VIA ELECTRONIC DELIVERY

April 12, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Security Holder Director Nominations; File No.7-19–0

Dear Mr. Katz:

I am a Professor at Brooklyn Law School and a former Commissioner of the Securities and Exchange Commission ("SEC"). I submit this letter on my own behalf and not on behalf of any client or group.

The proposal by the SEC with regard to shareholder nominations has proven extremely controversial for several good reasons. The SEC's authority to pass such a rule is not clear, and even if such authority exists, the rule would seriously change the long standing division between federal and state law with respect to the conduct of corporate elections. The SEC rule would interfere with complex and delicate state law norms regarding director elections and would increase, rather than decrease, the cost of proxy solicitations, a cost created by the SEC's own rules. Instead of the proposed rule, the SEC should consider ways to make proxy contests less expensive and, in addition, should consider how to work with the states to eliminate or change the plurality rule so that shareholders may vote "No" on director candidates and that vote would be meaningful.

Although arguments can be made against the longstanding model of board collegiality in view of the abuses of the 1990s, this model has also been of long term benefit to the national economy and should not be junked by SEC rulemaking in response to current short-term political pressures. Further, the board collegiality model has recently been altered by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). Further federal rules will put corporate governance into a straight jacket and discourage experimentation with new models just when such experimentation is needed the most to implement the independent board model of Sarbanes-Oxley.

If the case of *Business Roundtable v. SEC*[1] remains good law, the SEC's authority for this rule is questionable. Although the SEC's authority with respect to corporate governance has been enlarged by Sarbanes-Oxley, that statute did not enhance the SEC's authority under the proxy rules. As to the policy issues at stake, I do not believe that contested elections for directors will prove a good idea because such elections have the potential of turning the important task of

[1] 905 F.2d 406 (D.C. Cir. 1990).

searching for qualified directors into a political free for all. If the problem is that it is too difficult to oust incompetent or overreaching directors, better mechanisms than the SEC's current rule proposal should be considered. For example, shareholders might be given the right to vote "No" instead of merely abstaining on a vote for a particular director.[2] But alternative solutions of this type impinge upon the plurality rule of state law and so such changes would have to be worked out with state authorities and may well require legislation to be implemented. Although this could take time, there is no real urgency for putting a new proposal in place.

In addition to my doubts about the SEC's authority to change the rules concerning the election of directors under state law, my primary policy objection to the SEC's rule proposal is that minority shareholders do not owe any fiduciary duties to other shareholders, while directors owe general fiduciary duties to all shareholders. Therefore, unless shareholders who gain access to management's proxy are charged with new and additional duties to all shareholders, it is inappropriate for them to have access to management's proxy when other shareholder do not.

Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act") authorizes the SEC to prescribe proxy rules and regulations as are "necessary or appropriate in the public interest or for the protection of investors." In providing for proxy regulations, Congress assumed that an adequate system of shareholder voting rights was established under state laws, but sought to protect investors from the solicitation of proxies by outsiders seeking to take control of the corporation and also to guard against corporate executives and directors attempting to perpetuate themselves by misuse of corporate proxies.[3] Notwithstanding its potential breadth, section 14(a) has been interpreted primarily as a disclosure rather than a regulatory provision.[4]

Nothing in the Exchange Act provided for direct regulation of the internal corporate governance of securities issuers traded on the public securities markets until the enactment of Sarbanes-Oxley. A draft of the initial Exchange Act included a provision that "nothing in this title shall be construed as authorizing the [SEC] to interfere with the management of the affairs of an issuer."[5] But this provision was not included in the statute because it was viewed as "unnecessary, since it [was] not believed that the bill [was] open to misconstruction in [that]

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[2]Similar solutions have been suggested by others during this rulemaking proceeding, in particular Professor Joseph Grundfest. Ira Millstein and Chief Justice E. Norman Veasey.

[3] S. Rep. No. 1455, 73d Cong., 2d Sess. 1934, at 74, 77. *See also* SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

[4]*See* J.I. Case Company v. Borak, 377 U.S. 426, 431 (1964); Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416, 421-22 (D.C. Cir. 1992).

[5] S. 9323, 73d Cong., 2d Sess. (1934), at § 13(d).

respect."[6] The Supreme Court has held that the anti-fraud provisions of the Exchange Act require deception, manipulation or non-disclosure, rejecting the notion that the securities laws "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[7] Further, Sarbanes-Oxley does not addresses or enlarge the SEC's authority with regard to the proxy rules.

In *Business Roundtable v. SEC* [8] the D.C. Circuit Court invalidated a rule of the SEC attempting to regulate deviations from a one share, one vote regime for corporate shares of listed issuers. The court held that the SEC's rule exceeded the agency's authority under the Exchange Act because if the SEC were permitted to control the distribution of voting power, it would assume an authority that the Exchange Act's proponents disclaimed any intent to grant.[9] Rather, Congress believed that so long as investors received enough information, shareholder voting could work and therefore it gave the SEC power over voting procedure, not the substantive regulation of voting power.

In its rule proposal with regard to shareholder access to the proxy process, the SEC recognized that provisions of state law regarding director elections are fundamental factors upon which many of the assumptions, projections and analyses in the proposing release depend, but does not identify pertinent provisions of state law. The SEC proposing release attempts to avoid a conflict with state law by asserting that its proposed rules are conditioned on the existence of shareholders rights under state law, but does not cite to any such laws. Rather, the proposing release states that a company would not be required to include a director nominee if that would violate state law. This formulation ignores the reality that state law generally permits corporations freedom and experimentation with regard to shareholder elections, provided directors meet their fiduciary duties of care and loyalty and do not improperly interfere with the shareholder franchise.[10]

The SEC's rule proposal raises a variety of policy questions in addition to the legal questions summarized above. The policy question of relevance to me is whether activist institutional shareholders should be permitted access to management's proxy when these shareholders do not represent anyone but themselves and do not have any duties to either the corporation or other shareholders. Why should a corporation be managed for the benefit of these

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[6] H.R. Rep. No. 1383, 73d Cong., 2d Sess., at 35 (1934).

[7] Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 479 (1977).

[8] 905 F.2d 406 (D.C. Cir. 1990).

[9] *Id.* at 410.

[10] *See* Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

institutional investors rather than all of its shareholders? Further, the investment records during the 1990s bubble of many of the proponents of the SEC's rule do not necessarily recommend them as the best shareholder representatives.

Despite the corporate abuses 1990s, pension funds and other institutional investors are not blameless with regard to the creation of a stock market bubble. Should pension funds have been so heavily invested in equities at the top of the market? Were they being managed in an actuarial sound way? Were institutional investors doing a proper job of analyzing corporate values and allocating capital to the best companies? A large shareholder or group is not necessarily more representative of the interests of the shareholders as a body than management and the board, who have fiduciary duties to all of the shareholders. By contrast, one shareholder or minority group does not have any fiduciary duties to other shareholders. Contested elections are being advocated by a politically motivated group who may be overly influenced by governmental rather than business models.

Some commenters have recognized this issue, if only indirectly. There was considerable debate on the length of time a shareholder should own stock in a corporation before being eligible for making a shareholder nomination. In addition, there was a suggestion that a nominating shareholder should be required to represent its intent to hold the securities not only until the date of the election of directors, but thereafter for the duration of the nominee's term as a director if the nominee is elected.[11] Further, the shareholder should continue to hold the requisite stake in the corporation necessary to initiate a shareholder proposal.[12] One of the proponents of the rule acknowledged the costs and risks to public companies, and their shareholders, including the risk that nominees might seek to represent a limited group of shareholders and suggested that any security holder's nominee be required to certify that, if elected, the nominee would represent the financial interests of all security holders.[13] In the event the SEC determines to adopt a rule giving shareholders access to management's proxy, I believe shareholders obtaining such access should be required to be long term holders of the corporation's shares and commit to continuing to hold such shares for the duration of the term of any director they nominate who is elected to office. Yet, such a condition raises its own problems since the primary duty of institutional investors is to their own beneficiaries, not the shareholders of corporations in which they invest. This conflict of interest on the part of institutional investors is precisely why they should not be given access to management's proxy.

Some of the institutions which have urged the SEC forward in the direction of shareholder proxy access have declared that shareholders are owners of corporations and should have the right

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[11] Wachtel, Lipton, Rosen & Katz Letter of Comment on S7-19-03, Nov. 14, 2003, at 6.

[12] Business Roundtable Letter of Comment on S7-19-03, Dec. 22, 2003, at 63.

[13] Teachers Insurance and Annuity Association of America/ College Retirement and Equities Fund Letter of Comment on S7-19-03, Dec. 17, 2003, at 3.

to nominate candidates for directors on the company proxy card. In an institutional stock market, where pension funds are not investing their own money but the savings of pension fund beneficiaries and where the heads of such pension funds generally delegate investment decision making to a wide variety of pension fund managers, some of whom are long term investors but some of whom are short term traders and many of whom choose indexation as an investment strategy, it is really a legal fiction (however useful) to say that shareholders are owners of a company. While the choice of an investment strategy other than long term ownership does not mean such an institutional investor is indifferent to how the companies in, for example, an index fund perform, the institution is not analyzing any of the available information concerning the company and is not allocating capital in the economy to its best and most efficient use.

The SEC twice before proposed the idea of shareholder nominations as a way to assure better corporate governance, but then backed away from this proposal for, among other reasons, doubts concerning its authority to mandate such a regulation. In the current business bashing political climate, such doubts seems to have been pushed aside, but they should not be. Regulatory intrusion by the SEC into the shareholder nomination process goes to the very heart of corporate governance and would drastically change federal and state power to regulate internal corporate affairs. Further, it would give large institutions a new power to affect director elections without any correlative new duties and responsibilities.

Very truly yours,

Roberta S. Karmel