submit something . . . just the submission puts a bargaining chip on the table. There are going to be few new directors

¹⁴⁵ See AFL-CIO, Shareholder Access to the Proxy, AFL-CIO Fact Sheet, *available at* http://www.aflcio.org/corporateamerica/capital/access_qanda.cfm (last visited Dec. 17, 2003).

¹⁴⁶ Press Release, Fluor Will Expense Stock Options Once New Accounting Rules in Effect (May 9, 2003), *available at* <http://investor.fluor.com/news/20030509-108705.cfm> (last visited Dec. 17, 2003).

¹⁴⁷ Aaron Bernstein and Amy Borrus, *Labor Sharpens Its Pension Sword*, BUSINESS WEEK, Nov. 24, 2003, at 62.

¹⁴⁸ See *id.* at 62-63.

¹⁴⁹ See Marc Gunther, *CalPERS Rides Again*, FORTUNE, Dec. 8, 2003, at 149-50 (stating that “CalPERS and CalSTRS have gone beyond governance into social engineering”).

¹⁵⁰ *Id.* at 150.

voted on to boards via open access, but there are going to be a ton of shareholder issues where the shareholder is given an effective place to stand and negotiate with the board because the board does not want to have the publicity.”¹⁵¹ Similarly, Connecticut State Treasurer Denise Nappier has called the public’s reduced confidence in corporations and executives an “unprecedented window of opportunity” for reform on social issues such as environmental protection, treatment of workers and workplace diversity.¹⁵² Clearly, these investors will not limit their use of Election Contest shareholder proposals to those companies with an ineffective proxy process. Instead, they will use them as a bargaining chip or leverage for other causes.

Given the potential for unintended use and even abuse of the Commission’s Proposed Election Contest Rules, it is imperative that the proposal be crafted to prevent such strategic behavior. The provisions of the rules intended to serve these aims are utterly ineffective, however.

a. First Trigger: Shareholder-Proposed Election Contest Procedures.

The Commission has proposed to trigger the Election Contest procedure upon one or both of the following: (1) a shareholder proposal to activate the procedure, submitted by a shareholder or group of shareholders holding more than 1 percent of the company’s voting securities for one year, receiving a majority of votes cast; or (2) at least one of the company’s director nominees receiving “withhold” votes from more than 35 percent of the votes cast. According to the proposing release, the triggering events were included “[i]n order to focus the impact of the proposed security holder nomination procedure on those companies where there are criteria showing that the proxy process may be ineffective.”¹⁵³ Yet the first trigger, majority approval of a shareholder proposal to activate the Election Contest procedure, would be available to shareholders of *all* public companies. Accordingly, it would not achieve the Commission’s stated objective of targeting only those companies with an ineffective proxy process. Based on our experience with the proxy voting system, moreover, we believe these proposals would be submitted and receive approval of a majority of the votes cast with considerably greater frequency than the Commission acknowledges, even at companies with effective proxy processes.

The Commission has proposed a 1-percent threshold for Election Contest shareholder proposals to “ensur[e] that the process is used by security holders who represent a substantial

¹⁵¹ Michael P. Bruno, *Proxy Access Proposal Reveals Cracks in Governance Juggernaut*, INSTITUTIONAL SHAREHOLDER SERVICES FRIDAY REPORT (Oct. 24, 2003).

¹⁵² Matthew Greco, *Connecticut Treasurer Touts the Power of Social Investing to Reform*, INVESTOR RELATIONS BUSINESS (Oct. 27, 2003).

¹⁵³ 68 Fed Reg. at 60,789.

long-term interest in the subject company.”¹⁵⁴ The proposed trigger does not accomplish that goal, however. In fact, it will not be difficult for shareholders to satisfy the required 1-percent ownership threshold for Election Contest shareholder proposals. As an initial matter, the Commission’s analysis of this trigger is mistaken because it appears to be based on the assumption that only *individual* shareholders with a stake of more than 1 percent will file Election Contest shareholder proposals. However, the Proposed Election Contest Rules clearly provide that both individual shareholders and *groups* of shareholders with a combined stake of more than 1 percent can file such proposals. As a result, the Commission’s estimate of the number of shareholders who are likely to file Election Contest shareholder proposals is far too low.

Data obtained in a September 2003 survey of Business Roundtable members (the “September 2003 Survey”), demonstrate the error in the Commission’s estimates and show that a large number of companies would in fact face Election Contest shareholder proposals. The survey sought, among other things, data on the number of shareholders meeting certain ownership thresholds: ¼ percent, ½ percent, 1 percent, 2 percent and 3 percent. Based on the 80 responses we received, the average number of shareholders holding specified percentages was as follows:

- 46.15 shareholders hold ¼ percent or more shares outstanding;
- 25.35 shareholders hold ½ percent or more shares outstanding;
- 13.38 shareholders hold 1 percent or more shares outstanding;
- 6.89 shareholders hold 2 percent or more shares outstanding; and
- 4.25 shareholders hold 3 percent or more shares outstanding.

These data demonstrate that, given the almost infinite number of combinations of shareholders holding ¼ percent or more of a company’s outstanding shares, there likely would be far more 1-percent shareholder groups submitting Election Contest shareholder proposals than the Commission anticipates.

The Commission further underestimates the number of Election Contest shareholder proposals that would be filed because its estimate is based on the number of proposals filed in 2003—rather than the number of proposals that would be filed if the Proposed Election Contest Rules were adopted. As a result, the Commission’s estimate does not account for an increase of even *one* proposal over the number submitted in 2003, notwithstanding that the Proposed Election Contest Rules were designed specifically to increase shareholder opportunities to

¹⁵⁴ 68 Fed. Reg. at 60,790.

submit matters to vote through company proxy materials.¹⁵⁵ Moreover, even if historical data were sufficient to predict future behavior under the Proposed Election Contest Rules, the use of estimated data from 2003 is inadequate. The number of shareholder proposals submitted, brought to a vote and approved by a majority of votes cast all have increased substantially over the past three years, as reflected in this table:

	2001	2002	2003*	Percent Increase: 2001-2003
Shareholder Proposals Submitted	744	803	1,077	45%
Shareholder Proposals Brought to a Vote	406	439	586	44%
Shareholder Proposals Receiving Majority Votes (Votes Cast)	66	99	162	245%

Source: Investor Responsibility Research Center Database on Shareholder Proposals

*As of December 1, 2003

Any estimate based on historical data needs to account for this trend and the acceleration in Election Contest shareholder proposals that almost certainly would result from adoption of the Proposed Election Contest Rules.

Finally, the Commission fails to recognize that, as a consequence of the use of proxy voting guidelines discussed above, a majority of shares likely will approve Election Contest shareholder proposals reflexively whenever they are presented, regardless of the effectiveness of a company's proxy process. As noted, the November 2003 Surveys found that, on average, 40 percent of a public company's shares are cast by institutional investors (including ERISA plans) that follow ISS proxy voting guidelines. And, as also noted, many institutional investors that follow ISS guidelines tend to adhere to them *completely*, without regard to a company's particular circumstances or policies. (One typical response to the November 2003 Surveys reported that "[s]everal institutional investors with whom we have spoken have told us that they follow ISS voting guidelines without exception and would not discuss any issues concerning proxy voting with us." In the words of another: "We have historically been unable to engage in any substantive discussions with index funds and other institutions that either follow completely the ISS recommendations or outsource their voting decisions to ISS.") Thus, ISS voting guidelines often are the driving force behind institutional investor approval of shareholder proposals at public companies, even when the institutions have not evaluated such proposals on a company-by-company basis.

The Commission must expect that ISS will revise its proxy voting guidelines to support Election Contest shareholder proposals at all companies. ISS already expressed strong support

¹⁵⁵ See 68 Fed. Reg. at 60,809 n.189.

for an Election Contest procedure in a June 13, 2003 comment letter to the Commission.¹⁵⁶ Because ISS generally advocates its positions across the board, it is likely to revise its proxy voting guidelines to support Election Contest shareholder proposals at all companies, if for no other reason than to make access to company proxy materials available in case a company is not responsive in the future. The implications are plain: ISS is likely to recommend support for Election Contest shareholder proposals without exception, and the approximately 40 percent of an average company's shares that are voted in accord with the recommendations of ISS, consequently, likely will be voted in favor of Election Contest shareholder proposals. Coupled with the ineffectiveness of the Commission's proposed 1-percent ownership threshold as a screening mechanism for Election Contest shareholder proposals, the consequence would be that what the Commission characterizes as a narrow measure affecting a small portion of companies would, in fact, become a costly fixture at most large American companies. In the words of Commissioner Glassman, the Commission's action is akin to "dropping a cluster bomb when a surgical strike is more appropriate."¹⁵⁷

b. Second Trigger: Director "Withhold" Votes In Excess Of 35 Percent.

The second trigger in the Proposed Election Contest Rules is a company's receipt of more than 35 percent "withhold" votes for a director nominee. Certain important flaws with this trigger already have been identified above. First, the Commission supposes that a 35-percent withhold vote necessarily reflects a problem with the proxy process when, in fact, the director may be strongly supported by the other 65 percent of shareholders. Second, in cases where a 35-percent withhold vote does represent broader shareholder disapproval, the Proposed Election Contest Rules purport to target corporate "non-responsiveness," yet are triggered before a company even has a chance to respond to high withhold votes by, for example, declining to re-nominate the director.

Even more serious than these flaws in the Commission's premises, however, is its failure to recognize that once withhold votes are made a trigger for the Election Contest procedure, they will be cast with far greater frequency for reasons that may be unrelated to the proxy process or, indeed, to the individual director nominee. Accordingly, withhold votes will be an unreliable barometer of the "responsiveness" of companies' proxy processes and an ineffective means of limiting election contests to non-responsive companies.

The Commission bases much of its analysis of the "withhold" trigger on the supposition that historical voting data from the past two years is a reliable indicator of how frequently withhold votes would be cast if the Proposed Election Contest Rules were finalized. That is

¹⁵⁶ See Letter from James E. Heard, Chief Executive Officer, Institutional Shareholder Services, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (June 13, 2003).

¹⁵⁷ Commissioner Cynthia A. Glassman, Speech by SEC Commissioner: Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors (Oct. 20, 2003).

mistaken for several reasons, however. First, the historical data cited in the proposing release are inapposite—they measure withhold votes at the *full board* level,¹⁵⁸ whereas the Proposed Election Contest Rules would be triggered when any *individual director* received more than 35 percent withhold votes. The Commission’s data, as a consequence, under-predict the frequency with which the Election Contest procedure would be triggered under the rules.

The reliability of this data is called further into question by the Commission’s refusal to make it available for public review in accordance with the dictates of the APA. On November 13, 2003, the Business Roundtable, through counsel, asked the Commission to provide the study cited in this part of its proposing release; the request was declined.¹⁵⁹ The information then was promptly requested under the Freedom of Information Act, but it still had not been provided as of the comment deadline for this rulemaking. The Commission’s refusal to provide the data is a clear violation of the most basic rulemaking requirements.¹⁶⁰

Third, and most importantly, the Commission’s analysis of the “withhold” trigger does not account adequately for the powerful new incentives the rules would create for casting withhold votes, and the manner in which those incentives would interact with the investment practices—and, in some instances, agendas—of certain institutional investors discussed above. Simply, if these rules were finalized, they would give withhold votes an altogether new significance that would prompt shareholders to cast them not merely as a means of opposing a particular nominee, but also to trigger the Election Contest procedure and thereby put forward an alternative nominee the next year or, at minimum, to garner a valuable new bargaining chip to be used with the company. ISS guidelines already call for withhold votes for directors in numerous situations, and adoption of the proposed “withhold” trigger must be expected to spur revisions to these and other institutional investors’ voting guidelines to call for more frequent withhold votes for directors in light of the additional consequences attached. Already, the Council of Institutional Investors (“CII”) has noted approvingly that “passage of [the Proposed Election Contest Rules] will make it easier for shareholders to *vote out* irresponsible directors and add their own candidates to the slate.”¹⁶¹ And the director of investment policy for the pension fund of one of the largest labor unions has indicated that large institutional investors will begin

¹⁵⁸ See 68 Fed. Reg. at 60,790 n.78.

¹⁵⁹ Counsel for the Business Roundtable called the Commission’s Public Reference facility to request this data. On November 18, 2003, a representative of the Division of Corporation Finance left a message for the requesting attorney, stating that, according to the Commission’s Office of Economic Analysis, “the data is not publicly available” and would not be provided.

¹⁶⁰ See, e.g., Freedom of Information Act Appeal: Request No. 2004-0835 (Dec. 15, 2003).

¹⁶¹ E-mail from Austin Brentley, Council of Institutional Investors (Nov. 18, 2003, 11:40 a.m.) (emphasis added).

working to trip the “withhold” trigger as early as the 2004 proxy season.¹⁶² These actions will have the primary objective not of defeating particular director nominees, but of gaining greater control in an area of corporate governance properly reserved to the board of directors as regulated by state, not federal, law.

c. Third Possible Trigger: Failure To Implement A Majority-Vote Shareholder Proposal

The proposing release indicates that the Commission is considering a possible third trigger, based on a company’s failure to implement a majority-vote shareholder proposal (other than an Election Contest shareholder proposal) submitted by a shareholder or group of shareholders holding more than 1 percent of the company’s voting securities for one year. The Commission is mistaken in its premise that failure to implement a shareholder proposal indicates some flaw in the proxy process, and triggering election contests on this basis would further exceed the Commission’s statutory authority while proving unworkable in practice.

As contemplated in the proposing release, this possible third trigger would apply whenever a company receives a majority vote on a proposal submitted by a 1-percent shareholder, unless the board implements the proposal within a specified time period. Adopting such a trigger would be premised on the erroneous assumption that failure to implement a majority-vote shareholder proposal is indicative of an ineffective proxy process. In fact, however, a company’s receipt of majority votes on a shareholder proposal, and the board’s decision not to implement that proposal, often have nothing to do with the effectiveness (or ineffectiveness) of the company’s proxy process. As discussed above, institutional investor voting practices make it likely that certain shareholder proposals will receive majority votes at *all* companies, regardless of an individual company’s corporate governance practices or responsiveness. According to Georgeson:

Familiarity with institutional voting practices should lead to a high level of skepticism about claims that governance proposals are a referendum on corporate performance or that majority votes are a repudiation of the board and management. It is therefore surprising that the shareholder proposal process should now be suggested as a justification or trigger for access to the corporate proxy.¹⁶³

Moreover, under state law, a company’s board has a fiduciary duty to make its own determination as to whether implementation of a shareholder proposal is in the company’s best interests; automatic compliance with the results of a shareholder vote—regardless of the level of

¹⁶² See *Proposed Proxy Access Rule Leaves Proponents Uncertain About Preparations for 2004 Proxy Season*, 14 CORPORATE GOVERNANCE HIGHLIGHTS 43 (Oct. 31, 2003) (quoting Richard Ferlauto, director of pension investment policy at the American Federation of State, County and Municipal Employees).

¹⁶³ Georgeson Shareholder Communications, Inc., *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests* iii (2003).

support—would violate the board’s fiduciary obligations. If the third trigger were adopted, however, directors would feel significant pressure to implement a majority-vote shareholder proposal, regardless of their independent judgment of the company’s best interests.¹⁶⁴

And even if a board were to determine that implementation of a majority-vote shareholder proposal was in the company’s best interests, the board would need flexibility to determine the best *manner* in which to implement the proposal. For example, in recent years, many companies have faced majority votes on shareholder proposals relating to severance payments for executives. Although some boards have concurred that action on severance payments is warranted, many have found it necessary in considering implementation to modify or expand upon the general propositions contained in the shareholder proposal. Such modifications could trigger the Election Contest procedure under the approach contemplated by the Commission.

In our experience, boards take majority-vote shareholder proposals very seriously, in keeping with their fiduciary duties to the company and all of its shareholders.¹⁶⁵ This is demonstrated by the results of the November 2003 Surveys, in which 36 of the 132 responding companies reported that they had majority votes on shareholder proposals in the past two years. All 36 of those companies’ boards—100 percent—considered whether to implement the majority-vote proposal. Clearly, a board’s determination not to implement a majority-vote shareholder proposal—or to implement it in modified form—is not evidence of an ineffective proxy process. Instead, it reflects a board fulfilling its fiduciary duty to *all* shareholders, a responsibility at the heart of corporate governance under state law. For this reason, non-implementation (or partial implementation) would be an inappropriate trigger for the Election Contest procedure.

This third trigger also would exceed the Commission’s authority under Section 14(a) of the Exchange Act. As the Commission itself has recognized, “proposals by security holders that mandate or direct the board to take certain action may constitute an unlawful intrusion on the board’s discretionary authority under the typical [state] statute.”¹⁶⁶ Yet the Commission

¹⁶⁴ This could be particularly problematic in the case of shareholder proposals calling for the redemption of shareholder rights plans, or “poison pills.” Recent Delaware case law suggests that a board that redeems a poison pill may be precluded from reinstating it in the event that the company receives a hostile bid. *See Omnicare v. NCS Healthcare*, 818 A.2d 914 (Del. 2003) (holding that any defensive measure must independently meet the standard of not being preclusive, without regard to its reasonableness in relation to the threat to the company and its shareholders). Nevertheless, directors would face tremendous pressure to redeem pills if the third trigger were adopted. This could have significant negative consequences for shareholders.

¹⁶⁵ This is demonstrated by the public responses of companies that have received majority-vote shareholder proposals in recent months. *See, e.g.*, press releases issued by Hewlett-Packard (<http://www.hp.com/hpinfo/newsroom/press/2003/030721b.html>), Tyco (http://www.tyco.com/investor/general_release_detail.asp?prid=644) and Union Pacific (http://www.uprr.com/notes/investor/2003/r1003_policy.shtml).

¹⁶⁶ Release No. 34-12999, 41 Fed. Reg. 52,994, 52,996 (Nov. 22, 1976).

contemplates undertaking this “unlawful intrusion” by imposing a penalty (the Election Contest procedure) on companies that fail to implement certain shareholder proposals. As the courts have made clear in other contexts, agencies cannot bypass the limitations on their authority by making the failure to do something they *cannot* require a “trigger” for some burdensome requirement the agency *can* impose.¹⁶⁷ In this context, the Commission cannot directly require boards to implement majority-vote shareholder proposals; it therefore is statutorily prohibited from *coercing* boards to implement these proposals by threatening that, if they do not, they run the risk of a contested election in which at least one and as many as three directors could lose their positions.

Even if the Commission did possess authority to add this third trigger to a final rule, doing so would be a mistake because administering the trigger would be impracticable for companies and the Commission. The trigger would lead to confusion and delay, as the Commission sought to determine whether a majority-vote shareholder proposal in fact had been “implemented.” The number of Rule 14a-8 no-action request letters would increase greatly, as companies sought to exclude shareholder proposals under the “substantial implementation” standard. This, in turn, would consume additional Commission time and resources in processing no-action letter requests—an area where the Commission already devotes an “inordinate amount of resources.”¹⁶⁸ And as the Commission itself recognizes in the proposing release, implementation of a majority-vote shareholder proposal may not coincide with annual meeting cycles, making it impossible for companies to accomplish all the actions set forth in a shareholder proposal within the time period prescribed by the Commission.

Finally, the Commission has not estimated the considerable costs that would be associated with this possible third trigger, and the number of times the trigger would be tripped. Costs would include not only the direct and indirect costs resulting from the likely increase in Rule 14a-8 shareholder proposals and election contests themselves, but also the significant expenditure of management and board time and legal resources to determine whether these additional proposals could be implemented consistent with state law and a company’s business objectives.

d. Other Possible Triggers

The proposing release lists other possible triggers, including poor economic performance, market delisting, Commission sanctions, criminal indictment, restatement of earnings (once or more than once in a specified period) and election of a shareholder nominee as a member of the company’s board. These events, however, do not even arguably relate to the effectiveness of a

¹⁶⁷ See *supra* note 44.

¹⁶⁸ Howard Stock, *SEC Receives Record Requests to Bar Shareholder Proposals From Proxies*, INVESTOR RELATIONS BUSINESS, Apr. 21, 2003. Commissioner Atkins, in a speech to the Council of Institutional Investors, stated that he would “like to see us address whether there are means of removing—or more realistically reducing—the need of SEC staffers acting as referees in the shareholder approval process.” Commissioner Paul S. Atkins, Remarks Before the Council of Institutional Investors (Mar. 27, 2003).

company's proxy process and, as a result, could not conceivably achieve the Commission's stated objective. Moreover, these triggers present questions about the Commission's statutory authority at least as troubling as those discussed above.

e. Additional, Serious Unintended Consequences Of The Proposed Election Contest Rules

The preceding discussion has shown that 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 large institutional investors and the special agendas likely to be pursued by some of the largest institutional investors, such as union pension funds. The costs of the resulting election contests would be great, as corporations endeavored initially to prevent the triggers from being tripped, and then to assure the election of their preferred nominee over that put forward by a single shareholder or a shareholder faction.

The greatest harm threatened by these proposed rules, however, may well be the prospect—which the Commission itself "recognize[s]"—of "special interest" and "single issue" campaigns and candidates.¹⁶⁹ Having identified the problem, the Commission proposes a narrow and quite inadequate solution: restrictions on "prohibited relationships" between nominees and the nominating shareholder intended to ensure the "independence" of the nominee. While it certainly would be appropriate to ensure that shareholder nominees are not economically beholden to the shareholders nominating them, this is only a small part of the problem of special interests.¹⁷⁰ The harm typically posed by a "special interest" candidate is not that he or she will be economically beholden to the party nominating him or her, but instead that they will share a common *policy objective* that, once elected, the shareholder nominee puts ahead of the corporate well-being as a whole.¹⁷¹ A candidate with shared sympathies toward certain "social investment" policies may have no prohibited economic relationship with the union fund nominating him or her, for instance.¹⁷² But that does not minimize in the least the concern that, once elected, he or she will pursue those and other policies at the expense of the general corporate welfare and in a manner that could have a debilitating effect on the functioning of the

¹⁶⁹ 68 Fed. Reg. at 60,795.

¹⁷⁰ Notably, ISS has urged the Commission to "[r]emove the proposed disqualification of nominees who are affiliated with the nominating shareholders." Instead, ISS encourages "alignment between the nominee and nominating shareholders[.]" stating that "[a] shareholder who owns a significant amount of shares should be able to nominate affiliated individuals." Institutional Shareholder Services, *SEC Shareholder Access Proposal*, ISS VIEWPOINT (Dec. 12, 2003), <http://www.issproxy.com/pdf/ISS%20Viewpoint%20SH%20access.pdf> (last visited Dec. 17, 2003). This proposal would result in an even more severe form of the divided loyalty problem discussed at later points in these comments.

¹⁷¹ See 68 Fed. Reg. at 60,795-96.

¹⁷² See Marc Gunter, *CalPERS Rides Again*, FORTUNE, Dec. 8, 2003, at 149-50 (discussing the "social agenda" employed by CalPERS and CalSTRS in investment).

board and, over time, the vitality of the company as a whole. Indeed, even some trustees of CalPERS—the largest and among the most active pension funds—are concerned about this “overreaching,” where social concerns are prioritized ahead of fiduciary duty.¹⁷³

The role that labor unions could play in the election contest regime proposed by the Commission warrants particular attention. Union-controlled pension funds are among the largest and most influential institutional investors in the country.¹⁷⁴ Indeed, “[e]ver since John J. Sweeney took the reins of the AFL-CIO in 1995, he has been urging unions to use the power of their \$350 billion in pension funds to become shareholder activists.”¹⁷⁵ In the assessment of one authority, union-controlled pension funds have been “among the most active institutional investors this year.”¹⁷⁶ Labor unions were the leading proponents of shareholder resolutions regarding corporate governance in 2003, sponsoring nearly half of all such resolutions that came to a vote,¹⁷⁷ and have been among the primary proponents of the Proposed Election Contest Rules. The AFL-CIO website claims that more than “165 unions, pension funds, institutional investors and institutional investor associations” filed comments with the Commission supporting the rulemaking.¹⁷⁸ AFL-CIO President John Sweeney has spoken in favor of the proposal,¹⁷⁹ and AFSCME—one of the most politically active unions—has been recognized as among its “leading advocate[s].”¹⁸⁰

¹⁷³ *Id.* at 150.

¹⁷⁴ For example, “many” of the trustees who run CalPERS, the nation’s biggest pension fund, and CalSTRS “have close ties to unions.” *Id.*

¹⁷⁵ Aaron Bernstein & Amy Borrus, *Labor Sharpens Its Pension Sword; Unions are using their shareholder clout – and pickets – to lean on employers*, BUSINESS WEEK, Nov. 24, 2003.

¹⁷⁶ Barry B. Burr, ‘Holy grail’: Proxy ballot access missing from corporate governance list, PENSIONS & INVESTMENTS, Apr. 28, 2003 (quoting Charles M. Elson, law professor at the University of Delaware and director of its Center for Corporate Governance). Activity among unions and pension funds is increasing: Unions and Taft-Hartley pension funds filed some 400 combined shareholder proposals this year, up from 280 the previous year. *See id.*

¹⁷⁷ *See* Georgeson Shareholder Communications, Inc., *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests* i, 5 (2003).

¹⁷⁸ AFL-CIO, Shareholder Access to the Proxy, AFL-CIO Fact Sheet, available at http://www.aflcio.org/corporateamerica/capital/access_qanda.cfm (last visited Dec. 17, 2003).

¹⁷⁹ Statement by AFL-CIO President John J. Sweeney on the SEC’s Proposed Rules Granting Shareholders Access to the Proxy (Oct. 8, 2003), available at <http://www.aflcio.org/mediacenter/prsptm/pr10082003.cfm> (last visited Dec. 17, 2003).

¹⁸⁰ Burr, *supra* note 176.

In the past twenty years, unions increasingly have come to advance their interests through “corporate campaigns.” If the Proposed Election Contest Rules were adopted, unions could make use of the rules to exploit—and disrupt—the new Election Contest procedure contemplated by the Commission. A “corporate campaign” is a broad-based attack on a company with which a union has a labor dispute, in which the union attempts to impair the company’s operations and reputation through a variety of means, including consumer boycotts, repeated and ill-founded complaints to government agencies, and harassment of company officers and directors.¹⁸¹ In the words of one informed observer, “[c]orporate campaigns have become a weapon of choice in the union movement’s arsenal, and it appears they will remain the weapon of choice for the foreseeable future.”¹⁸² A leading union proponent of the Proposed Election Contest Rules has a history of employing such “standard union tactics” against companies.¹⁸³

Significantly, investors already are among the targets of corporate campaigns. As the D.C. Circuit has recognized, a corporate campaign often involves “negative publicity campaigns aimed at reducing the employer’s goodwill with employees, *investors*, or the general public.”¹⁸⁴ In the words of another authority, unions “often attempt to have the target company and its officials portrayed as villains by *investors*, customers, vendors, employees, and the public at-large.”¹⁸⁵

If the Proposed Election Contest Rules were finalized, they quickly would become an important new weapon in corporate campaigns. Unions could use their pension fund holdings to trigger potentially costly campaigns over shareholder-sponsored Election Contest proposals, as well as “withhold” campaigns intended to drive up company costs and potentially create an opening for shareholder-nominated candidates in the next year’s election. That, in turn, would provide the opportunity for a union-backed candidate or candidates to excoriate current management and to criticize—to some extent at corporate expense—the management policies at the heart of the underlying labor dispute between the company and union. If the union-backed candidate or candidates were elected, the prospects of a bitterly divided and ultimately dysfunctional board are of course quite real. Some industry experts, for instance, have attributed the recent financial crises at United Airlines to union representation on the company’s board, and

¹⁸¹ See, e.g., H. Northrup and C. Steen, *Union “Corporate Campaigns” As Blackmail: The RICO Battle At Bayou Steel*, 22 HARV. J.L. & PUB. POL’Y 771 (Summer 1999).

¹⁸² Statement of Charles I. Cohen, Senior Partner, Morgan, Lewis & Bockius LLP, *Labor-Management Relations In Global Economy*, Employer-Employee Relations Subcommittee on House Education and the Workforce, available at 2002 WL 100237911 (Oct. 8, 2002).

¹⁸³ See, e.g., Joann S. Lublin, *Labor: Unions Brandish Stock to Force Change*, WALL ST. J., May 17, 1996, at B1.

¹⁸⁴ *Food Lion, Inc. v. United Food & Commercial Workers Union*, 103 F.3d 1007, 1014 n.9 (D.C. Cir. 1997) (emphasis added).

¹⁸⁵ Statement of Charles I. Cohen, *supra* note 182.

those directors placing union aims ahead of the company's interests.¹⁸⁶ Similarly, in the November 2003 Surveys, one respondent noted the "real possibility that nominees of pension funds will cause the board to allocate an unreasonable amount of time to consideration of labor issues such as unionization, compensation and benefits." Equally important, however, is the cost and disruption that the election contest itself could cause, even if the union-sponsored candidate were ultimately defeated. In a broad-based corporate campaign, this alone may be enough to serve the union's purposes—as reflected in the recent acknowledgment by the Carpenters' Pension Fund that a shareholder proposal submitted at one company was intended not to improve corporate welfare or even directly change corporate policy, but rather to "send a signal to political and business leaders."¹⁸⁷

The disruption and division that could result from the election of shareholder-sponsored nominees is not limited, of course, to those nominated or backed by labor unions. As one respondent to the November 2003 Surveys put it, "the proposed rule would create fragmented boards with individuals of varying agendas and objectives, which may differ from the long-term interests of the corporation and its shareholders." Survey respondents also predicted a "likely drop in the company's confidence that board matters would remain confidential—a director elected via the proposed process might feel obligated to share with his or her nominating [shareholders] sensitive information." This would destroy collegiality and inhibit the kind of open, candid discussion that characterizes a well-functioning corporate board. The company and all of its shareholders would suffer as a result.

In the long term, director recruitment and retention would suffer as well. As noted above, the past two years have seen more changes in corporate governance than the previous twenty, and the cumulative effect of these reforms and directors' potential increased exposure to personal liability already has made it more difficult for companies to recruit and retain qualified directors. We are concerned that adopting the Proposed Election Contest Rules would exacerbate this problem by increasing the number of contested director elections, thereby deterring from board service well-qualified individuals who do not want to routinely stand for election in a contested situation.

C. The Rulemaking Is Flawed In Other Significant Respects.

The Proposed Election Contest Rules also run afoul of numerous important constraints on agency rulemaking.

¹⁸⁶ Marilyn Adams & David Kiley, *United vows no disruption; Chapter 11 filing biggest for a U.S. airline*, USA TODAY, Dec. 10, 2002.

¹⁸⁷ Press Release, Fluor Will Expense Stock Options Once New Accounting Rules in Effect (May 9, 2003), available at <http://investor.fluor.com/news/20030509-108705.cfm> (last visited Dec. 17, 2003).

1. *The Commission Has Given The Public Insufficient Time To Comment On The Proposed Rule, With The Consequence That The Commission Has Insufficient Information To Engage In Informed Rulemaking.*

The Commission has allowed interested parties only 60 days to review the Proposed Election Contest Rules and supporting data, to gather and review additional information pertaining to the rules, and to submit that information—which the Commission itself has asked for in innumerable parts of the proposing release—together with comments intended to inform and enhance the agency’s exercise of its decision-making responsibilities. We expressed these concerns to the Commission in a letter dated November 17, 2003, which requested that the comment period be extended by at least 60 days.¹⁸⁸ That request has been ignored.

The short 60-day comment period is inadequate for interested parties to comprehensively review, comment on, and provide all information requested in the proposal. As Chairman Donaldson has recognized, “the issue of shareholder nominees in a company’s proxy materials is a very serious matter,” requiring meaningful public comment.¹⁸⁹ Among other things, the Proposed Election Contest Rules have the potential to alter dramatically corporate governance. They present significant questions regarding the Commission’s authority, federalism, and the relative roles of the states and federal government in establishing shareholder rights and delineating the responsibilities of shareholders and boards of directors, as shown above.

Consideration of these issues, as well as the mechanics of the Proposed Election Contest Rules, is “complex.” Although the Commission concedes this fact, the proposing release does not provide detailed analysis of many of the issues implicated by the proposal.¹⁹⁰ Instead, the Commission has largely shifted the burden of data collection and analysis to the public, posing, for instance, approximately 350 questions for public consideration in the proposing release. We have endeavored to answer many of the Commission’s questions in the course of these comments. Due to the short comment period, however, we have not yet been able to compile a concordance correlating the positions set forth herein with the specific questions posed in the proposing release. We anticipate seeking to supplement the administrative record with such a document at an appropriate point in the future.

Commissioner Atkins has referred to the number of questions in the proposing release as “unique,” stating:

¹⁸⁸ The points made in our November 17, 2003 letter are incorporated herein by reference.

¹⁸⁹ Chairman William H. Donaldson, Remarks at Open Meeting of the Securities and Exchange Commission (Oct. 8, 2003).

¹⁹⁰ See 68 Fed. Reg. at 60,787.

I cannot remember a release that has so many pages of questions seeking public input. More than half of the substance of this release is request for comment. Why? Because the devil is in the details of this proposal and, frankly, we don't have all of the information that we need to work out the details.¹⁹¹

Similarly, Commissioner Glassman stated, "the release may have broken all records in terms of the number of questions asked."¹⁹²

Given the complexity of the Proposed Election Contest Rules and the hundreds of questions asked by the Commission in the proposing release, the 60-day comment period has not afforded interested parties enough time to comment "meaningfully."¹⁹³ The Commission, as a consequence, has fallen short of its obligation to engage in thorough, well-informed rulemaking, thereby transgressing the APA, Executive Order 12,866, and principles of sound public administration.¹⁹⁴

2. *The Proposing Release Does Not Analyze Pertinent State Law That Is Required For Reasoned Decision-Making.*

As discussed in Section I above, the Commission's proposal to regulate the election of corporate directors intrudes on matters traditionally reserved for regulation by the states. The proposing release seemingly acknowledges its uneasy relationship with state law, stating that the Proposed Election Contest Rules "would apply only where the company's security holders are permitted under state law to nominate a candidate or candidates for election as a director."¹⁹⁵

And yet, although ascertaining the provisions of state laws is accordingly a necessary first step in determining the number of entities covered by the Proposed Election Contest Rules, the Commission nowhere identifies, discusses or analyzes pertinent state laws in an effort to determine the number of states that, in its judgment, explicitly or implicitly prohibit the form of regulation the Commission proposes. Moreover, there is no reference to the Commission having

¹⁹¹ Commissioner Paul S. Atkins, Remarks at Open Meeting of the Securities and Exchange Commission (Oct. 8, 2003).

¹⁹² Commissioner Cynthia A. Glassman, Remarks at Open Meeting of the Securities and Exchange Commission (Oct. 8, 2003).

¹⁹³ See, e.g., *Florida Power*, 846 F.2d at 771 (requiring meaningful comment under the APA); Exec. Order No. 12,866, at § 6(a)(3)(A) (requiring agencies to "afford the public a meaningful opportunity to comment on any proposed regulation").

¹⁹⁴ See, e.g., *Estate of Smith v. Bowen*, 656 F. Supp. 1093, 1097-99 (D. Colo. 1987) (finding a 60-day comment period to be inadequate where interested parties did not have enough time to consider and comment on the "details" of a proposed rule).

¹⁹⁵ 68 Fed. Reg. at 60,787, 60,808.

solicited specifically the views of appropriate state officials.¹⁹⁶ By not investigating the actual consequences of the laws of the various states for the Proposed Election Contest Rules, the Commission has failed in the proposing release to determine, let alone provide, the most basic information about the scope and impact of its proposal: where in the United States (and to how many companies) the Proposed Election Contest Rules would apply.

In the proposing release, the Commission states: “We do not know the precise number of states that prohibit security holders from nominating a candidate or candidates for election as director or the number of companies that are permitted to and do/or (would) include a prohibition against nominating a candidate or candidates in their articles of incorporation or bylaws.”¹⁹⁷ Accordingly, the Commission does not know whether the Proposed Election Contest Rules would take effect in no states or all 50 states. Moreover, the type and nature of state laws that would be pertinent are unclear from the proposing release.

The failure of the Commission to consider pertinent state laws before publishing its proposal has several consequences. First, the absence of this critical data regarding the scope of the Proposed Election Contest Rules is flatly inconsistent with the APA’s requirements for notice-and-comment rulemaking and reasoned decision-making.¹⁹⁸ Second, it is unclear what the extent of any benefit—if there is one—would be from the adoption of the Proposed Election Contest Rules given their subservience to state law. The traditional supremacy of state law in the director nomination and election process, and the Commission’s purported acknowledgment of that supremacy in its proposing release, suggest that, even in states where the rules presently could apply, state law could be amended to prohibit their application. Potential conflicts between state and federal law could affect the Commission’s authority to promulgate and ability to enforce the rules.¹⁹⁹ Third, by not addressing substantively state-law issues, the proposing release contains no reliable estimate of the number of companies that will be affected and burdened by the Proposed Election Contest Rules.²⁰⁰

¹⁹⁶ See Exec. Order No. 12,866, at § 1(b)(9).

¹⁹⁷ 68 Fed. Reg. at 60,808.

¹⁹⁸ See, e.g., *International Ladies Garment Workers Union v. Donovan*, 722 F.2d 795, 814 (D.C. Cir. 1983) (where an agency believes that certain uncertainties exist, it is “obligated to identify these uncertainties and to explain why” action has been taken “prior to ‘engaging in a search for further evidence’”(quoting *Motor Vehicle Mfrs. Ass’n*, 463 U.S. at 52)).

¹⁹⁹ See Paperwork Reduction Act, 44 U.S.C. § 3508 (“[b]efore approving a proposed collection of information, the Director shall determine whether the collection of information by the agency is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility”). Practical utility is defined in the regulations as “the actual, not merely the theoretical or potential, usefulness of information.” 5 C.F.R. § 1320.3(l).

²⁰⁰ See, e.g., *Horsehead Res. Dev. Co.*, 16 F.3d at 1269 (remanding part of an EPA rule because the agency relied on “pure speculation” in establishing its standard rather than undertaking an examination of the relevant data).

[Footnote continued on next page]

3. *The Proposing Release Gives Inadequate Attention To Potential Harms And Lacks A Meaningful Cost-Benefit Analysis.*

The proposing release contains no substantive analysis of potential harms that would result from adoption of the Proposed Election Contest Rules. Rather, the Commission provides only a few paragraphs that merely list—and do not analyze or counter in any way—concerns about the Election Contest procedure that have been raised by the public and of which the Commission already is aware.²⁰¹ Reasoned decision-making requires such concerns to be addressed substantively.²⁰² These concerns include, among other things, that the Election Contest procedure likely will:

- be costly and disruptive to companies;
- turn every director election into an election contest;
- increase the frequency of proxy contests;²⁰³
- be utilized in attempted changes in control;²⁰⁴
- discourage qualified board candidates from agreeing to serve on a company's board of directors;

[Footnote continued from previous page]

and engaging in reasoned analysis); *National Parks & Conservation Ass'n*, 998 F.2d at 1532-33 (reversing an FAA order as that was not “rational” or “reasonable” on grounds that the agency presented a subjective evaluation of impact rather than empirical evidence of impact). *See also* Paperwork Reduction Act, 44 U.S.C. §§ 3506(c)(1)(A)(iv), 3506(c)(2)(A)(ii) (requiring an agency to provide “specific,” “objectively supported,” and “accurate” estimates of the burdens that would result under the proposed rule) “Burden” is defined by statute and regulation to mean “the total time, effort, or financial resources expended by persons to generate, maintain, [retain, or disclose] or provide information.” 44 U.S.C. § 3502(2); 5 C.F.R. § 1320.3(b).

²⁰¹ *See* 68 Fed. Reg. at 60,786-87, 60,814.

²⁰² *See, e.g., Chemical Mfrs. Ass'n v. EPA*, 28 F.3d 1259, 1265-66 (D.C. Cir. 1994) (finding an EPA rule arbitrary and capricious where the agency inadequately addressed comments and responded in a “high-handed and conclusory manner”); *Alltel Corp. v. FCC*, 838 F.2d 551, 556 (D.C. Cir. 1988) (identifying as arbitrary and capricious an order of the FCC where, among other things, the FCC failed to provide a “reasoned explanation” for its actions by not responding to challenges).

²⁰³ There are already an increasing number of proxy contests. *See* Rajeev Kumar, Deputy Director of U.S. Research, *Postseason Report: Proxy Battles Rise Again, and So Do Stock Prices*, available at http://www.issueatlas.com/content/subscription/postseasonfiles2003/proxy_contests.htm (last visited Dec. 18, 2003) (“The 2003 proxy season, fresh off last year’s full-throttle run, has been another pace-setting year, according to Institutional Shareholder Services, Inc. data.”).

²⁰⁴ *See Inside Track with Broc: Ned Young on Shareholder Access and Possible Changes in Control*, Dec. 16, 2003, available at http://www.thecorporatecounsel.net/member/InsideTrack/12_16_03_Young.htm (last visited Dec. 18, 2003).

- disrupt board dynamics and balkanize boards;
- be employed by special interest groups whose interests diverge from shareholders generally; and
- lessen the time that boards would have to engage in strategic and long-term thinking.²⁰⁵

Because of the Commission’s failure to analyze these harms substantively, and because of the artificially low burden and cost estimates it provides (discussed below in Section II.D), the proposing release lacks the rigorous cost-benefit analysis of the economic and competitive consequences of the Proposed Election Contest Rules that is required under the APA, the Exchange Act and Executive Order 12,866. Proper use of the cost-benefit mechanism “requires that sufficient levels of time and resources be provided to permit careful, thorough, and technically and scientifically sound data-gathering and analysis. When cost-benefit analyses are presented without effective characterization of the uncertainties associated with the results, cost-benefit studies can be used in highly misleading and damaging ways.”²⁰⁶ The Commission has not devoted sufficient time and resources to cost-benefit analysis. The perfunctory section in the proposing release entitled “Cost-Benefit Analysis” fails to discuss substantively and adequately the likely costs and benefits of the Proposed Election Contest Rules.²⁰⁷

4. *The Proposing Release Pays Inadequate Attention To Alternatives.*

The Commission also provides no substantive analysis of alternatives to the sweeping and burdensome rules that it has proposed. Out of 42 pages of text, the proposing release’s scant attention to alternatives is limited to two paragraphs in Section VI.²⁰⁸ The proposing release only identifies two alternative proposals, even though the Commission’s Division of Corporation Finance recently identified as many as four alternatives to the Proposed Election Contest

²⁰⁵ See 68 Fed. Reg. at 60,786-87, 60,814. “Even if shareholders were more interested in governing, the number of shareholders in widely held companies makes it unlikely that they would be effective in making decisions or even overseeing management’s conduct.” Cynthia A. Glassman, Speech by SEC Commissioner: Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors (Oct. 20, 2003).

²⁰⁶ OMB, Report To Congress On The Costs And Benefits Of Federal Regulations, at 26 (1998), *available at* <http://www.whitehouse.gov/omb/inforeg/costbenefitreport1998.pdf> (internal quotations omitted) (last visited Dec. 17, 2003).

²⁰⁷ See 68 Fed. Reg. at 60,812-815.

²⁰⁸ See *id.* at 60,817. Because the Commission’s reference to alternatives occurs in its analysis under the Regulatory Flexibility Act, 5 U.S.C. § 603, its insufficient analysis is geared towards the concerns of small companies. That analysis is insufficient with respect to companies of all sizes.

Rules.²⁰⁹ Moreover, the proposing release offers no substantive comparison of the respective costs and benefits of the alternative proposals to the Proposed Election Contest Rules. The Commission is required both to consider alternatives thoroughly and to provide a substantive cost-benefit analysis. Rulemaking that fails to consider alternatives, or that fails to provide a substantive cost-benefit analysis, is arbitrary and capricious.²¹⁰

Significantly, the Commission fails to analyze whether existing, recent reforms and developments related to board composition, director independence and corporate governance generally obviate the need for the Proposed Election Contest Rules at this time. As discussed above, the Commission, among other things, recently approved new NYSE and NASDAQ listing standards related to board composition and director independence. These listing standards call for increased independence of, and an enhanced role for, nominating committees. Although the proposing release dedicates *one sentence in passing* to these listing standards, the Commission fails to provide any substantive analysis of the standards, including their likely effect on the director nomination and election process.²¹¹ In a recent speech, however, Commissioner Glassman acknowledged that if these listing standard reforms take hold, “then that is a significant step that should improve the effectiveness of the nomination process and quality of nominees.”²¹² She similarly noted, “the Commission recently proposed rules that would make the nomination process more transparent.”²¹³ Even if the Commission believes that the revised listing standards are insufficient, the Commission fails to articulate any rationale for not encouraging greater consideration of shareholder nominees by nominating committees instead of advancing the Proposed Election Contest Rules. Alternatively, if the Commission moves forward with the Proposed Election Contest Rules, it could provide that companies who adopt a procedure to encourage greater consideration of shareholder nominees by their nominating committees would avoid the requirements set forth in any final rule.

Moreover, companies themselves have begun adopting policies allowing shareholders to nominate candidates for the board of directors using company proxy materials, a fact also ignored in the proposing release. For example, Apria Healthcare Group, Inc. recently adopted a

²⁰⁹ See SECURITIES AND EXCHANGE COMMISSION DIVISION OF CORPORATION FINANCE, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS at 7 (July 15, 2003).

²¹⁰ See, e.g., *Int'l Ladies Garment Workers Union*, 722 F.2d at 814-20 (vacating an action of the Department of Labor under the APA because the decision was not rational in light of the fact that the agency failed to consider alternatives adequately and did not explain why it based its impact prediction on one set of studies rather than another set of studies). See also *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43; the Exchange Act, § 3(f), 15 U.S.C. § 78c(f); the Exchange Act, § 23(a)(2), 15 U.S.C. § 78w(a)(2); H.R. Rep. No. 104-622 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3901.

²¹¹ See 68 Fed. Reg. at 60,786.

²¹² Cynthia A. Glassman, Speech by SEC Commissioner: Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors (Oct. 20, 2003).

²¹³ *Id.*

policy permitting shareholders to propose board candidates to be included in company proxy materials.²¹⁴ And Hanover Compressor Company recently agreed to allow shareholders to nominate directors as part of a class action settlement.²¹⁵ Rather than give recent efforts such as these (and the other corporate governance reforms discussed above) an opportunity to work or fail—or to permit companies time to meet desired objectives voluntarily—the Commission instead has proposed burdensome and sweeping regulation as a matter of first resort.

The Commission’s scant attention to alternatives does not provide adequate notice of the Commission’s intent, is clearly inconsistent with the APA’s notice-and-comment requirements, and cannot be the basis for rational decision-making under the APA.

5. *The Proposed Director Election Contest Rules Improperly Create Legal Requirements Now, Even Before The Consideration Of Comments And The Adoption Of Any Final Rule.*

The Commission’s proposal is exceptional because it attempts to direct steps to be taken by public companies *now*, *before* the rules become effective or are even finalized.²¹⁶ This aspect of the proposal clearly runs afoul of the APA and has serious implications under the United States Constitution.

Under the Proposed Election Contest Rules, a shareholder proposal adopted after January 1, 2004 would constitute a triggering event.²¹⁷ For shareholders to submit such proposals for consideration at Spring 2004 annual meetings, the proposals in most cases would need to have been submitted to companies between November 2003 and January 2004, before adoption of any final rule. In the proposing release, the Commission explicitly states that, “pending final action” on the Proposed Election Contest Rules, companies should advise shareholders in their 2004 proxy statements whether a 1-percent shareholder or group of shareholders has submitted an Election Contest proposal. This is not required under current law, however, and is designed solely as a step in implementing proposed rules that remain in the early stages of the rulemaking process. The Commission nonetheless suggests in its proposing release

²¹⁴ See, e.g., Will Boye, *Apria Makes Room For Shareholder Nominees*, INSTITUTIONAL SHAREHOLDER SERVICES, June 13, 2003, available at <http://www.issproxy.com/articles/archived/archived49.asp> (last visited Dec. 17, 2003).

²¹⁵ See, e.g., Will Boye, *Hanover Settlement Seen As "Breakthrough" For Equal Access*, INSTITUTIONAL SHAREHOLDER SERVICES, May 23, 2003, available at <http://www.issproxy.com/articles/archived/archived40.asp> (last visited Dec. 17, 2003).

²¹⁶ The Section of Business Law of the American Bar Association filed comments with the Commission on November 3, 2003 that objected to this aspect of the proposal. We incorporate by reference those comments.

²¹⁷ See 68 Fed. Reg. at 60,790.

that failure to advise shareholders of the implications of such an Election Contest proposal could constitute a violation of Rule 14a-9 of the securities laws.²¹⁸

We respectfully submit that it is inconsistent with the notice and comment requirements of the APA to attempt to compel public companies to take steps that currently are not required by law, and that would only be required if the rulemaking now underway resulted in a final rule in which the pertinent provisions of the proposal were retained without material change.²¹⁹ Moreover, an agency ordinarily must publish a substantive rule “not less than 30 days before its effective date,” or 60 days if a rule is deemed to be a “major rule.”²²⁰ The Commission has yet to receive comments on its rule proposal let alone publish any final rule from which this 30- or 60-day period would begin to run.²²¹ No statutory exception applies for the Proposed Election Contest Rules to take effect *now, before* any final rule is adopted.²²² Accordingly, failure by an affected party to abide by the *proposed* rules could not violate the securities laws.²²³

Significantly, pre-effective date application of the Proposed Election Contest Rules also could have serious consequences under the United States Constitution, which prohibits the federal government from enacting ex post facto laws.²²⁴ An ex post facto law is one that criminally punishes conduct that was lawful when it occurred.²²⁵ Courts have applied this

²¹⁸ See *id.*

²¹⁹ See APA, 5 U.S.C. § 553(c).

²²⁰ *Id.* at § 553(d) (30-day requirement). Pursuant to Chapter 8 of the APA (as added by the Congressional Review Act provisions of the Small Business Regulatory Enforcement Act), 5 U.S.C. § 801 *et. seq.*, an agency must inform the OMB, and the OMB must ultimately determine, if a rule constitutes a “major rule.” See 5 U.S.C. § 802. Designation as a “major rule” means that a rule cannot become effective for at least 60 days to enable Congress adequate time to consider a joint resolution of disapproval. The Proposed Election Contest Rules, if promulgated in their current form, likely would constitute a “major rule.”

²²¹ See, e.g., *Ngou v. Schweiker*, 535 F. Supp. 2d 1214, 1216 (D.D.C. 1982) (noting that the 30-day period under § 503(d) begins to run after publication of a final rule).

²²² See APA, 5 U.S.C. § 553(d). Courts have required agencies to defer the effective dates of rules where the time allowed by the agency is “arbitrary” or “capricious.” See, e.g., *National Ass’n of Indep. Television Producers and Distribs. v. FCC*, 502 F.2d 249, 254-55 (2d Cir. 1974) (holding that eight months was an unreasonably short time to allow broadcasters to plan new programming).

²²³ See, e.g., *United States v. Gavrilovic*, 551 F.2d 1099, (8th Cir. 1977) (stating that conduct occurring at day 27 after publication of a final rule could not be unlawful under the final rule).

²²⁴ U.S. CONST. art. I, § 9.

²²⁵ See *Stogner v. California*, 123 S. Ct. 2446, 2450 (2003).

doctrine to agency rulemaking.²²⁶ The Exchange Act permits criminal prosecution for a violation of the securities laws, including Rule 14a-9.²²⁷ As noted above, the proposing release warns companies that a failure to abide by the Proposed Election Contest Rules before they are enacted could be treated later as a violation of Rule 14a-9. Thus, to the extent that the Commission sought to enforce Rule 14a-9 criminally in this context, the constitutional rights of affected parties would be implicated. Furthermore, even if the Commission were to take civil action in this context, due process concerns would arise.²²⁸ The mere possibility of ex post facto and due process concerns arising is symbolic of the severe and unintended consequences that would result from any pre-effective date application of the Proposed Election Contest Rules.

D. The Commission Has Not Assessed Adequately The Economic Impact Of The Proposed Election Contest Rules, Which Would Impose Great Costs On Publicly Held Corporations And The Economy As A Whole.

The preceding sections have identified some of the great costs and harmful effects that would result from the Commission's Proposed Election Contest Rules. This section will demonstrate in greater detail the many shortcomings in the Commission's evaluation of the costs the proposal would impose on American companies and the economy as a whole.

As the Commission recognizes in its proposing release, the Exchange Act, Paperwork Reduction Act, and Regulatory Flexibility Act require that it undertake a thorough and accurate analysis of the costs the Proposed Election Contest Rules would impose on regulated entities and the economy as a whole. The APA, for its part, requires that this economic analysis be reasonable and substantiated, and that the conclusions the Commission draws from the economic analysis have a reasoned, rational basis in the data the Commission gathers. The Information Quality Act,²²⁹ and guidelines issued by the Commission pursuant to that Act and OMB regulations,²³⁰ further require that the data used in such regulatory analysis be "accurate, reliable, and unbiased," that it be carefully reviewed by subject matter experts and appropriate levels of management, and that there be "adequate disclosure about underlying data sources, quantitative methods of analysis and assumptions used, to facilitate reproducibility of the

²²⁶ See, e.g., *Hamm v. Latessa*, 72 F.3d 947, 956 n.14 (1st Cir. 1995); *Prater v. United States Parole Comm'n*, 802 F.2d 948, 953-54 (7th Cir. 1986); *Rodriguez v. United States Parole Comm'n*, 594 F.2d 170, 174 (7th Cir. 1979).

²²⁷ See Exchange Act, § 32, 15 U.S.C. § 78ff(a).

²²⁸ See, e.g., *Landgraf v. USI Film Prods.*, 511 U.S. 244, 253 (1994) (Due Process Clause protects interests in fair notice and repose that may be compromised by retroactive legislation).

²²⁹ Pub. L. No. 106-554, App. C, § 515.

²³⁰ Securities and Exchange Commission Final Data Quality Assurance Guidelines, available at <http://www.sec.gov/about/dataqualityguide.htm> (last visited Dec. 19, 2003).

information, according to commonly accepted scientific, financial or statistical standards, by qualified third parties.”²³¹

In this case, however, the Commission’s estimates of the proposed rules’ costs and burdens are inadequate and unreliable on their face, and vastly understate the proposal’s far-reaching effects.

It should be noted at the outset that one of the most remarkable aspects of the Proposed Election Contest Rules is the degree to which the Commission has shifted to the public tasks that properly fall to the Commission itself. (The proposing release “may have broken all records in terms of the number of questions asked,” Commissioner Glassman has observed.²³²) This shortcoming is particularly evident in the portions of the proposing release addressing the proposal’s burdens and costs. The requirements governing rulemaking dictate that *the Commission* analyze and estimate a proposed rule’s burdens and costs both adequately and accurately.²³³ Yet, rather than undertake a substantive study of the likely costs of the Proposed Election Contest Rules, the Commission largely requests commenters to provide this information.²³⁴ As noted above, the Commission has posed approximately 350 questions to the public, stating that “[w]ith regard to any comments, we note that such comments are of great assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.”²³⁵ In this regard, the Commission is asking the public to do that which the Commission itself has failed to do.

Perhaps inevitably, the consequence of the Commission’s approach is cost estimates in the proposing release that are unreliable even in the judgment of the Commission itself. In the section of the proposing release addressing the Paperwork Reduction Act, the Commission concedes that “[a]ll of the [burden] figures [provided] are estimates because *there is no reliable way to predict* how many more security holder proposals would be submitted based on the proposed amendments, how often the events would be triggered or how many security holders

²³¹ *Id.*

²³² Commissioner Cynthia A. Glassman, Remarks at Open Meeting of the Securities and Exchange Commission (Oct. 8, 2003). See also the discussion above at pages 44-45.

²³³ See, e.g., *Horsehead Res. Dev. Co.*, 16 F.3d at 1269 (remanding part of an EPA rule because the agency relied on “pure speculation” in establishing its standard rather than undertaking an examination of the relevant data and engaging in reasoned analysis). The Commission also is obligated to provide reliable, accurate cost estimates under other laws and provisions, including, among others, the Exchange Act, 15 U.S.C. §§ 78c(f), 78w(a)(2); Executive Order No. 12,866; and Paperwork Reduction Act, 44 U.S.C. §§ 3506(c)(1)(A)(iv), 3506(c)(2)(A)(ii).

²³⁴ See, e.g., 68 Fed. Reg. at 60,787 (requesting comment on the actual costs of the Proposed Election Contest Rules for companies).

²³⁵ *Id.* at 60,807.

would be able to meet the applicable requirements.”²³⁶ Indeed, burden and cost estimates in the proposing release are not merely unreliable, they are artificially low. They wholly fail to identify the scope of entities that would be covered by the Proposed Election Contest Rules, grossly underestimate the frequency with which the rules’ requirements would be triggered, and inadequately account for the extensive costs that would arise once the triggering does occur.²³⁷

In the proposing release, the Commission estimates a total annual incremental expenditure of *14 hours of company personnel time (at an estimated total cost of \$1,200)* and *10 hours of outside professional time (at an estimated total cost of \$3,000)* for each “affected” company.²³⁸ These estimates fail on their own terms. As the Commission would have it, all of the following would take a total of 24 hours’ work and \$4,200 in expenses on the part of all the executive officers and board members, in-house counsel and other company personnel, and outside lawyers, consultants, and other professionals whose involvement would become necessary once the proposed rules’ requirements were triggered:

- a new disclosure requirement that the company notify shareholders that it has received an election contest shareholder proposal by a more than 1-percent shareholder, including the burdens and costs associated with the Exchange Act Rule 14a-8 shareholder proposal process such as shareholder preparation of the proposal, the company’s consideration, in consultation with counsel, of whether the proposal meets the procedural and substantive requirements of Rule 14a-8, the company’s discussion with the proponent regarding the proposal in the hopes of obtaining a

²³⁶ *Id.* at 60,811 (emphasis added).

²³⁷ This rulemaking is not the first time that the Commission’s failure to engage in substantive burden analysis has resulted in artificially low cost estimates. In the proposing release accompanying the rule to implement Section 404 of the Sarbanes-Oxley Act of 2002, the Commission estimated that compliance would require an additional *5 hours* of corporate time per affected company. *See* P.L. 107-204, 116 Stat. 745 (2002). In response to concerns expressed by commenters, the Commission was forced in the final rule to increase this estimate hundreds of times over, from *5 hours* per company to *383 hours of work*, or an annual burden estimate under the Paperwork Reduction Act of \$91,000 (not including additional auditor’s fees). *See* Release No. 33-8238 (June 5, 2003). *See also* Alix Nyberg, Sticker Shock, *When Congress passed the Sarbanes-Oxley Act of 2002, it didn't worry about how much it would cost companies. Today, CFOs are totting up the compliance bill—and they don't like what they see*, CFO MAGAZINE, Sept. 8, 2003, at 51 (noting Commission history of low-balling estimated compliance costs in rulemaking). Even that estimate has proved far too low. A September 2003 survey by CFO Magazine reveals that more than 80 percent of CFOs view the Commission's revised \$91,000 estimate as unrealistically low. Indeed, 48 percent of companies will spend at least \$500,000 on Sarbanes-Oxley Act compliance, with 25 percent spending more than \$1 million. *See id.* *See also* Margaret A. Johnsson, *New regulations: preparing for unplanned costs; Regulation; analysis of costs of complying with executive certification of corporate financial statements*, FINANCIAL EXECUTIVE, Jan. 1, 2003, at 16 (noting actual compliance costs in the hundreds of thousands to millions of dollars). We are concerned with a repeat of these events in this rulemaking, where the Commission again has published a concededly unreliable burden estimate that is artificially low. As noted throughout, the various regulations governing Commission rulemaking require it to provide reliable estimates.

²³⁸ *See* 68 Fed. Reg. at 60,814.

- withdrawal, counsel's preparation of a request to the Commission for permission to exclude the proposal ("no-action request"), and the company's preparation of a statement of opposition if the proposal is included in the proxy materials;
- the company's costs to disclose the shareholder vote regarding an election contest shareholder proposal, to announce that it would be subject to the shareholder nomination procedure, and to announce any change in the date of its annual meeting;
 - shareholders' preparation of notices to the company of their intent to require the company to include shareholder nominees in the company's proxy materials; shareholders' preparation and filing of Exchange Act Schedule 13G and related certifications; shareholders' preparation of statements of support for their candidate or candidates and/or opposition to the company's nominees; the company's preparation and review of the information to be included in the proxy materials; the company's preparation and review of its statement in support of its nominees and in opposition to the shareholder nominees; the company's preparation of any notice as to why any shareholder nominee is not eligible for the proxy materials; and
 - costs related to election contests, including, among other things, executive and director time and distraction from performance of their regular duties, other company personnel time and distraction from normal duties, legal fees, and the expenses of professional proxy solicitors.²³⁹

In fact, consideration of just a few of the costs that would result from the Proposed Election Contest Rules illustrates the inadequacy of the estimate in the proposing release. First, the Commission fails to account adequately for the fact that companies would often treat Election Contest shareholder proposals as contested events.²⁴⁰ To prevent shareholders from triggering the process whereby shareholders may nominate directors in company proxy materials, companies will expend new resources to scrutinize, challenge and attempt to defeat Election Contest shareholder proposals.²⁴¹ Because more shareholder proposals would be submitted under the Proposed Election Contest Rules, companies also would challenge more shareholder proposals at the Commission in an attempt to obtain permission to exclude them.

Although the Commission's analysis of the number of no-action requests that would result is based on historical data rather than on analysis of what could be expected under the Proposed Election Contest Rules, application of even the historical data in the proposing release

²³⁹ *Id.* at 60,809-11; ARANOW & EINHORN ON PROXY CONTESTS FOR CORPORATE CONTROL § 21.01 (3d ed. 1998).

²⁴⁰ *See, e.g., Motor Vehicles Mfrs. Ass'n*, 463 U.S. at 43 (stating that an agency rule is arbitrary and capricious where an agency has "failed to consider an important aspect of the problem").

²⁴¹ *See Proposed Proxy Access Rule Leaves Proponents Uncertain About Preparations for 2004 Proxy Season*, *supra* note 162.

demonstrates that its total burden estimate is artificially low. The Commission estimates “an annual incremental disclosure burden of approximately 25 hours for each Exchange Act Rule 14a-8 no-action contest that a company” undertakes.²⁴² By comparison, the proposing release asserts that the Proposed Election Contest Rules would cause only a total of 24 burden hours a year for each “affected” company. A company challenging even one shareholder proposal as a result of the Proposed Election Contest Rules (which all “affected” companies likely would do) would *exceed* the release’s total annual burden estimate. Courts have held that where, as here, an agency’s burden estimates are irrational and internally inconsistent, agency action premised on those estimates is impermissible.²⁴³

Second, the Commission’s burden estimates do not account adequately for increased printing and mailing expenses that would result from the Proposed Election Contest Rules. Contrary to the assertion in the proposing release that there would be no additional printing and mailing burdens under the rules, all companies that are “affected” by the rules would be likely to experience increased printing and mailing expenses that outpace current expenditures.²⁴⁴ Increased printing and mailing costs would result from companies distributing more materials (in frequency and/or size) to shareholders as a consequence of increased shareholder proposals and the inclusion of shareholder candidates in company proxy materials.²⁴⁵ The proposing release cites an estimate that an additional two ounces of proxy materials mailed to 100,000 shareholders would result in an increased mailing cost of \$308,825.²⁴⁶ Assuming the accuracy of this modest estimate, an “affected” company’s printing and mailing costs for an addition two ounces of proxy materials would radically surpass the total annual financial burden that the Commission

²⁴² The November 2003 Surveys suggest that each “affected” company will spend an average 30.8 hours and \$13,896 for each no-action request.

²⁴³ See, e.g., *National Parks & Conservation Ass’n*, 998 F.2d at 1532-33 (reversing an FAA order that was not “rational” or “reasonable” on grounds that the agency presented a flawed, subjective evaluation of impact rather than empirical evidence of impact); *American Paper Inst. v. EPA*, 660 F.2d 954, 964 (4th Cir. 1981) (finding an EPA cost estimate to be arbitrary and capricious because, among other things, it was “internally inconsistent”).

²⁴⁴ See 68 Fed. Reg. at 60,814.

²⁴⁵ See, e.g., *id.* at 60,800 (requiring companies to include shareholder nominees in company proxy materials, and permitting supporting statements of all nominees in company proxy materials).

²⁴⁶ See 68 Fed. Reg. at 60,814.

estimates for the “affected” company.²⁴⁷ This example again demonstrates the irrationality of the Commission’s burden estimates.²⁴⁸

Third, the Commission’s burden estimates do not account for the fact that the Proposed Election Contest Rules have the potential to turn every director election into an election contest.²⁴⁹ Although the proposing release concedes the “high costs associated with undertaking an election contest,” it erroneously contends that resources that would be expended by companies for election contests under the rules would merely offset current election contest expenditures.²⁵⁰ But because the Proposed Election Contest Rules are designed to enable shareholders to nominate directors in company proxy materials, there would by definition be more instances where shareholder nominees are actually included in a company’s proxy materials, giving rise to more election contests than currently exist. In such instances, and pursuant to their fiduciary duties, company directors would be forced to expend all necessary and permissible resources to defeat unqualified shareholder nominees.

Elections will in a sense be treated as “contested” even where no shareholder nominee appears on the ballot because companies would have an incentive to expend resources to ensure not merely that their nominees win, but that they do so with fewer than 35 percent “withhold” votes. Company costs in this area, which also are unaccounted for, could include executive and director time and distraction from regular duties, increased legal fees, the use of proxy solicitors, and increased costs of printing and mailing resulting from the inclusion of additional information in company proxy materials and additional shareholder communications.²⁵¹ The cost of even one proxy contest likely would exceed the total \$4,200 burden estimate conveyed in the proposing release.²⁵²

This understatement of economic impact is the product of a process that does not appear to have any systematic empirical basis. Rather than conducting surveys or employing other methodologies that might have fully and objectively revealed the true impact of the Proposed

²⁴⁷ The November 2003 Surveys also reveal that each “affected” company is likely to spend \$15,324 to print and mail one additional shareholder proposal. Thus, the mailing of even one shareholder proposal would exceed the Commission’s total cost estimate (\$4,200) by more than threefold.

²⁴⁸ See, e.g., *National Parks & Conservation Ass’n*, 998 F.2d at 1532-33 (reversing an FAA order that was not “rational” or “reasonable” on grounds that the agency presented a flawed, subjective evaluation of impact rather than empirical evidence of impact).

²⁴⁹ See, e.g., *Motor Vehicles Mfrs. Ass’n*, 463 U.S. at 43 (stating that an agency rule is arbitrary and capricious where an agency has “failed to consider an important aspect of the problem”).

²⁵⁰ See 68 Fed. Reg. at 60,814.

²⁵¹ See, e.g., *id.* at 60,800 (companies may include supporting statements of nominees in their proxy materials).

²⁵² See ARANOW & EINHORN, *supra* note 239, at Exhibit 21-1 (3d ed. 1998).

Election Contest Rules, the Commission simply offered its own estimated averages without any apparent data source. The approach lacks even rudimentary checks to ensure accuracy. To the extent any process was used to develop the averages, the Commission does not reveal this information in a way that would allow outside, independent parties to replicate it in order to check its responsibility and accuracy.²⁵³

Had the Commission formed its estimates based on a systematic methodology, such as an objective survey, its projections would have been completely different. Indeed, the November 2003 Surveys followed precisely the approach that should have been used by the Commission: a thorough survey of a broad cross-section of potentially affected parties to assess the likely impact of the proposal. As described in more detail in the summary of survey results that is attached to these comments,²⁵⁴ the November 2003 Surveys included responses from a sample of 137 companies that range from small concerns to large corporations. Even though great care was taken to avoid any bias that might have overstated the results, which included the interpretation of ambiguous answers in the way that yielded the lowest possible cost, the November 2003 Surveys confirmed that the Commission's estimates are hundreds of times too low. Detailed cost breakdowns submitted by more than 90 companies reveal that the average cost for one "affected" company exceeds the Commission's estimate for the entire regulated community. According to the survey results, adoption of the Proposed Election Contest Rules would lead to an additional total burden of more than 500 hours and \$700,000 per "affected" company.²⁵⁵

III. If The Commission Nevertheless Moves Forward With The Proposed Election Contest Rules, Extensive Revisions Are Necessary.

For all of the reasons set forth above, we strongly urge the Commission not to move forward with adoption of the Proposed Election Contest Rules. If the Commission, despite its lack of authority and failure to satisfy applicable rulemaking standards, nevertheless determines to pursue this complex rulemaking, we submit that substantial changes in the Proposed Election Contest Rules are necessary in order to: (1) better meet the Commission's objective of targeting companies where the proxy process has proven ineffective, and (2) make the rules more workable for both shareholders and public companies. In addition, the Commission should consider the interaction of its rulemaking with state law and company bylaws, and the impact of the rules on other aspects of the proxy process, including communications with shareholders.

²⁵³ See *supra* note 230.

²⁵⁴ See Summary of the November 2003 Surveys.

²⁵⁵ According to the November 2003 Surveys, the average burden and cost for each "affected" company in connection with opposing the occurrence of a trigger would be 192.3 hours and \$162,299, and the average burden and cost in connection with opposing an Election Contest nominee and supporting the company's nominees would be 323.9 hours and \$580,321. The companies that have actually experienced a proxy contest in the past two years reported even greater costs in connection with opposing an Election Contest nominee, reporting costs ranging up to \$15 million or more.

Finally, if the Commission proceeds to adopt final election contest rules, it should establish procedures to resolve the disputes that inevitably will arise under such rules. The substantial modifications we are suggesting would, under the APA, require the Commission to undertake a new round of notice and comment.²⁵⁶

Our suggested revisions in the event that the Commission proceeds with the Proposed Election Contest Rules are described in detail below.

A. Election Contest Triggering Events

We concur with the Commission that any election contest rules must focus on companies at which objective criteria indicate an ineffective proxy process. Accordingly, we agree with the Commission that if final election contest rules are adopted, they only should be “triggered” by certain events. As discussed above, however, we do not believe that the proposed triggers would accomplish the Commission’s stated objective. Therefore, if the Commission decides to adopt the Proposed Election Contest Rules, the triggering events should be substantially revised to ensure that the rules come into play only when warranted.

1. Shares Outstanding, Not Votes Cast

At the outset, all triggering events should be calculated based on the total number of a company’s outstanding shares, not the number of shares voted on a particular matter. This is a critical distinction, and one that is necessary to achieve the Commission’s objective of targeting companies where the proxy process has been ineffective. A trigger based on the number of shares voted, rather than the total number of shares outstanding, would not reflect the effectiveness (or ineffectiveness) of the proxy process in the view of *all* of the company’s shareholders. It thus would not accomplish the Commission’s goal of targeting companies with an ineffective proxy process. A trigger based on the number of shares outstanding, on the other hand, would measure more appropriately the effectiveness of the proxy process from the perspective of *all* of the company’s shareholders.

2. Election Contest Shareholder Proposals

We strongly oppose triggering any final rules on a majority vote by shareholders to activate the Election Contest procedure. As noted above, this trigger would be available to shareholders of all public companies, not only those with an ineffective proxy process, and thus would not meet the Commission’s stated objective. Our experience with the proxy voting system, discussed in detail in Section II.B.2 above, suggests that many Election Contest shareholder proposals would be submitted and, indeed, would receive majority approval, even at companies where the proxy process is not ineffective.

²⁵⁶ See, e.g., *National Mining Ass’n v. v. Mine Safety & Health Admin.*, 116 F.3d 520, 531-32 (D.C. Cir. 1997) (holding notice inadequate where a final rule was not a “logical outgrowth” of a proposed rule); *American Water Works Ass’n v. EPA*, 40 F.3d 1266 (D.C. Cir. 1994) (same).

If, despite these flaws, the Commission nevertheless moves forward with a trigger based on approval of an Election Contest shareholder proposal, the Commission should require the proponents of such proposals to satisfy an ownership threshold of at least 25 percent for two years. Such a threshold would be more effective than the proposed 1-percent, one-year threshold in establishing substantial shareholder interest, and accordingly would be a more reliable indicator that the cost and disruption of a contested director election is warranted. A higher threshold also would decrease the likelihood of a company receiving an Election Contest shareholder proposal from a single shareholder with a personal grievance against the company or its board.

In addition, the Commission should place limits on the frequency of triggering events so that companies are not barraged with Election Contest shareholder proposals year after year. Under Rule 14a-8, a shareholder proposal addressing the same subject matter as a proposal previously included in the company's proxy materials may be omitted if the previous proposal did not receive a certain minimum level of shareholder support. Specifically, Rule 14a-8(i)(12) provides that, if a proposal deals with "substantially the same subject matter" as another proposal or proposals included in the company's proxy materials within the preceding 5 calendar years, the company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the previous proposal received: (1) less than 3 percent of the vote if proposed once within the preceding 5 calendar years; (2) less than 6 percent of the vote on its last submission to shareholders if proposed twice within the preceding 5 calendar years; or (3) less than 10 percent of the vote on its last submission to shareholders if proposed three times or more within the preceding 5 calendar years.²⁵⁷ We believe that a similar concept should apply to Election Contest shareholder proposals.

Although we believe the concept of Rule 14a-8(i)(12) should apply to Election Contest shareholder proposals, we submit that the standards for repeated inclusion of such proposals should be higher than those set forth in Rule 14a-8. Specifically, we recommend that the Commission permit companies to exclude Election Contest proposals for two years (the same period of time the Election Contest procedure would be triggered if an Election Contest proposal were approved) following a vote in which less than 25 percent of shares outstanding voted in favor of such a proposal. Establishing a higher standard for repeated inclusion of Election Contest proposals is warranted not only by the substantial cost and disruption associated with such proposals, but also by their mandatory nature.

3. *Withhold Votes*

Although the second proposed trigger—"withhold" votes exceeding a certain level—more closely focuses on the Commission's objective of targeting companies where the proxy process has been ineffective, it, too, would require substantial revision if the Commission were to proceed with a final rule. As proposed, the rules would activate the Election Contest procedure immediately upon a company's receipt of more than 35 percent withhold votes for a

²⁵⁷ 17 C.F.R. § 240.14a-8(i)(12).

director nominee.²⁵⁸ Yet the fact that a substantial percentage of shareholders have withheld votes from a particular director hardly establishes that the company as a whole is non-responsive. The company’s nominating committee and board, for example, might decide not to re-nominate that director in subsequent years. This would be clear and unassailable evidence that the company was, in fact, responsive to shareholder concerns. Under the current proposal, however, the company nonetheless would be subject to the Election Contest procedure.

To correct this deficiency, the Commission should revise the rules to trigger the Election Contest procedure only where a director nominee receives more than a specified percentage of withhold votes *and* the board subsequently determines to re-nominate that director. We believe that the logistics of providing notice to shareholders of a decision to re-nominate, including establishing any necessary time limit for board action, could be set forth in the rules.

In addition, we believe that the proposed 35-percent standard is too low to demonstrate that a company’s proxy process has been ineffective. A director who receives 35 percent withhold votes may be very well-regarded by the other 65 percent of shareholders who supported his or her candidacy. Moreover, the fact that a director receives a minority of withhold votes does not demonstrate that the proxy process is ineffective. On the contrary, it is evidence that the proxy process is working: the majority of shares voted for the director, and he or she was elected to the board. To better meet its objective of targeting companies with an ineffective proxy process, the Commission should raise the threshold for withhold votes to at least 50 percent of shares outstanding, reflecting the will of a true majority of shareholders.

B. Companies To Which The Proposed Election Contest Rules Would Apply

In the proposing release, the Commission indicates that “if state law permits companies incorporated in that state to prohibit security holder nominations through provisions in companies’ articles of incorporation or bylaws, the proposed [Election Contest] procedure would not be available to security holders of a company that had included validly such a provision in its governing instruments.”²⁵⁹ We concur with the Commission’s intent in this regard. In fact, we think it is required by principles of federalism. We are concerned, however, that this intent is not conveyed adequately in the text of the Proposed Election Contest Rules. On the contrary, the proposed rule text states only that the Election Contest procedure would be available to shareholders where “applicable state law does not prohibit the registrant’s security holders from nominating a candidate or candidates for election as a director.”²⁶⁰ Based on this language, it could be argued that only state law—and not a company’s governing documents—can be the source of a prohibition on shareholder nominations.

²⁵⁸ See 68 Fed. Reg. at 60,789.

²⁵⁹ *Id.* at 60,787-88.

²⁶⁰ *Id.* at 60,819.

The text of the Proposed Election Contest Rules should be revised to effectuate more clearly the Commission’s intent. Specifically, we recommend that Proposed Rule 14a-11(a)(1) be revised to state that the proposed Election Contest procedure will be available to shareholders only where “neither applicable state law, *nor company governing instruments that comply with state law*, prohibit the registrant’s security holders from nominating a candidate or candidates for election as a director.”

C. Qualifications To Nominate Director Candidates

Once the Election Contest procedure is triggered under the Proposed Election Contest Rules, any shareholder or group of shareholders beneficially owning—individually or in the aggregate—more than 5 percent of the company’s voting securities for at least two years would be permitted to nominate one or more director candidates in the company’s proxy materials.²⁶¹ As discussed below, we believe the proposed ownership threshold should be raised and the proposed holding period extended in order to justify the cost and disruption that the Election Contest procedure would engender. In addition, a nominating shareholder’s ability to nominate candidates in successive years should be linked to the success of the shareholder’s candidates in previous elections. Finally, similar to the requirement in Rule 14a-8 and consistent with state law and company bylaws, nominating shareholders should be required to attend the company’s annual meeting to nominate their candidates.

1. Ownership Threshold To Nominate Directors

In view of the substantial cost and disruption that would result from the Election Contest procedure, we agree with the Commission that there should be a threshold ownership requirement for nominating shareholders if the Proposed Election Contest Rules are adopted. However, the proposed 5-percent threshold is far too low.

When a board of directors nominates a slate of director candidates, it must act in a manner it believes to be in the best interests of the company and all of its shareholders. Accordingly, a board that receives a shareholder nominee through the Election Contest procedure would be required to consider whether the board’s own nominees would better manage the business and affairs of the company and better satisfy applicable expertise standards (*e.g.*, the Commission’s “audit committee financial expert” rules and NYSE and NASDAQ financial literacy/expertise requirements). If so, the board’s fiduciary duties would require it to act to counter the shareholder nominee. This is likely to result in substantial costs, borne by the company and *all* of its shareholders. The holders of just 5 percent of a company’s shares lack a sufficient stake in the company to warrant imposing such costs on *all* shareholders.

The 5-percent ownership threshold in the current proposal is particularly troubling given the ease with which shareholders could band together to reach the 5-percent threshold. As discussed above, our September 2003 Survey indicates that a 5-percent threshold could result in

²⁶¹ *See id.* at 60,794.

a very large number of shareholders nominating candidates to be included in company proxy materials, given the almost infinite number of combinations of shareholders owning even ¼ percent of a company's shares. The Commission errs in concluding that data concerning the number of shareholders who *individually* could satisfy a higher threshold (10 percent) suggests that shareholders would have difficulty in *aggregating* their shares to meet such a threshold.²⁶²

Because it would not be difficult for shareholders to band together to nominate director candidates, and because contested director elections would result in significant costs for all shareholders, we believe that it would be more appropriate to limit the Election Contest procedure to shareholders or groups of shareholders holding at least 25 percent of a company's voting securities. This threshold, though still a minority, would demonstrate that a significant portion of shareholders are willing to bear the costs of a contested election. It thus would better justify those costs.

2. *Holding Period*

Although we agree with the Commission that nominating shareholders should be required to hold their shares for at least two years prior to the nomination date, we believe that this holding period alone is insufficient and should be extended through the service of any elected Election Contest nominee. Specifically, nominating shareholders should be required to represent their intent to continue to satisfy the requisite ownership threshold for the duration of their nominees' service on the board. (In contrast, the Proposed Election Contest Rules would only require the nominating shareholders to intend to hold their securities through the date of the relevant annual or special meeting.²⁶³)

Requiring nominating shareholders to maintain a significant stake in the company would address to some extent the problem of special-interest or single-issue directors because a nominating shareholder who is required to maintain a significant financial stake in the company *after* the nominee is elected can be expected to be marginally less likely to nominate a candidate who will pursue a special-interest agenda at the expense of the company's long-term interests. On the other hand, permitting shareholders to liquidate their holdings in the company immediately upon election of a shareholder nominee, as proposed, would impose no consequences on shareholders who nominate special-interest directors.

3. *Right To Nominate Candidates In Successive Years*

If the Commission moves forward with the Proposed Election Contest Rules, a shareholder's right to nominate director candidates in successive years should be linked to the success of the shareholder's candidates in previous elections. In other words, a shareholder whose nominee fails to receive at least 50 percent of the votes outstanding in an election in one

²⁶² See *id.*

²⁶³ See *id.*

year should not be permitted to submit nominees through company proxy materials in the remaining year of the Election Contest procedure, as that shareholder has not demonstrated sufficient support to elect its candidates to the board. It therefore would be inappropriate to require the company to again expend the significant resources necessary to evaluate that shareholder's nominees and undertake an election contest in future elections.

4. *Annual Meeting Attendance*

The Proposed Election Contest Rules, if finalized, should require that a nominating shareholder, or a representative who is qualified under state law to nominate a candidate on such shareholder's behalf, attend the company's annual meeting and nominate any Election Contest candidates in person. This prerequisite would be consistent with state law and company bylaws and would parallel Rule 14a-8(h), which requires that proponents or their representatives attend the annual meeting to present shareholder proposals.²⁶⁴ Furthermore, similar to Rule 14a-8(h)(3), if the nominating shareholder(s) or a qualified representative failed without good cause to appear and nominate the candidate, the company should be permitted to exclude from its proxy materials in the following two years all Election Contest nominees submitted by that shareholder or group of shareholders.

D. *Eligibility Of Election Contest Nominees*

1. *Relationships Between The Nominee, The Nominating Shareholder(s) And The Company*

Consistent with the corporate governance reforms enacted over the past two years, we believe that the board of directors must have a role in evaluating the independence, eligibility and qualifications of Election Contest nominees. The board, through its nominating committee, is best positioned to assess the qualifications of director nominees and the composition of the board as a whole. Bypassing the nominating committee, on the other hand, would undercut the role and independence of the board and could have serious, negative consequences for the company and all of its shareholders. For example, as discussed above, it could result in the election of directors who do not meet the board's independence or qualification standards.

Accordingly, although the Commission is correct to require in any final rule that Election Contest nominees meet the *objective* independence standards of a national securities exchange (e.g., the NYSE) or national securities association (e.g., NASD), nominees also should be required to meet the *subjective* independence standards of the NYSE or NASDAQ (requiring a board determination that the nominee has no material relationship that would impair independence). In addition, the Commission should require Election Contest nominees to meet

²⁶⁴ Such a prerequisite also would be consistent with the Commission's new proxy disclosure rules, which require a company to disclose its policy regarding director attendance at annual meetings and the number of directors who attended the prior year's annual meeting. See Final Rule: Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Release No. 33-8340 (Nov. 24, 2003).

the same qualification standards applicable to all director nominees, as determined by the board and its nominating committee. To assist the board in evaluating an Election Contest nominee's qualifications, the Commission should require such nominees, or the nominating shareholders, to provide additional information (such as information regarding financial expertise) to the board upon request.

As discussed in Section II.B.2.e above, the Proposed Election Contest Rules create the possibility of the nomination and election of special-interest or single-issue directors who advance the relatively narrow agendas of the shareholders who nominated them— notwithstanding such candidates' objective "independence." Although this is a flaw in the proposal that cannot be fully addressed and is among the reasons the rulemaking should be abandoned, we recommend that, at a minimum, the Commission require Election Contest nominees to certify that they are aware of their duties under state law to act in the best interests of the company and *all* of its shareholders.

Finally, we support requiring nominating shareholders to represent that neither the nominee nor the nominating shareholder (nor any member of the nominating shareholder group, if applicable) has a direct or indirect agreement with the company regarding the nomination.²⁶⁵ As the Commission suggests, however, we believe there should be an exception in any final election contest rules to permit negotiations and other communications between the nominating shareholder and the company regarding Election Contest nominees.²⁶⁶ Such an exception would permit companies to respond to nominating shareholder concerns and, possibly, prevent the costly and divisive proxy contests that would result from inclusion of Election Contest nominees in company proxy materials.

2. Consistency With State Law, Federal Law And Exchange Rules

The Commission is correct not to require a company to include in its proxy materials a shareholder nominee whose candidacy or, if elected, board membership would violate controlling state law, federal law or the rules of a national securities exchange or national securities association (other than independence standards).²⁶⁷ Absent such a requirement, a shareholder could nominate and successfully champion the election of a director who is employed by the company's competitor, potentially causing the company to violate Section 8 of the Clayton Act of 1914. Furthermore, it is critical as a matter of state law to limit the availability of the proposed Election Contest procedure to situations in which state law permits, and a company's governing instruments do not prohibit, shareholders to nominate candidates for director.

²⁶⁵ See 68 Fed. Reg. at 60,796.

²⁶⁶ See *id.*

²⁶⁷ See *id.* at 60,795.

E. Scope Of Election Contest Procedure

1. Duration Of Procedure

If the Commission moves forward with the Proposed Election Contest Rules, the Election Contest procedure should be activated for only one year following the occurrence of a triggering event, rather than the two years proposed. Limiting the procedure to one year would permit the company's shareholders to evaluate the impact of any election contest on the proxy process. If necessary (*i.e.*, if the proxy process remained ineffective), then the shareholders would have the option to trigger the Election Contest procedure again the following year. This would be much less disruptive for companies than assuming that two contests (and all the costs they involve) are always necessary. Accordingly, we urge the Commission to limit the effective duration of any triggering events to one year.

2. Number Of Election Contest Nominees

The Proposed Election Contest Rules would require companies to include in their proxy materials one shareholder nominee if the total number of directors is 8 or fewer, two shareholder nominees if the number of directors is between 9 and 19, and three shareholder nominees if the number of directors is greater than 20.²⁶⁸ One shareholder nominee should be the limit, regardless of the size of the board. The election of just one shareholder-nominated candidate could lead to a fragmented board unable to function effectively as a team. Permitting dissident shareholders to include *more* than one Election Contest nominee in company proxy materials would only exacerbate these problems and result in voting blocs on boards. The scope of the disruption this could cause is reflected in the results of our November 2003 Surveys, in which close to 90 percent of companies responding had nine or more directors.

The Commission's proposal for addressing situations in which the number of Election Contest nominees exceeds the number of permitted nominees also needs to be revised. As proposed, the rules would require companies to include in their proxy materials the nominee(s) of those nominating shareholders with the largest beneficial ownership.²⁶⁹ We recommend instead that, in the event that too many nominees are submitted, a company's nominating committee be permitted to select the Election Contest candidate. This would be consistent with the important role of nominating committees discussed above.

F. Notice Requirements

The Proposed Election Contest Rules set forth various notice requirements for both companies and nominating shareholders. Any final rules should, as the Commission has proposed, limit company notice of triggering events to periodic reports. As discussed below,

²⁶⁸ See *id.* at 60,797.

²⁶⁹ See *id.* at 60,798.

however, the proposed notice requirements for nominating shareholders should be revised in several respects.

1. *Company Notice Of Triggering Events*

Providing notice of a triggering event in Item 4 of Forms 10-Q, 10-QSB, 10-K or 10-KSB, as currently proposed,²⁷⁰ would furnish adequate notice to shareholders. Disclosure in a periodic report is predictable in time, place and form and, as a result, can be easily located and identified by interested shareholders. This notice obligation should not be extended to require a report on Form 8-K or other public notice. If notice of a triggering event were required in a Form 8-K or another public notice, shareholders would need to monitor those outlets regularly to determine whether a trigger had occurred, rather than simply reviewing periodic filings on a quarterly basis. In addition, public companies already must file periodic reports; an alternative notice mechanism would result in an additional filing obligation for subject companies, without a corresponding additional benefit to shareholders.

2. *Shareholder Notice To The Company Regarding Shareholder Nominations*

a. *Timing Of Shareholder Notice*

The Proposed Election Contest Rules would require that a nominating shareholder provide notice to the company of a proposed Election Contest nominee no later than 80 days before the mailing of the company's proxy materials for the upcoming annual meeting.²⁷¹ If notice were not submitted in a timely manner, the nominee would be deemed ineligible.

Timely notice by the shareholder should remain an eligibility requirement in any final rule. A company must be able to rely on a firm deadline, after which no additional Election Contest nominees need be considered. The proposed 80-day deadline must be reviewed more carefully, however, because it may conflict with the advance-notice provisions for shareholder nominations often set forth in company bylaws. These provisions, which are permitted by state law, vary from company to company. We recommend that rather than imposing an 80-day deadline for notice of Election Contest nominees at all companies, the Commission instead defer to companies' advance-notice bylaw provisions, which must comply with state law.²⁷² For those

²⁷⁰ See *id.* at 60,793.

²⁷¹ See *id.* at 60,798.

²⁷² Under state law, company bylaws “must be reasonable in their application.” *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401 (Del. 1985). See also *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (holding that management’s “inequitable action” in amending the company’s bylaws to allow shareholders only six weeks—rather than the originally scheduled two months—to wage an election contest “does not become permissible simply because it is legally possible”).

companies without advance-notice bylaw provisions, the Commission could provide a default deadline such as the 80 days proposed.

b. Contents Of Shareholder Notice

As discussed above, assuring the independence—and primary loyalty to the company—of shareholder nominees is among the most vexing problems in the Commission’s proposal, one that is not adequately addressed in the Proposed Election Contest Rules. As recommended above, the Commission should require Election Contest nominees to meet both the objective and subjective independence criteria in NYSE and NASDAQ corporate governance listing standards. To assist a nominating committee in determining whether an Election Contest nominee meets subjective independence criteria, the nominating shareholder’s notice to the company should provide additional information regarding charitable, personal and other material relationships not covered by the objective independence standards.

Furthermore, the Commission should require nominating shareholders to certify that their notice to the company does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading. Such a certification would permit the company to make the determination required by Proposed Rule 14a-11(a)(3) (requiring the company to determine an Election Contest nominee’s eligibility based, in part, on the absence of false statements in the nominating shareholder’s notice to the company).

The Commission also should require nominating shareholders and nominees to inform the company immediately of any change in the status or relevant relationships of the nominating shareholder or the nominee that would render such nominee ineligible for inclusion in the company’s proxy materials or service on the company’s board. Currently, the Proposed Election Contest Rules provide no mechanism for ensuring continued compliance with shareholder and nominee eligibility criteria.

c. Filing Of Shareholder Notice With The Commission

The Commission is correct to include in the proposal a requirement that a nominating shareholder file the contents of the shareholder’s notice with the Commission. This will make it clear that the nominating shareholder—not the company—is liable for the contents of that notice.

d. Company Response To Shareholder Notice

Under the Proposed Election Contest Rules, a company that determines it is *not* required to include an Election Contest nominee in its proxy materials must disclose that determination and the company’s reasoning in the proxy materials.²⁷³ This disclosure would not be meaningful to shareholders and, indeed, could cause confusion by providing information concerning a nominee who is not standing for election. Requiring this disclosure for numerous rejected nominees (as companies may receive nominees from more than one shareholder) would

²⁷³ See 68 Fed. Reg. at 60,801.

cause even greater confusion. Moreover, notice to the nominating shareholder in the proxy materials would be unnecessary, as the Proposed Election Contest Rules already require the company to notify the nominating shareholder separately that it has rejected that shareholder's nominee. Accordingly, companies should not be required to disclose information in proxy materials about rejected Election Contest nominees.

If a company determines that an Election Contest nomination *has* been submitted properly, then the company would be required under the Proposed Election Contest Rules to advise the nominating shareholder of the required form and timing of the proxy disclosure that the shareholder may submit.²⁷⁴ This is inconsistent with the Commission's intent that the nominating shareholder have full legal responsibility for the shareholder's proxy submission. If a company must guide each nominating shareholder in proper proxy procedures, then some measure of responsibility for the shareholder's compliance with the proxy rules is shifted to the company.

G. Voting For Company Nominees As A Group

The Proposed Election Contest Rules would overrule long-standing practice by prohibiting a company from providing its shareholders the option of voting for the company's nominees as a group.²⁷⁵ Instead, the proposal would require that each candidate be voted on separately. In the proposing release, the Commission suggests that grouping a company's nominees, as permitted under current Commission rules, "may make it easier to vote for all of the company's nominees than to vote for the security holder nominees in addition to some of the company nominees."²⁷⁶ We disagree. Providing shareholders with the *option* to vote for a company's nominees as a group would not make it more difficult for them to vote for Election Contest nominees. Moreover, barring shareholders from voting for a company's nominees as group could cause confusion for the many shareholders who for decades have been permitted to vote for a company's slate of nominees. In fact, prior to 1979, shareholders could vote only for or against the entire slate of directors.²⁷⁷ Finally, boards and nominating committees put considerable effort into selecting the company's slate of nominees, taking into account the expertise, experience and independence of the board as a whole, in accordance with their fiduciary duties. Shareholders should be permitted to rely on this process and vote for the company's nominees as a group if they so desire.

²⁷⁴ See *id.* at 60,801.

²⁷⁵ See *id.* at 60,800.

²⁷⁶ *Id.*

²⁷⁷ See Release No. 34-16356 (Nov. 21, 1979).

H. Liability Issues

It is imperative that any final rule retain the proposal's provision that nominating shareholders are responsible for all information they provide in the Election Contest process.²⁷⁸ Companies should have no liability for this information, except when they expressly incorporate it by reference in other filings when they know it to be false. In order to make clear to shareholders that the nominating shareholder is the source of—and the party responsible for—all information concerning an Election Contest nominee, a company should be permitted to state in its proxy materials that (1) information concerning the nominee was provided by the nominating shareholder, not the company, (2) the company has no responsibility or liability for the information, and (3) the nominating shareholder has sole responsibility and liability for the information. Moreover, any final rule should state clearly that responsibility and liability for any information provided by a nominating shareholder would be imposed solely upon the nominating shareholder. The Proposed Election Contest Rules state only that the company is not liable.²⁷⁹

Any final rule also should avoid creating vexatious litigation that would not accomplish the Commission's objectives. It should include a specific statement that nothing in the rule is intended to, or does, create a private right of action against public companies or their directors, officers or employees based upon compliance or non-compliance with the rule's provisions, and that authority to enforce compliance with the rule is vested exclusively in the Commission.²⁸⁰

In addition, as it has done in other areas,²⁸¹ the Commission should include in any final rule a safe harbor provision deeming companies to have fulfilled their obligations under the rule if certain conditions are met. For example, if the Commission moves forward with the possible third trigger (non-implementation of a majority-vote shareholder proposal), which we oppose, it must include a safe harbor provision stating that where a company's board has considered a majority-vote proposal and affirmatively determines that it cannot implement the proposal based on the board's fiduciary duty, then (1) the Election Contest procedure would not be triggered; and (2) no suit or enforcement action could be brought under the rule. Similarly, the Commission must provide safe harbors from application of the proposed Election Contest procedure and from litigation relating to the procedure where the board has met specified obligations under the other proposed triggers.

²⁷⁸ See 68 Fed. Reg. at 60,822.

²⁷⁹ See *id.*

²⁸⁰ The Commission has included similar provisions in other rules. See, e.g., 17 C.F.R. § 205.7 (2003) (providing that nothing in the Commission's rules relating to up-the-ladder reporting by attorneys is intended to, or does, create a private right of action against attorneys, law firms or companies, and that authority to enforce compliance with such rules is vested exclusively in the Commission).

²⁸¹ See, e.g., 17 C.F.R. § 229.303(c)(2)(ii) (2003) (providing that the "meaningful cautionary statements" element of statutory safe harbors will be satisfied if a company meets all requirements of the Commission's rule relating to disclosure of off-balance sheet arrangements).

I. Schedule 13D/13G Issues

The Proposed Election Contest Rules would require that nominating shareholders be eligible to report their security ownership on a Schedule 13G, meaning that they acquired their securities in the ordinary course of business and not for the purpose (or with the effect) of changing or influencing control of the company.²⁸² Requiring that nominating shareholders be eligible to file a Schedule 13G is appropriate. Exchange Act Rules 13d-1 and 16a-1(a)(1) should be revised to make clear, however, that nominating shareholders must comply with those provisions regardless of their participation in a nominating shareholder group, so that a Schedule 13D filer cannot become eligible to file a Schedule 13G simply by joining a nominating shareholder group.

In addition, although nominating shareholders should be *eligible* to file a Schedule 13G, they should be required to include in their Schedule 13G certain supplemental information called for in Schedule 13D. This information may bear directly on the evaluation of a nominee's eligibility, particularly the nominee's independence from the nominating shareholder. Specifically, Item 2 of Schedule 13D, regarding the identity and background of the reporting shareholder, and Item 6 of Schedule 13D, regarding contacts, arrangements, understandings or relationships with respect to the company's securities, may directly support or conflict with information provided to the company pursuant to proposed Rule 14a-11(c)(8). By relying only on the current form of Schedule 13G, a company would not be able to perform a meaningful, comparative analysis between the submission required by proposed Rule 14a-11 and Schedule 13G. An expanded Schedule 13G (including Items 2 and 6 of Schedule 13D), therefore, would assist the company in analyzing the nominee's eligibility and the accuracy of the nominating shareholder's notice.

J. Related Issues

The proxy process is an integrated, complex system involving companies, directors, shareholders, proxy solicitors, proxy voting services and others. The Proposed Election Contest Rules would revise a subset of this complex structure. We are concerned, however, that the Commission has not adequately considered the impact that such rulemaking would have on other parts of the proxy process. In particular, the Commission should consider the impact of the Proposed Election Contest Rules on the mechanics of communications with shareholders. It also should consider the impact of the NYSE's "10-day rule" and the need for a method to resolve disputes that arise under the Proposed Election Contest Rules. It is not possible at this time even to identify, much less analyze, the numerous collateral consequences that the Proposed Election Contest Rules would have because the proposing release contains so many uncertainties regarding the scope and workings of the proposed procedure. This highlights not only the deficiencies in the rulemaking to date but also the need for additional analyses and opportunity for public comment should the Commission decide to move forward with the proposal.

²⁸² See 68 Fed. Reg. at 60,805.

1. *Proxy Mechanics And Communications With Shareholders*

As discussed in Section III.C.1 above, a board's fiduciary duties to the company and its shareholders likely will require it to counter any Election Contest nominee. This would result in additional communications between the company and its shareholders, in order to solicit support for board-nominated candidates. In this regard, there generally are at least five times more communications to shareholders in a proxy contest than during a routine annual meeting solicitation. In light of this projected increase in shareholder communications, we believe that it is incumbent upon the Commission to undertake—as part of this rulemaking—a review of its rules relating to communication with the beneficial owners of shares held in “nominee” or “street” name (meaning those shares held of record in the names of brokers, banks, or other intermediaries).

The Commission's existing shareholder communication rules (set forth in Exchange Act Rules 14b-1,²⁸³ 14b-2²⁸⁴ and 14a-13²⁸⁵) make it difficult and expensive for companies to communicate with the beneficial owners of their securities held in street name. A study conducted in 1997 found that approximately 70 to 80 percent of all outstanding public company shares were held in street name.²⁸⁶ Companies may only communicate with the beneficial owners of these shares by going through the brokers and banks (“nominees”) that are registered as the owners of the securities. Many of these brokers and banks contract with agents, primarily ADP Brokerage Services Group (“ADP”), to perform shareholder communication and proxy services.²⁸⁷

Historically, only nominees or their agents were able to contact directly the beneficial owners of securities held in street name.²⁸⁸ In an effort to provide companies with the ability to communicate directly with these beneficial owners for at least some purposes, the Commission adopted rules in 1983, which went into effect in 1986, requiring nominees and their agents to provide companies with lists of “non-objecting beneficial owners” (or “NOBOs”) who did not object to having their names and addresses supplied to companies.²⁸⁹ Objecting beneficial owners (or “OBOs”) still only may be contacted directly by nominees or their agents. At a 2001

²⁸³ 17 C.F.R. § 240.14b-1.

²⁸⁴ 17 C.F.R. § 240.14b-2.

²⁸⁵ 17 C.F.R. § 240.14a-13.

²⁸⁶ See Release No. 34-38406 (Mar. 14, 1997), at n.5.

²⁸⁷ See *id.*

²⁸⁸ See Release No. 34-19291 (Dec. 2, 1981).

²⁸⁹ See Release No. 34-20021 (July 28, 1983).

forum, ADP personnel estimated that OBOs represent approximately 75 percent of shares held in street name.²⁹⁰

Even companies' ability to communicate with NOBOs (those who do *not* object to having their names and addresses supplied to companies) is limited. Under current rules, only nominees (not the company) have voting authority for the beneficial owners of the securities held in street name.²⁹¹ Accordingly, only nominees or their agents may mail proxy voting materials to these owners; companies may only use NOBO lists to mail their annual reports and for supplemental materials.²⁹² (As just noted, the rules provide companies with no ability to communicate directly with OBOs.)

In addition to being difficult, the process of communicating with the beneficial owners of shares held in street name is very costly. Not only must a company go through nominees and agents to disseminate its proxy materials; it also must pay fees to those nominees and agents for assembling lists of NOBOs. Currently, the fee paid by public companies *per NOBO* consists of a \$.065 fee paid to nominees, and an additional fee paid to agents of nominees (typically ADP).²⁹³ ADP's fee is based on a sliding scale, where the per-NOBO fee depends on the size of the NOBO list (the per-NOBO fees are: \$.10 for 1 to 10,000 NOBOs; \$.05 for 10,001 to 100,000 NOBOs; or \$.04 for 100,001 or more NOBOs).²⁹⁴

The shareholder communication process described above is cumbersome, circuitous, and often prohibitively expensive. As noted, the current framework for distinguishing between NOBOs and OBOs and requiring companies to seek and pay for NOBO lists was developed in the early 1980s. Over the ensuing two decades, street-name holdings have become increasingly prevalent,²⁹⁵ further restricting companies' ability to communicate with the owners of these shares. Furthermore, the current system does not take advantage of the tremendous technological advances that have been made since the 1980s. For example, many issuers now are providing Internet voting for their registered shareholders, a technology that was unavailable in the 1980s. If nominees were able to give omnibus proxies to their customers (*i.e.*, beneficial

²⁹⁰ Based on information provided by ADP representatives at meetings of the Proxy Voting Review Committee, held on August 29, 2001 and October 17, 2001.

²⁹¹ See Release No. 34-23847 (Nov. 25, 1986) (stating that “[s]tate law generally recognizes exercise of voting authority by record owners only”).

²⁹² See Release No. 34-22533 (Oct. 15, 1985).

²⁹³ See Supplementary Material .92 to NYSE Rule 451.

²⁹⁴ See ADP Fee Schedule (Mar. 2003).

²⁹⁵ See Release No. 34-38406 (Mar. 14, 1997) (noting that “stockholdings continue to migrate from registered to street or nominee ownership”).

owners) to permit them to vote their shares directly, beneficial owners of shares held in street name would be able to use the same Internet voting system as registered beneficial owners.

For all of these reasons, it is incumbent on the Commission to re-examine the shareholder communication framework in connection with its consideration of the Proposed Election Contest Rules, which (as noted above) are likely to result in a substantial increase in companies' communications with shareholders. Even before the Election Contest procedure is triggered, companies will have a need to communicate with the beneficial owners of their shares in connection with triggering events. Companies will need to provide shareholders with information regarding Election Contest shareholder proposals, and will need to support board-nominated candidates in order to avoid tripping the "withhold" votes trigger.²⁹⁶ And, of course, once the Election Contest procedure is triggered and shareholder nominees included in company proxy materials, the board will have a resultant fiduciary duty to support the nominees it believes would best serve the interests of the company and *all* of its shareholders.²⁹⁷

2. NYSE "10-Day Rule"

As a part of this rulemaking, the Commission also should consider the role of NYSE Rule 452, which governs the voting of shares held in street name by brokers. NYSE Rule 452 (the so-called "10-day rule") gives brokers discretionary authority to vote proxies for beneficial owners who have not given voting instructions by the tenth day before the meeting at which the votes are to be cast. This authority is limited, however, to voting on routine matters and therefore may exclude the authority to vote in a contested director election or on a shareholder proposal to activate the Election Contest procedure.²⁹⁸

If brokers were unable to vote on behalf of non-responding shareholders in election contests or on Election Contest shareholder proposals, companies would have an even greater need to communicate with their shareholders to solicit votes in support of board-nominated candidates or against Election Contest shareholder proposals. Moreover, if the 10-day rule were abolished, as some commenters have recommended,²⁹⁹ the overall number of votes cast would decrease considerably because votes would not be cast on behalf of beneficial owners of shares

²⁹⁶ Consistent with the Commission's existing communications rules, we would anticipate that any means of direct communication available to companies also would be available to nominating shareholders.

²⁹⁷ See *infra* at Section III.C.1.

²⁹⁸ See Supplementary Material .11(2) to NYSE Rule 452 (providing that brokers may not use the "10-day rule" to give a proxy where the matter to be voted upon "is the subject of a counter-solicitation, or is part of a proposal made by a stockholder which is being opposed by management (*i.e.*, a contest)").

²⁹⁹ See, e.g., Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (May 10, 2003), SEC File No. S7-10-03; Letter from James E. Heard, Chief Executive Officer, Institutional Shareholder Services, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (June 13, 2003), SEC File No. S7-10-03.

held in street name who do not give voting instructions to their brokers. Therefore, because the Proposed Election Contest Rules include a “withhold” votes triggering event based on the number of votes cast (as opposed to the number of shares outstanding), eliminating the 10-day rule would make the threshold for withhold votes much easier to trigger. Accordingly, elimination of the 10-day rule would increase companies’ need to communicate with shareholders in the event of a withhold votes campaign against a board-nominated candidate. Therefore, if the Commission determines to move forward with the Proposed Election Contest Rules, it must consider the role of Rule 452 as well as the Commission’s existing shareholder communication rules.

3. Resolution Of Disputes

If, despite the numerous and serious flaws in the Proposed Election Contest Rules outlined above, the Commission proceeds to finalize election contest rules, it must establish procedures to resolve the disputes that almost certainly would arise once the rules were in place. For example, the rules would require companies to determine, among other things: (1) whether an Election Contest shareholder proposal must be included in the proxy materials; (2) whether a triggering event has occurred; and (3) whether a shareholder nominee must be included in the proxy materials, including whether the notice and eligibility requirements have been met. Any one of these complex determinations could result in a dispute between the company and certain shareholders.

In the proposing release, the Commission suggests that companies and shareholders could go to court to resolve these disputes. Waiting for proxy issues to be resolved in court, however, is not practicable for companies, which must mail their proxy materials and hold their annual meetings within a specified time period. Moreover, this “solution” would be extraordinarily disruptive, distracting and costly for companies and shareholders alike.

Accordingly, if the Commission decides to move forward with the complex rules that it has proposed, it also must create a mechanism to resolve—in a timely manner—the disputes that will arise under them. We anticipate that this mechanism would resemble the current procedure to resolve disputes arising under Rule 14a-8 (the shareholder proposal rule).³⁰⁰ As discussed above, however, the Rule 14a-8 procedure already requires an “inordinate amount” of

³⁰⁰ The Council of Institutional Investors (“CII”), the National Association of State Retirement Administrators (“NASRA”) and the National Council on Teacher Retirement (“NCTR”)—proponents of this rulemaking—made this point in their comments to the Commission regarding the Proposed Election Contest Rules, stating, “[t]he final rule should include mechanisms—such as the ones in place to review shareowner resolutions submitted under rule 14a-8 of the Securities Exchange Act of 1934—to handle disputes over director eligibility, shareowner eligibility and any other issues relating to the rule. We firmly believe that the SEC should mediate disputes arising from the rule.” Letter from Sarah A.B. Teslik, Executive Director, CII, Jeannine Markoe Raymond, Director of Federal Relations, NASRA, and Jim Mosman, Executive Director, NCTR, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 12, 2003), SEC File No. S7-19-03.

Commission resources,³⁰¹ and the number of Rule 14a-8 shareholder proposals continues to increase.³⁰² The Commission should consider carefully whether it can—and should—devote the necessary resources and personnel to resolving disputes under any final election contest rules.

IV. Conclusion

Promulgation of the Proposed Election Contest Rules would violate the substantive and procedural limits on the Commission’s rulemaking authority while failing to achieve the Commission’s stated objective. The result would be significant adverse changes in corporate governance at a time when the case for changes of this nature has not been made, and when other important changes instituted by Congress, the major securities markets, and the Commission itself are still taking hold. The Business Roundtable, which strongly supported enactment of the Sarbanes-Oxley Act and the other recent corporate governance reforms, respectfully submits that the Commission should not proceed with this rulemaking.

³⁰¹ Howard Stock, *SEC Receives Record Requests to Bar Shareholder Proposals from Proxies*, INVESTOR RELATIONS BUSINESS, Apr. 21, 2003 (quoting Commissioner Paul Atkins).

³⁰² *See infra* Section II.B.2.a.

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(Submitted as Separate Appendix)

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