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TASK FORCE ON POTENTIAL CHANGES TO THE PROXY RULES

June 13, 2003

Via email: rule-comments@sec.gov
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attention: Jonathan G. Katz, Secretary

File No. S7-10-03; Release No. 34-47778
Notice of Solicitation of Public Views Regarding Possible Changes to the Proxy Rules

Ladies and Gentlemen:

This letter is submitted on behalf of a specially created task force (the "Task Force") of the Association of the Bar of the City of New York, comprised of members of the Association's Committee on Corporations, Committee on Federal Regulation of Securities and Special Committee on Mergers, Acquisitions and Corporate Control Contests.[1] The Task Force was formed to respond to the Commission's announcement, on April 14, 2003, that it will conduct a thorough review of the proxy rules to "ensure that they are serving the best interests of today's investors, while at the same time, fostering sound corporate governance and transparent business practices."[2]

A key impetus for the Commission's announcement is the issue of shareholder access to the company's proxy statement and card for the purpose of nominating director candidates, which is the subject of this letter. Although shareholder access proposals ("Access Pro-

[1] This letter has been reviewed and approved by each of those committees.

[2] SEC Press Release 2003-46.

posals")[3] are not new, they gained attention during this year's proxy season as a result of a campaign by the American Federation of State, County and Municipal Employees' Pension Plan ("AFSCME") seeking to require a number of companies to include in the company's proxy statement and its proxy card board nominations and supporting statements by shareholders owning a specified minimum percentage of the company's securities.

Access Proposals seek a fundamental change to one of the most basic aspects of corporate governance -- the manner in which directors are nominated and elected and the board's responsibility and role in that process -- and if adopted by the Commission would have wide-ranging and radical effects on the governance of public companies in the United States. Before adopting any significant change to that system beyond those recently adopted or proposed as noted below, the Commission must determine whether the benefits, if any, of such a new system would outweigh the risks of such a significant change. The Task Force believes that adoption of an Access Proposal at this time does not meet that hurdle.

The United States has always been at the vanguard of effective corporate governance. In the vast majority of cases, our public corporations and their boards of directors carry out their obligations to all of their stakeholders with the utmost professionalism and integrity, and our system works well. A cornerstone of that system is the ability of public companies to find accomplished, highly ethical and well-qualified individuals who are able and willing to take on commitments -- as well as the financial and professional risks -- necessary to function as directors of public companies. To the extent that the system was found to have broken down in the case of Enron, WorldCom, and other corporate scandals uncovered over the past few years, Congress, the Commission, the stock exchanges, corporate governance groups, and many public corporations, have responded by engaging in an extensive and very public process of critical examination (and self-examination) and by proposing and adopting numerous measures designed to further improve our corporate governance system.

These efforts have produced one of the most wide-ranging sets of changes to the system of corporate governance in the past seventy years. A central element of these changes is new rules and regulations to be finalized in the near future that mandate an increase in the proportion of independent directors on any public company board. Such changes further mandate an unprecedented increase in the power that independent directors, as a separate board constituency, will have over key corporate governance-related decisions. Particularly relevant to the issues addressed in this letter, all New York Stock Exchange and Nasdaq listed companies (with limited exceptions for controlled companies) will be required to have a board comprised of a majority of independent directors, to have the nominating process for directors controlled by the

[3] Access Proposals have been made in various forms over the years, including by legislation and Commission rule-making, as well as Access Proposals made in the form of proposed changes to the bylaws or proxy statement processes of individual companies.

independent directors, and (for all NYSE companies) to have publicly-available corporate governance guidelines covering, among other things, director qualifications and responsibilities.[4]

The Task Force believes that the implementation of the Sarbanes-Oxley Act of 2002, of the rules promulgated by the Commission under the Act, and of the changes to the listing rules of the stock exchanges and Nasdaq have begun and will continue to produce important and positive changes to corporate governance. Such changes include evolution in the process of board nominations and elections. We are, however, only at the beginning of this evolution, and in the next months and years we will see the effects of these initiatives as well as of others, the final implementation of which is still pending.

The Task Force believes that any serious consideration of an Access Proposal -- or any other significant revisions to the rules governing nomination or election of directors -- should not take place until the scope and effect of initiatives already implemented are fully understood. There is no compelling need at this time to adopt significant changes in the current system of director elections -- given the recent focus on, and enhancements to, the nominating process, as well as the very real alternative of conducting an election contest under the existing rules. The Task Force further believes that such changes could be a significant deterrent to effective corporate governance. Finally, the Task Force believes that any change in the fundamental way in which nominations of board candidates are made, a subject traditionally committed to the business judgment of the board, is and should be the province of state, rather than federal, regulation.

As Commission Chairman William H. Donaldson has noted, a balance must be struck between enacting governance reforms and overburdening and distracting boards in a manner that would interfere with the intended functioning of boards as overseeing bodies.[5] The Task Force believes that at least until the recently adopted corporate governance initiatives have been implemented and their effectiveness evaluated, the Commission should be especially cautious before taking any action that would mandate or result in any significant changes in the conduct of directors or of companies in connection with the nomination or election of directors. If the

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[4] The current NYSE proposals will require listed companies to have a nominating committee comprised solely of independent directors, with a publicly disclosed charter setting forth the committee's purpose, which must include the identification and selection, or recommendation to the board for selection, of qualified candidates for election to the board, and its goals and responsibilities, which must reflect the board's criteria for selecting new directors and oversight of the evaluation of the board and management. The current Nasdaq proposals will require independent director approval of director nominations, either by an independent nominating committee or a majority of the independent directors. While current Nasdaq proposals do not require corporate governance guidelines, many Nasdaq companies already have such guidelines.

[5] Chairman William H. Donaldson, U.S. Securities and Exchange Commission, *Remarks Before the Economic Club of New York* (May 8, 2003).

Commission concludes that some revision to the proxy rules concerning nomination or election of directors is necessary at this time, we believe that disclosure-based initiatives would be better suited to the historical focus of our securities laws and would complement the recent enhancements to the independence of nominating committees.

Background. Access Proposals have been made in this country, and for sound reasons rejected, for over 60 years. As early as 1942, the Commission considered and, as a result of unfavorable public comment and congressional criticism, rejected an Access Proposal. The issue was raised and rejected in 1977 and again in connection with the Commission's broad proxy rules reforms in 1992. Congress has also periodically considered and rejected Access Proposals. Just last year, a bill was proposed in Congress that would have required shareholder access to the company's proxy statement. That proposal was not included in the comprehensive corporate governance legislation encompassed in the Sarbanes-Oxley Act of 2002. Thus, despite regular legislative and regulatory consideration of initiatives seeking use by shareholders of company proxy statements, the Commission and Congress have repeatedly reached the conclusion not to require such access.

Policy Reasons Against Access Proposals. The Task Force believes that many of the reasons that have led to rejection of Access Proposals in the past, as well as recent developments in corporate governance rules and regulations, lead equally to the conclusion that an Access Proposal should not be adopted at this time. These reasons include the following:

- Adoption of an Access Proposal is likely to lead to disruptive and unnecessary diversion of company and Commission resources, without any apparent offsetting economic benefit. When a public company faces a proxy contest, significant amounts of human and financial resources are devoted to explaining the board's position and the reasons that the board's nominees should be elected. A system that will make proxy contests the rule, as opposed to the exception, would result in additional expenditures and diversion of resources, at a time when our nation's economy can least afford that disruption. This is particularly problematic in light of the absence of any reliable economic evidence suggesting that the inclusion of shareholder-nominated directors on a board leads to better managed companies or increases the chances of avoiding the types of problems that have led to the recent focus on corporate governance.

- Adoption of an Access Proposal will facilitate the election of "special interest" directors, reversing the recent shift toward full independence of board members. Directors who are nominated by a single stockholder, by a group of stockholders, or by labor unions, social activists or other subsets of the shareholder population, may view themselves as representing that particular nominating group rather than the shareholders as a whole. If contested elections become the norm, whether over a few board seats or the entire slate, boards of directors risk balkanization, with directors elected that represent particular "parties" or viewpoints. While diversity and new perspectives are often helpful for a board, balkanization of a board as a result of a particular director or group of directors "representing" a narrow stockholder group is clearly disadvantageous and flies directly in the face of the recent initiatives of the stock exchanges, Congress and the Commission to increase independence of directors from both management and specific groups of shareholders.[6]

- Adoption of an Access Proposal may result in the use of company resources to facilitate the nomination of board candidates who are not qualified or who would not likely be nominated by an incumbent board in the exercise of its fiduciary duties. Special interests groups and other prospective nominating shareholders do not owe fiduciary duties to the shareholders as a whole in determining whom to nominate for director of a public company. Special interest groups often have agendas other than the company's long-term best interests and, in contrast to the board, may nominate directors solely for such self-serving reasons. Self-interested promotion of director candidates is permissible under the existing proxy rules where special interests use their own solicitation materials. However, the company's proxy materials and other resources should not be used to promote the potentially self-serving purposes of a single shareholder or group. In fact, one of the key functions of both the nominating committee and the entire board is to ensure, through the exercise of their fiduciary duties, that the company's proxy materials are used to support only those board candidates who have been selected in the best interests of the company and all shareholders.[7] To permit the company's own proxy materials to be used for the election of persons who are either unqualified or who have otherwise not been selected (or, in some cases, have been rejected) by the nominating committee or the board would be to permit certain shareholders to cir-

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[6] Section 301 of the Sarbanes-Oxley Act of 2002 requires that an audit committee of an issuer be composed entirely of independent directors and prohibits service by a director who is "an affiliated person of the issuer." In its rules, the Commission has clarified that a person holding <u>less than 10%</u> of a company's stock does not lose his or her independence based solely on that stock ownership; ownership of 10% or more of a company's stock may result in exclusion of the holder from service on that company's audit committee on the grounds that such person is considered insufficiently independent. *See* SEC Release No. 33-8220 (Apr. 9, 2003).

[7] In certain circumstances, public companies have agreed to recommend that their shareholders vote in favor of the election of the nominees or designees of specific shareholders. These "recommendation" agreements generally give the board the ability to refuse to recommend a specific nominee if, for example, that nominee is not reasonably satisfactory to the board or otherwise does not possess the minimum qualifications for board membership.

cumvent the judgment of directors who, as fiduciaries, make decisions with respect to company property -- including the proxy statement -- on behalf of all shareholders as a whole.

- An Access Proposal, if adopted, is likely to create a disincentive for able candidates to seek, and for current members to continue with, board service. Whether as a result of increased contentiousness in board elections, increased balkanization of boards, or risk to reputation in the event of a loss of an election contest to a shareholder nominee, an Access Proposal would deter well-qualified individuals that currently serve as directors from continuing with board service and would make it more difficult to recruit new board members. In light of the increased scrutiny being placed on public company directors as a result of the Sarbanes-Oxley Act, the proposed stock exchange and Nasdaq rules and recent events, it has become increasingly more difficult for many companies to find well-qualified individuals willing to commit the time required to serve as a director. The Task Force believes that adoption of an Access Proposal at this time would likely exacerbate the retention and recruitment problem, resulting in an even smaller pool of well-qualified individuals willing to serve on corporate boards.

- Access Proposals, as noted previously, are tied to the core of corporate governance -- the election of directors. The importance of the director nomination process and the extent of the required disclosure in the context of contested elections warrant a separate proxy statement on behalf of the proponent. Adopting an Access Proposal would, in essence, mean contested election of directors would occur within a single company proxy statement. It has long been the policy of the Commission and the intent of the proxy rules that shareholders that wish to present director candidates must do so under a separate proxy statement rather than the one distributed by the company. This policy is based on the notion that increased disclosure and clear identification of the soliciting party are necessary in director election contests. The current proxy rule requirement that separate proxies be used in the case of director election contests prevents confusion and protects shareholders by clearly identifying each party's director candidates and supporting positions.[8]

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[8] In addition to the broader policy concerns they raise, Access Proposals pose substantial practical problems, including potential exposure of issuers and directors to unjust legal liability; questions concerning the amount and substance of disclosure required of shareholder nominees and their proponents; potential difficulties in obtaining a quorum if brokers are not able to vote undirected shares at their discretion in connection with contested elections; issues concerning the ability of a company to vote signed but unmarked proxy cards; issues concerning the circumstances that would require the filing of preliminary proxy statements; and questions of whether

Access Proposals Are Properly the Subject of State Regulation. By implementing an Access Proposal the Commission would, either directly or indirectly, depending on the details of the rule, be regulating the internal affairs of corporations -- an area that has traditionally been viewed as the proper province of state, not federal, regulation. It has been settled for more than a quarter of a century that, absent explicit congressional authorization, the internal affairs of a corporation are properly the province of state law. "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." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (emphasis in original, quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)). The internal affairs of a corporation include the "relations between management and stockholders." *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 549 (1949).

It is well-established that when enacting the Securities Exchange Act, Congress did not intend that the Commission have authority to regulate the internal affairs of corporations. "Noting that opponents expressed alarm that the bill would give the Commission 'power to interfere in the management of corporations,' the Senate Committee on Banking and Currency said it had 'no such intention' and that the bill 'furnish[ed] no justification for such an interpretation.'" *The Business Roundtable v. S.E.C.*, 905 F.2d 406, 411 (D.C. Cir. 1990) (quoting a 1934 Senate Report, at 10). The Court of Appeals for the D.C. Circuit upheld this limitation, ruling that the Commission's rule-making authority, as authorized by the Exchange Act, does not extend to regulation of an issue "that is concededly a part of corporate governance traditionally left to the states." *Business Roundtable*, *supra*, at 408.

Proponents of an Access Proposal may seek to portray it merely as another federal regulation granting procedural access to a federally mandated disclosure document, but this would be a superficial view glossing over the likely and intended impact of such a Proposal. One must look beyond the form of an Access Proposal, to its effect. Mandating shareholder access to the proxy statement and the proxy card of the company for the purpose of nominating director candidates would, as a practical matter, impose a substantive regulation on existing modalities of corporate governance regulated by state corporate statutes, and work fundamental and substantive effect on the state-determined allocation of power to govern the corporation amongst shareholders and directors. It is this effect that the D.C. Circuit court cited in *Business Roundtable*, *supra*, at 411-12, in invalidating the Commission's one-share one-vote rule as exceeding the Commission's authority, stating: "[S]tate Corporate law . . . regulates the distribution of powers among the various players in the process of corporate governance, and the Commission's present leap beyond disclosure is just that sort of regulation."

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proponents whose nominees are included on the company's proxy card can mail their own proxy cards without including the company's nominees on those cards.

Radical Changes to the Existing Regulatory Scheme Are Not Necessary at This Time. In addition to these significant policy and legal reasons, the existing regulatory scheme already provides meaningful avenues for shareholders to engage in the nomination process. State law currently provides all shareholders, large and small, the right to nominate directors at annual meetings, and state courts (Delaware in the vanguard) have been vigilant guardians against abusive conduct that interferes with the shareholder franchise.[9]

In addition, both state law and the federal proxy rules permit shareholders to solicit proxies for the election of alternative slates, including “short slates.” As part of the Commission’s sweeping proxy reforms of 1992, the Commission improved the ability of shareholders to communicate and to run “short slate” election contests. Under the existing proxy rules, running an election contest is a viable alternative and a meaningful threat, and election contests occur regularly. In recent years, as a result of the Commission’s improved “short slate” rules, many election contests have been short slate contests, and a majority have resulted in either the successful election of the shareholder nominee(s) or a negotiated settlement with the company. In addition, the mere threat of a proxy contest is frequently sufficient to prompt companies to negotiate with significant shareholders to add one or more particular nominees to the board.

Even if one accepts as a premise that the quality of corporate directors and thus corporate governance would necessarily be improved if shareholders had a wider choice among director candidates, including qualified nominees proposed by a variety of interested shareholders in addition to candidates vetted by an independent nominating committee, it is not clear that an Access Proposal would in practice achieve this result. The principal benefit of an Access Proposal over prevailing nomination and proxy solicitation practice is that it arguably lowers the financial cost of a shareholder nomination by giving shareholders free access to the company’s basic proxy statement and proxy card. However, election contests, if they are to have a chance of success or even to create meaningful debate, are not limited to a basic mailing. They commonly require multiple mailings of proxy statements, the production and mailing of other additional materials, newspaper advertisements, telephone campaigns, use of professional proxy solicitors and a variety of other expenses. The savings afforded by a "free ride" on the company's proxy statement and card defrays only a small part of the expense involved in conducting a serious proxy challenge with a meaningful chance of success.

Moreover, monetary expense is but one hurdle to a successful shareholder nomination and it may well be the lesser one. A significant commitment of institutional and human resources is also required to prepare and wage a campaign to identify and vet well-qualified nominees, to develop and articulate a persuasive platform, to take that platform "on the road" and to make presentations to investors and their advisors -- such as ISS – in order to actually solicit votes for one's nominees. Although there are advocacy groups or activist investment firms

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9 *See, e.g., MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132-33 (Del. 2003)); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 660-64 (Del. Ch. 1988)).

whose resources are devoted to such efforts, our experience suggests that many, if not most, professional or institutional investors do not have such dedicated resources and are reluctant to expend their non-financial resources when seeking to elect shareholder-nominated directors. When such investors encounter instances where they believe the expenditure of such effort is justified, monetary expense is not often an obstacle to action. Access Proposals are neither designed nor likely to alter this practical reality.

The current corporate governance changes enacted by Congress, the Commission and the stock exchanges and other regulatory and listing bodies, are designed to enhance dramatically the overall corporate accountability to shareholders and potential investors. These reforms will ensure that substantially all public companies will have nominating committees comprised entirely of independent directors (employing a stricter definition of independence) and will require nominating committees to adopt and publicly disclose their charters. In addition, both these changes and other external factors have increased the focus of investors and others on the performance and effectiveness of nominating committees.[10] The Task Force believes that the increased independence of, and continued investor focus on, nominating committees is more likely to lead to meaningful long-term improvements in corporate governance than is the adoption of an Access Proposal.[11]

To the extent that the Commission believes that the existing modalities of director nomination and election, including the newest governance initiatives, will not be sufficient for today's markets, and that additional changes must be implemented even before the newest initiatives have been fully implemented, the Task Force believes that the Commission should focus its consideration on disclosure-based alternatives, such as required disclosure of all nominations that have been received by the company, which would be more consistent with the disclosure objectives of the proxy rules and traditional role of the Commission. Even in this area, however, the Task Force would ask that the Commission carefully evaluate any proposed rules to ensure that they would neither require nor lead to undesirable consequences, such as those described above

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[10] *See* Will Boye, *TIAA-CREF: Keep Focus on Internal Nomination Process*, The ISS Friday Report (Apr. 25, 2003) (quoting Peter Clapman, chief counsel of corporate governance for large institutional shareholder TIAA-CREF: "'The primary focus still ought to remain on the internal process of the way companies nominate directors …. We want to work very hard to improve the quality of nominating and corporate governance committees.'").

[11] *See also* Barry B. Burr, *Gaining Steam: Wisconsin Fund Could Lead Charge for Open Balloting: More Groups Consider Shareholder Access to Proxy Ballots New Governance Battlefield*, Pension & Inv. 4, *available in* 2002 WL 9531150, at *1-2 (Aug. 19, 2003) (quoting Charles M. Elson, law professor at and director of the University of Delaware's Center for Corporate Governance: "'If the nominating committee is truly independent and takes into consideration the interests especially of large shareholders, access to the proxy ballot [by shareholders] is unnecessary" and noting that such access "'could create a free-for-all ….'").

in connection with Access Proposals, which would act as a significant disincentive for highly qualified individuals to serve as directors. In addition, if after the recent reforms have been given a chance to succeed, there remain a few companies that ignore the letter or spirit of the new focus on independent nominating committees, the Commission could at the appropriate time consider whether specific limited measures could be designed to address those specific situations.

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Proponents of Access Proposals hold up concepts of shareholder democracy which, in the aftermath of recent corporate scandals, are appealing notions. But such notions can be misleading if they are mistaken for a tonic to cure all corporate governance ills. An Access Proposal poses a substantial risk that it would not improve corporate governance, but rather would force companies to expend substantial additional resources, would reduce the pool of qualified board candidates who would be willing to be nominated by companies and would increase the risk of balkanized boards lacking independence in the most significant sense of owing their undivided loyalty to the shareholders as a whole. In light of these potential risks, of the absence of any economic evidence supporting such a sharp change in the balance of corporate authority, and of the sufficiency in general terms of the existing scheme, and in light of the question regarding the authority of any body outside of a state legislature to implement an Access Proposal, the Task Force believes that the Commission should not propose adoption of an Access Proposal or any other significant change to the rules governing nominations or election of directors at this time. Rather, the changes to the corporate governance scheme reflected in the Sarbanes-Oxley Act, in the stock exchange listing standards and in other regulatory rules -- some of which are not yet even effective -- should be given a chance to work before any significant change to the proxy scheme is considered.

Respectfully submitted,

Task Force on Potential Changes to the Proxy Rules

By: David M. Silk, Task Force Chairman