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December 22,2003

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

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Re: File No. S7-19-03

Dear Mr. Katz:

This letter is submitted on behalf of the Business Roundtable, an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. We appreciate this opportunity to provide our views on the Cornmission's proposal to require companies to include shareholder nominees for director in company proxy materials under certain circumstances (the "Proposed Election Contest Rules"). Due to the importance with which we view this proposal and the significant number of questions raised in the proposing release, we are providing below general comments on the proposal and are submitting more detailed comments in an attachment to this letter.

The Business Roundtable has long been a strong supporter of good corporate governance. We have issued numerous statements addressing corporate governance, including *Principles of Corporate Governance,* released in May 2002, and ***Executive Compensation: Principles and Commentary***, from November 2003. We strongly supported enactment of the Sarbanes-Oxley Act of 2002, implementation of the Commission's rules related to the Sarbanes-Oxley Act, and revisions to the corporate governance listing standards of the New York **Stock** Exchange ("NYSE") and NASDAQ Stock Market, Inc. We share the Commission's belief that corporate boards and management must hold themselves to high standards of corporate governance.

In light of the commitment of the Business Roundtable and our members to good corporate governance, **we** have spent considerable time reflecting on the Proposed Election Contest Rules. We undertook several surveys of our members' companies and reviewed surveys conducted by the American Society of Corporate Secretaries, the results of which are described in the detailed comments submitted herewith. We

regret to report that our review leaves us convinced that the proposal would not result in better corporate governance and suffers from **the** following serious flaws:

First, the Commission is authorized only to regulate *disclosures* in the proxy process. The proposed rules, however, extend well beyond disclosure, and thus exceed the Commission's statutory authority. Rather, they would regulate corporate governance in a manner the Supreme Court has said is reserved to the states.

Second, the procedures by which this proposal has been put forward violate the Administrative Procedure Act and other important constraints on agency rulemaking. The short 60-day comment period allowed by the Commission has been insufficient for interested parties to comprehensively review and comment on the proposal, a failing made all the more serious by the unusual extent to which the proposing release relies on the public to provide evidence that ordinarily is gathered and reviewed by an agency before proposing a rule. These shortcomings have been exacerbated by the Commission's apparent reliance on data that it has declined to make available to the public for review.

Third, the Proposed Election Contest Rules would initiate sweeping, harmful changes in corporate governance practices while failing to achieve the Commission's expressed regulatory objective of improving the proxy process at unresponsive companies. By overlooking the voting practices of institutional investors and the incentives and leverage the rules would give special interest groups, the proposal seriously underestimates the frequency with which election contests would be triggered even at healthy, well-managed companies. The proposal likewise does not adequately recognize the expense corporations will feel compelled to incur to ensure that each of their directors' primary loyalty is to the company and *all* shareholders, rather than to a coalition of union pension funds or other special interest groups. If the election of alternative directors did occur under the Proposed Election Contest Rules, dual loyalties and divided boards would result—a problem that the Commission has partly foreseen, but has not resolved.

For the foregoing reasons, we oppose the adoption of the Proposed Election Contest Rules. We believe adoption of the proposed rules would be particularly inappropriate at this time, given the significant recent corporate governance reforms by Congress, the Commission, the NYSE, and NASDAQ that are still being implemented.

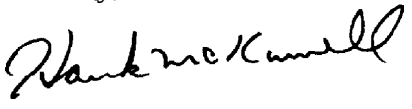
At the conclusion of the attached detailed comments, however, we identify significant modifications to the Proposed Election Contest Rules that would be necessary if the Commission were to proceed to a final rule notwithstanding the problems inherent in the proposal. (Principles of administrative law would require that, before these changes and any other significant modifications to the proposal could be adopted in a final rule, there would need to be a second round of notice and comment.) Most importantly, any final rule would have to target only companies whose shareholders

actually and objectively lack adequate access to an effective proxy process. In this connection, we believe that the trigger relating to shareholder access proposals would have to be eliminated; the votes required for any action under the Proposed Election Contest Rules would have to be a majority of shares outstanding rather than a majority of shares voted; the ownership threshold for shareholders to nominate directors would need to be increased to 25 percent; and a process would have to be established for the Commission to resolve disputes that arise under the rules.

In sum, to address a perceived problem that is only vaguely identified and wholly unsubstantiated, the Proposed Election Contest Rules exceed the Commission's legal authority and would initiate significant changes in corporate governance at a time when the impact of the many important reforms **of** the last year is only beginning to be understood. 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.

Thank you for considering our comments on the Proposed Election Contest Rules. We would be happy to discuss our concerns or any other matters that you believe would be helpful.

Sincerely,



Henry A. McKinnell, Ph.D.
Chairman of the Board and CEO
Pfizer Inc
Chairman
The Business Roundtable

Enclosures

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

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 Cornmission 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]

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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 cornmenters . . . 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 Cornmission'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."* 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

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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

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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

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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.

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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, 24,394 (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

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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-Lire*** 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 **tnes** 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

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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.

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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

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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 worlcplaces 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]

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45 18A **AM.** JUR. 2D *Corporations* § 1049 (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 41 1-12. **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

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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 (1**934)** (" 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

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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 expiained 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 wouid "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

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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] Subsectior;(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

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[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

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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 reports[88] **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

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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. § 780. 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 Cornmission 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

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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. 1I, 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 Act[100] and Executive Order 12,846.[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

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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. 11, 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 (1994). 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 koc*** 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

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[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]

[Footnote continued from previous page]
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 Cornmission Has Nut 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

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[123] ***68*** Fed. Reg. at 60,786. It should **be** noted that the Commission did not issue an advance notice of **proposed** rulemalung 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 telltale 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

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[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.

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[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

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[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 Fur 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-

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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

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[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."

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[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,

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[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 recornmendations 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 recornmendation." "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

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[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

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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

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[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

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[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 I-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

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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

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[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

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[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—1 00 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

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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 reinstituting 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/newsroodpress/2003/03072**.html), Tyco (**http://www.tyco.com/investor/g,eneral**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**

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[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

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[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, "[elver 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]

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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 – andpickets – to lean on employers,* BUSINESS WEEK, Nov. 24,2003.

176 **Barry** B. Burr, *'Holygrail': 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

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181 *See, e.g.*, H. Northrup and C. Steen, ***Union*** *"CorporateCampaigns" 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.

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[186] Marilyn Adams & David Kiley, *United vows no* ***disruption; Chapter*** *I I 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.codnews/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 Cornmission 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 Donaidson 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:

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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 Fur 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 Cornmission having

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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]

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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 infarmation, 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

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[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 Cornmission 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, Apna Healthcare Group, Inc. recently adopted **a**

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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

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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

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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.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 Cornmission 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 Cornmission 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

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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, § **5**15.

230 Securities and Exchange Commission Final **Data** Quality Assurance Guidelines, *available at* http://www.sec.pov/about/dataqualityauide.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

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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

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[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 **$9**1,000 (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 corporatefinancial 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

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[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

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[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

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[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]

111. 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.

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[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 Cornmission'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.

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[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

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[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.

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[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

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[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

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[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

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[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 infomation (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.

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[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,

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[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

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[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 Cornmission

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? 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

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[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.

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[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.

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[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.

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[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-2[284] and 14a-13[285]) 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

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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** $0.065 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

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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

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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, **US.** 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

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[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. 57-19-03.

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.

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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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Mr. Chairman, there is no use trying to write a bill that will be effective, which will cure these evils, that will protect the public in general and investors in particular, which will please also the great exchanges of this country. These stock exchange amendments were offered in the committee. We were able to vote them down. They will be offered on the floor of this House, and I intend to brand every one of them as they come. Some people in this country may want the New York Stock Exchange and its satellites and hirelings to write this legislation. I do not. [Applause.] I do *want* to write a bill that will deal justly and fairly with every group and with every individual in this land. I have been held up I know as an enemy *to* business, but there is nothing in my career in Congress *that* warrants it. Twenty-four months ago I was called one à the arch reactionaries of *the* House and *of* the country, but when I went out with the securities' bill and tried to protect the investing public in this country by giving *them* information about securities that were offered *to* them, and stopping a lot of pretty bad practices that were going an, I was then advertised as a radical *or* a bolshevik. When I came along following *the* recommendation of the President *of the* United States and the platform upon which he was elected and upon which *each* and every one of you on my right was elected, trying to carry out this legislation *in* the protection *of* the people against Ute rapacities of *the* past, I am again branded as one who is willing to go out and destroy business.

Let me tell you something, and I say this *to* representatives of the exchanges who are doing me the honor to sit in the galleries this afternoon. They have not yet lost hope that they will be able to pull the teeth of this bill so they are *still* around here, and I am glad to have them here.

They are engaged *in* a business that ought to go *on*, that has a very legitimate and important function to perform. We should have a market place for the exchange of securities, but it should be a clean and honest market place.

They are *in* a business that, since 1929, has not stood in such high favor in the United States. In their own selfish interest, if their judgment was used, instead of their fear, they would want a strong bill for the regulation of the exchanges in order to reestablish the faith and confidence *of* the people so *that* they will again in the future, if they forget their unhappy experience of the past, use these exchanges as a place of barter and trade for securities.

Then I took up sections 11 and 12 of this bill with this business man, and I said to him, "if you will point out one thing in sections 11 and 12", and that is the registration requirements for securities, "one line that regiments business, that interferes with the operation of your own business, that makes it unduly burdensome, I will take it out." I sat down with him, and I began to read these things to him. What are they supposed to do? When they try to *scare* you about what the Commission is asking them to do, let me show you what the committee on stock list of the New York Stock Exchange asks them to do and the questions which they ask them to answer. Here I hold in my hand the printed list of requirements; observe all those questions covering several pages, which must be answered. The New York Curb Exchange also has detailed requirements. Now, what do we ask them to report? You know there is a remarkable thing about this bffl. It contained a provision that they should report to *the* stock exchange and *to* the Commission. They objected to reporting to the Commission. Why I was never able *to* figure out; but they were perfectly willing that a copy of the report that they made to the stoc': exchange, when they had an application for a listing of their securities, should be filed with the Commission. what the difference is in that I do not know, but we did put in the bill a provision that they should file the original with the stock exchange and a duplicate with the Commission if *the* Commission asked them te do it.

Now, *what* do we ask them to do?

(A) The organization, financial structure, and nature of business.

Is that harmful? Is that irksome?

(B) The terms, position, rights, and privileges of the different classes of securities outstanding.

(C) The terms on which their securities are to be, and during the preceding 3 years have been, offered to the public or otherwise.

(D) The directors and officers, their remuneration (including amounts paid, or which may become payable, as a bonus or under a profit-sharing agreement), and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer.

Is it asking too much that they give us their bonus lists? I think, my friends, that when an officer of a company is paid a salary sufficient unto his labor, then if the company happens to make profits, those profits are the property of the stockholders. I think it is a very bad thing not only from the standpoint of what I think is the right thing to do but also from the standpoint of the very looks of things for a man to receive $150,000 a year as a salary and eight or nine hundred thousand dollars at the end of the year as a bonus.

It appears to me that if a man is paid from $75,000 to $150,000 a year, he is reasonably compensated; and if not he alone but all of the people in the organization and all the people that labor to produce what it sells should make $900,000, it either ought to be distributed to the stockholders or among those who made it possible. We ask merely that the stockholders be informed of the bonuses. If that is regimentation of business, then that is it.

Then we ask for:

Remuneration (including amounts paid, or which may become payable, as a bonus or under a profit-sharing agreement) in excess of $10,000 per annum, to any person other than directors and officers.

(F) Management and service contracts of material importance to investors;

(G) Options existing or to be created with respect to their securities;

(H) Balance sheets for the 3 preceding years certified by independent public accountants or otherwise, as the Commission may prescribe; and

(I) Profit-and-loss statements for the 3 preceding years, certified by independent public accountants or otherwise, as the Commission may prescribe.

Such copies of articles of incorporation, bylaws, trust indentures, or corresponding documents by whatever name known, underwriting arrangements, and other similar documents.

And so forth.

Now, I want *to* say that before a man *can* list his *stock* on the New York Stock Exchange, he may be required to file that much or mare (apart from the disclosure of bonuses, which certainly the investing public has a right to know), but there 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—and we have had all of these amendments—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.

Now, the talk has been that they would have uniform accounting for all corporations of the country. There is nothing like *that* in this bill. There is no attempt to do it, but if an agency of the Government is going to try to regulate the sale or dealing in securities of any corporation doing business in interstate commerce, there must be intelligent reporting so that somebody *can* understand it.

I asked some of our railroad brethren years ago, when we were trying to get them to bring about a system *of* uniform accounting, which we afterward had to pass a law to make them do, why they did not get up figures that somebody could understand. It took a Philadelphia lawyer to understand their figures. Finally, by *act* of Congress, they were forced to bring about a uniform system of accounting, which they fought *very* strenuously, and today *each* railroad will tell you that they themselves would oppose the repeal of that requirement.

I do not say that the average business in the country is on the same footing with the railroads, because the railroads strictly a regimented industry, being public-service corporations and subject In all of their dealings to the law.

I do challenge these people to show me where there is any interference, but *they* cannot show it. This fear went out from Washington. Propaganda was spread throughout the

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73D CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
2d Session } { No. 1383

SECURITIES EXCHANGE BILL OF 1934

APRIL 27, 1934.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

Mr. RAYBURN, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

[To accompany H.R. 9323]

The Committee on Interstate and Foreign Commerce, to whom was referred the bill (H.R. 9323) to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes, report favorably thereon without amendment and recommend that the bill do pass.

I. INTRODUCTORY STATEMENT

THE PRESIDENT'S MESSAGE AND LETTER

On February 9, 1934, the President sent the following message to Congress:

To the Congress:

In my message to you last March proposing legislation for Federal supervision of national traffic in investment securities I said: "This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt with on exchanges."

This Congress has performed a useful service in regulating the investment business on the part of financial houses and in protecting the investing public in its acquisition of securities.

There remains the fact, however, that outside the field of legitimate investment naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.

Such speculation has run the scale from the individual who has risked his pay envelop or his meager savings on a margin transaction involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corporations with large resources, often not their own, which sought by manipulation to raise or depress market quotations far out of line with reason, all of this resulting in loss to the average investor, who is of necessity personally uninformed.

The bill is conceived in a spirit of the truest conservatism. It attempts to change the practices of exchanges and the relationship between listed corporations and the investing public to fit modern conditions, for the very purpose that they may endure as essential elements of our economic system. The lesson of 1921–29 is that without changes they cannot endure.

The bill is not a moral pose or a vengeful striking back at brokers for the losses which nearly the entire Nation has suffered in the last 5 years. Nor is its purpose or effect to regiment business in any way. It is simply an earnest attempt to make belated intelligent adjustments, long required by changing conditions, in a faulty system of distributing shares in corporate enterprise among the public—a system which from the coldly objective viewpoint of the welfare of a conservative public simply has not worked. The out-of-date unsuitability to post-war conditions of a whole series of economic interrelationships of which the stock exchanges are the nerve center has uncontrollably accentuated natural moderate fluctuations of our economic system into mad booms and terrible depressions. And such booms and depressions constitute a more red danger to the stability of a moderate, honest, individualistic state than all the unsound theories in the world. This bill seeks to save, not destroy, stock markets and business, by making necessary changes in time.

The fundamental fact behind the necessity for this bill is that the leaders of private business, whether because of inertia, pressure of vested interests, lack of organization, or otherwise, have not since the war been able to act to protect themselves by compelling a continuous and orderly program of change in methods and standards of doing business to match the degree to which the economic system has itself been constantly changing—changing in the proportion of the wedth of the Nation invested in liquid corporate securities traded in on the stock exchanges, changing in the relationship of the distribution of securities and the trading in securities to the balanced utilization of the Nation's credit resources in the financing of agriculture, commerce, and industry. The repetition in the summer of 1933 of the blindness and abuses of 1929 has convinced a patient public that enlightened self-interest in private leadership is not sufficiently powerful to effect the necessary changes alone—that private leadership seeking to make changes must be given Government help and protection.

Since the war the interest of the public at large in the ownership of corporate enterprise has grown bigger, the size of the corporate unit has increased, the diffusion of corporate ownership has widened. all correlatively. Not only is nearly one half of the entire national wealth of the country represented by corporate stocks and corporate and Government bonds, but nearly one half of that corporate wealth is vested in the 200 largest nonbanking corporations which, piercing the thin veil of the holding company and disregarding a relatively few notable exceptions, are owned in each case by thousands of investors and are controlled by those owning only a very small proportion of the corporate stock. Ownership and control are in most cases largely divorced. It is estimated that more than 10.000.000 individual men and women in the United States are the direct possessors of stocks sad bonds; that over one fifth of all the corporate stock outstanding in the country is held by individuals with net incomes of less than $5,000 a year. Over 15,000,000 individuals held

in meeting competition, not only from other American corporations, but frequently from foreign companies engaged in the same line of business. This fear, though genuine, has in luge measure proved to be unfounded.

The reporting provisions of the proposed legislation are a very modest beginning to afford that long-denied aid to the exchanges in the way of securing proper information for the investor. The provisions carefully guard against the disclosure of trade secrets or processes. But the idea that a fair report of corporate assets and profits give unfair advantage to competitors is no longer seriously entertained by any modern business man. The realistic corporate executive knows that his alert competitors have a pretty good notion of what his business is and if he is unable to compete with them it is because he is hopelessly behind in the keen competitive struggle. The reporting provisions of the legislation have been approved by such conservative investment services as Moody's and Standard Statistics and, despite the wild fears spread throughout the country by powerful lobbyists against this bill, intelligent business men recognize that general knowledge of business facts will only help and cannot hurt them. The possession of these facts has for a number of years been the exclusive perquisite of powerful banking and industrial groups. Making these facts generally available will be of material benefit and guidance to business as a whole.

CONTROL OF UNFAIR PRACTICES BT CORPORATE INSIDERS

A renewal of investors' confidence in the exchange markets can be effected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. Men charged with the administration of other people's money must not use inside information for their own advantage. Because it is difficult to draw a clear line as a matter of law between truly inside information and information generally known by the better-informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity. For that reason, this bill requires the disclosure of the corporate holdings of officers and directors and stockholders owning more than 5 percent of any class of stock, and prompt disclosure of any changes that occur in their corporate holdings, Short selling and selling against the box by insiders are prohibited.. These provisions have been called the "anti-Wiggin provisions" of' the bill. The Committee is aware that these requirements are not. air-tight and that. the unscrupulous insider map still, within the law, use inside information for his own advantage. It is hoped, however, that the publicity features of the bill will tend to bring these practices. into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises. whose securities are registered on the public exchanges.

Fair corporate suffrage is an important right that should attach to, every equity security bought on a public exchange. Managements of.' properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the manage-

merit policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights. Inasmuch as only the exchanges make it possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according to shareholders fair suffrage. For this reason the proposed bill gives the Federal Trade Commission power to control the conditions' under which proxies may be solicited with a view to preventing the recurrence of abuses which have frustrated the free exercise of the voting rights of stockholders.

CONTROL OF THE EXCHANGES AND OVER-THE-COUNTER MARKETS

The importance of the actual workings of the exchanges themselves' although greet, should not be exaggerated. The stronger and more subtle economic forces affecting speculation come from without the exchanges, But as this speculation converges upon the exchanges, the control of the exchange mechanism is a necessary part of any effective regulation. It is for that reason that the bill gives the Federal Trade Commission broad powers over the exchanges to insure their efficient and honest functioning. Theoretically floor trading bas been assumed to be of value in stabilizing prices and preventing undue fluctuations. The studies conducted by the special counsel for the Senate Committee on Banking and Currency have thrown considerable doubt upon the value of floor trading. The large floor traders seldom stem the tide but run with it. Their activity tends to accentuate the moves of the market and to stimulate undue speculation. The importance of active, constant trading can readily be exaggerated. A relatively stable market over a period is of much greater importance to investors than a fictitiously stable market that involves no more than one eighth of a point spread between sales but results in wide fluctuations over days or weeks. The market's liquidity depends upon its relative stability and not upon the spreads between momentary sales. To prevent the artificial stimulation of the market that comes from excessive speculative trading unrelated to investment, the Commission is given power to regulate and, if need be, prevent floor trading. The Commission is further given power to prevent excessive trading by members off the floor who at times are tempted to stimulate the market by numerous in and out transactions which cost them nothing more than the nominal commissions paid to the $2 brokers.

No issue has been more disputed than that centering sbout the functions of the specialist. There are many who believe that the exchange mechanism would function better without tho specialist, that the work done by the specialist could be done more effectively by a clerk or official of the exchange clearing the orders m a purely mechanical way, much as they are cleared today on the New York Stock Exchange in the "bond crowd." There are others who believe that a specialist should be obliged to act either as a dealer or as a broker and should not be permitted to combine the functions of dealer and broker. The jobber on the London Stock Exchange is essentially a

(b) The Commission and the Federal Reserve Board are given power to define accounting, technical, and trade terms.

(c) The act is *not* to apply *to* instrumentalities and agencies of the United States, except where they are specifically included.

SECTION 4. TRANSACTIONS Oh' UNREGISTERED EXCHANGES

This section forbids the use of the mails and interstate commerce to any exchange which is not registered as a "national securities exchange" under section 5, but authorizes the Commission *to* exempt from *this* prohibition small exchanges as to which it finds thst r e p tration would be impracticable and unnecessary in the public interest or far the protection of investors. Such exemption map be withdrawn under stated circumstances.

SECTION 5. REGISTRATION OF NATIONAL SECURITIES EXCHANGES

Subsection (a) provides for registration as a "national securities exchange" upon application by any exchange which agrees *to* comply and to require its members to comply, with the act and the rules and regulations thereunder, and which furnishes the Commission with required information.

An exchange desiring registration is required by subsection (b) to provide for the disciplining of members who are guilty of conduct "inconsistent with just and equitable principle of trade", and must include *is* this category any willful violation *of* the act or any rule or regulation thereunder.

It is provided in subsection *(c)* that exchanges may adopt any rules not inconsistent with the act or *the* rules and regulations thereunder or the laws of the State in which it is located.

Subsection (d) directs the Commission *to* grant an application for registration if it appears *that* the exchange is so organized as to be able to comply with the act and rules and regulations thereunder and to insure fur dealing and the protection of investors.

Subsection (e) provides that the Commission's order granting or denying an application for registration shall be made within 30 days unless the application has been withdrawn,

Subsection (f) permits an exchange to withdraw its registration upon such terms as the Commission may deem necessary for the protection of investors.

SECTION 6. MARGIN REQUIREMENTS

The Federal Reserve Board is *directed* by subsection (a) *to* prescribe by rules and regulations the maximum amount of *credit* which may be extended and maintained on any security (other than an exempted security) which is registered on *a* national securities exchange. As far as the initial extension of credit is concerned it is indicated by the act that this should be based on a standard of 55 percent of the current market price of the security or 100 percent of its lowest market price during the preceding 36 calendar months, but in no case more than 75 percent of the current market price. Until July 1, 1936, the lowest price on or after July *1*, 1933, is to be considered as the lowest price during the preceding 36 calendar months. Matters of detail

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NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996

P.L. 104–290, see *page 110 Stai. 3416*

DATES OF CONSIDERATION AND PASSAGE

House: June 18, 19, September 28, 1996

Senate: June 27, October 1, 1996

Cong. Record Vol. 142 (1996)

House Report (Commerce Committee) No. 104-622, June 17, 1996
[To accompany H.R. 3005]

Senate Report (Banking, Housing, and Urban Affairs Committee)
No. 104–293, June 26, 1996
[To accompany S. 1815]

House Conference Report No. 104–864, Sept. 28, 1996
[To accompany H.R. 30051

The House bill was passed in lieu of the Senate bill. The House Report (this page) is set out below. The House Conference Report (page 3920) and the President's Signing Statement (page 3923) follow.

HOUSE REPORT NO. 104–622

[page 1]

The Committee on Commerce, *to* whom was referred the bill (H.R. 3005) to amend the Federal securities laws in order to promote efficiency and capital formation in the financial markets, and to amend *the* Investment Company Act of 1940 to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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dealers may borrow. It also exempts from Federal margin requirements, adopted under section 7, credit extended, maintained, or arranged to or for a member of a national securities exchange or registered broker or dealer (1) a substantial portion of whose business consists of transactions with persons other than brokers or dealers, or (2) to finance market making or underwriting activities.

SECTION 104—PROSPECTUS DELIVERY

Section 104(a). This section requires the Commission to report to the Congress on the steps the Commission has taken, or anticipates taking, to facilitate the electronic delivery of prospectuses to institutional and other investors. Such report is to be delivered within 6 months of enactment of the Act.

Section 104(b). The provision requires the Commission to report to the Congress its views and recommendations concerning the Advisory Committee on Capital Formation. The Advisory Committee is preparing a report to the Commission, which is expected to recommend a shift in the traditional Securities Act approach of registering offerings to a "company" registration approach. The report required by section 104(b) should also describe any actions taken to implement the recommendations of the Advisory Committee and is to be delivered within 1 year of the enactment of the Act.

The Committee notes that an alternative to the existing registration approach, such as one that relies on company disclosure, could streamline both registration and disclosure requirements, while actually enhancing information flow and protection to investors. In that context, the Commission should consider whether an alternative vehicle to the prospectus can more efficiently and effectively delivery information to investors.

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SECTION 105—EXEMPTIVE AUTHORITY

Section 105 provides the Commission with broad and general exemptive authority under both the Securities Act and the Exchange Act, similar to the authority provided to the Commission under other securities statutes. Both the Investment Company Act and the Investment Advisers Act provide the Commission with authority to exempt any persons, securities, or transactions from any provision of the statute or the rules thereunder. Moreover, the Trust Indenture Act of 1939 ("Trust Indenture Act") provides the Commission with similar broad exemptive authority with respect to the provisions of that Act.

Section 105(a). This section adds a new Section 28 to the Securities Act to provide the Commission with the authority, by rule or by regulation, to conditionally or unconditionally exempt any person, security, or transaction, or any class of the same, from any provision or provisions of the Act or any rule or regulation thereunder. Section 28 allows the Commission enhanced flexibility to more easily adopt new approaches to registration, disclosure, and related issues, such as are being considered by the Commission's Advisory Committee on Capital Formation. The Committee expects that the Commission will use this authority to promote efficiency,

Competition and capital formation in the marketplace, consistent with the public interest and investor protection. The Committee also intends that the Commission at an early date raise the ceilings on various exemptions adopted pursuant to Section 3(b) of the Securities Act, the small offering exemption under the Securities Act, from $5,000,000 to not less than $10,000,000, including increasing the exemption amount of offerings for certain employee benefit plans, pursuant to Rule 701 under the Securities Act, and small public offerings, pursuant to Regulation A under the Securities Act.

Section 105(b). The legislation adds a new Section 36 to the Exchange Act to provide the Commission with authority under the Exchange Act similar to that contained in new Section 28 of the Securities Act. Unlike its Securities Act counterpart, however, Section 36 of the Exchange Act also allows the Commission to act by order. To assist the Commission in handling individual exemptive requests, Section 36 permits the commission to determine the procedures and circumstances under which an exemptive order may be granted. The Committee expects that the Commission will use this authority to promote efficiency, competition and capital formation in the marketplace, consistent with the public interest and investor protection.

The Department of Treasury has authority under Section 15C of the Exchange Act to regulate government securities broker-dealers. The Government Securities Act Amendments of 1993, which enacted Section 15C, prescribed a consultative process for both Treasury and Commission rulemaking under that section. The legislation provides that the broad grant of exemptive authority to the Commission in new Section 36 of the Exchange Act does not extend to Section 15C of the Exchange Act or to the definitions in Sections 3(a)(42) through (45) as used in that section.

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SECTION 106—PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Section 106 requires the Commission to consider efficiency, competition, and capital formation when it engages in rulemaking or reviews SRO-proposed rules pursuant to the Securities Act, the Exchange Act, or the Investment Company Act under a "public interest" standard. The new section makes clear that matters relating to efficiency, competition, and capital formation are only part of the public interest determination, which also includes, among other things, consideration of the protection of investors. For 62 years, the foremost mission of the Commission has been investor protection, and this section does not alter the Commission's mission. In considering efficiency, competition, and capital formation, the Commission shall analyze the potential costs and benefits of any rulemaking initiative, including, whenever practicable, specific analysis of such costs and benefits. The Committee expects that the Commission will engage in rigorous analysis pursuant to this section. Such analysis will 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.

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73D CONGRESS 2d Session } SENATE { REPORT No. 792

FEDERAL SECURITIES EXCHANGE ACT OF 1934

APRIL 17 (calendar day, APRIL 20), 1934.—Ordered to be printed.

Mr. FLETCHER, from the Committee on Banking and Currency, submitted the following

REPORT

[To accompany S. 3420]

The Committee on Banking and Currency, to whom was referred the bill (S. 3420) to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass. This bill is a substitute for the bill (S. 2693) introduced on February 9, 1934, and on which extensive hearings were held.

Them follows a statement regarding the nature of the bill as reported, a general analysis thereof, and a summary of the bill by sections.

I. INTRODUCTORY STATEMENT

1. The Resident's Message

On February 9, 1934, the President sent the following message to congress:

To the Congress:

In my massage to you last March proposing legislation for Federal supervision of national traffic in investment securities I *mid*, "This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt with on exchanges."

This Congress has performed a useful service in regulating the investment business on the part of financial houses and in protecting the investing public in its acquisition of securities.

Then remains the fact, however, that outside the field of legitimate investment, naked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble.

Such speculation has run the scale from the individual who has risked his pap envelop or his meager savings on a margin transaction involving stocks with whose true value he was wholly unfamiliar, to the pool of individuals or corpora-

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5. Corporate Reports

The information required to be filed under the Securities Act of 1933 relates only to the situation at the time a security is issued. Reports under this bill will provide adequate information reasonably up to data as long as the security is traded in on an exchange.

This aspect of the proposed legislation has been the target of an intensive campaign in the form of letters and telegrams addressed to Members of Congress and especially to members of this committee. The extent of the protest makes it worthy of serious consideration: but it appears that this opposition is largely based on a misunderstanding of the bill. the fear of exposure on the part of some corporations which have heretofore managed to withhold from investors their true financial condition, or the efforts of stock brokers hostile to other portions of the bill, who are endeavoring to marshal all possible aid in defeating the bill by inciting their customers to protest.

The principal objection directed against the provisions for corporate reporting is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations. The committee has no such intention, and feels that the bill furnishes no justification far such an interpretation. To make this point abundantly clear, section 13 (d) specifically protides that nothing in the act shall be construed to authorize interference with the management of corporate affairs.

The bill provides thnt securities traded in upon exchanges must be registered with the Commission, and that a condition of such registration shall be the furnishing cf complete information relative to the financial condition of the issuer, which information shall be kept up to date bv adequate periodic reports. The Commission is give4 complete discretion not only to esempt securities from the operation of most sections of the act—including those dealing with corporate reports—but also to require in corporate reports only such information as it deems necessary or appropriate in the public interest or to protect investors. In this connection it should be noted that section 3 (a) (12) empowers the Commission to define "exempted. securities" and sections 12 and 13 authorize it to vary the specifications for reports where those indicated are deemed inappropriate. Moreover, by section 23 a corporation is granted an unconditional right to a private hearing in any case where it feels that information filed with the Commission should not be made public, and by section 24, the Commission's determination on such hearing is subject to court review.

The argument has also been made that the provision for corporate reports will impose an undue burden on corporations by compelling them to keep their accounts in the manner prescribed by the Commission. The bill, however, merely permits the commission to spec4 the methods to be followed in preparing the reports made to it, and does not attempt to direct the manner in which the corporate books of account shall be kept. The only corporations apt to be seriously affected in this respect are those which do not keep even in their confidential files the information essential for the preparation of reports on which may be based an intelligent analysis of the value of their securities for investment purposes.

Abuse of the dual function of principal and agent has been shown to be especially flagrant in the case of specialists. The bill leaves the regulation of specialists to the Commission, but directs that dealings by a broker specialist for his own account shall be reasonably limited. The bill also authorizes the Commission to regulate floor trading, a practice which enables speculators on the scene of activities to indulge in many manipulative devices and to demoralize the market in times of excessive trading.

One situation exists in which the combining of the functions of dealer and broker results in such clear abuse that it has been deemed advisable to include a statutory prohibition. The bill forbids any person who is both a broker and a dealer to use an exchange, the mails, or instrumentalities of interstate commerce, to effect any transaction involving the sale on margin, of a security in the distribution of which he has participated during the preceding 6 months. While a dealer is assisting in the distribution of a new issue, he is most strongly tempted to persuade his customers to invest in it. A broker is also required to disclose in writing to a customer, any interest which he has in the transaction, in such manner as the Commission may prescribe, failing which disclosure, the customer may disaffirm the transaction within 10 days.

7. Proxies

In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought. For example, in one case brought to the committee's attention, proxies were solicited by the president of a corporation by means of a letter which purported to describe certain transactions concerning which ratification by the stockholders was sought. The letter omitted all mention of other important details such as previously granted secret options in the corporation's stock, and the president's individual interest in an underwriting agreement made by the corporation, which furnished the real motive behind the request for ratification. The solicitation in that case so far succeeded that not a single stockholder appeared at the meeting in person, and an employee of the company voted all proxies in favor of ratifying all acts and proceedings taken by the directors and officers of the corporation. The committee recommends that the solicitation and issuance of proxies be left to regulation by the Commission.

8. Civil Liabilities

Experience with State laws designed to prevent the exploitation of the investor by supervision of the sale of securities has demonstrated the inadequacy of criminal penalties as the sole sanction. Customers are ordinarily reluctant to resort to criminal proceedings, and in the absence of complaints by them, the discovery of violations is often impossible. Furthermore, if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. With these considerations in view, the bill provides that any person who unlawfully manipulates the price

In order to give protection against "strike" suits, or litigation brought in bad faith, the court is authorized to assess reasonable costs, including attorney's fees against either party to the suit, and even to require in advance an undertaking for the payment of such costs. If the suit is brought by a party who has been induced to buy or sell a security by a false or misleading statement with regard to it, in violation of paragraph (4), the defendant may escape liability even if the statement was false or misleading if he can prove that he acted in good faith. A defendant may recover contribution from any other participant in the illegal transactions, who would have been liable if separately sued. Suits for recovery under this subsection must be commenced within 2 pears after discovery of the violation, and, in any case, within 6 years of its occurrence.

Subsection (f) exempts from the operation of section 9 all "exempted securities".

Section 10. Regulation of the Use of Manipulative and Deceptive Devices

The scope of the section is confined to transactions effected by the use of the mails, the instrumentalities of interstate commerce, and the facilities of a national securities exchange.

Subsection (a) subjects to regulation by the Commission short sales and the use of stop loss orders, which greatly facilitate speculation.

Subsection (b) authorizes the Commission by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the investor.

Section 11. Restrictions on Floor Trading by Members

Subsection (a) directs the Commission to regulate or prevent floor on the part of members. By such regulations those who are actually on the Scene of speculation may be restricted from taking undue advantage of this privilege. The Commission is also directed by rules and regulations to prevent such excessive speculation on the part of members who operate from off the floor as it may deem detrimental to the maintenance of a fair and orderly market. The Commission may make such exemptions as are necessary or appropriate in the case of "exempted Securities" and transactions by odd-lot dealers and specialists.

Subsection (b) authorizes the registration of members as odd-lot dealers or specialists, or both, pursuant to the rules of the exchange, and subject to rules and regulations of the Commission. As an odd-lot dealer a member shall be permitted to deal for his own account only so far as reasonably necessary in the performance of this particular function, and the Commission is directed to limit a member's dealings for his own account as specialist to those which are necessary for the maintenance of a fair and orderly market. The specialist is forbidden to reveal the orders on his books to favored persons. This information must be available to all members or else kept entirely confidential. The specialist is likewise prohibited from exercising purely discretionary orders as distinct from market or limited price orders.

Subsection (c) authorizes the Commission to exempt small exchanges from the provisions of this section.

Subsection (d) provides that any member, or any person doing business through a member, who acts both as a broker and dealer shall

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U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Remarks Before the Council of Institutional Investors

by

Commissioner Paul S. Atkins

U.S. Securities and Exchange Commission

Washington, D.C
March 27, 2003

Good Morning. I'd like to thank Sarah Teslik and the other Council officers, as well as you, the members, for inviting me to speak to you this morning. It is a great honor and an enormous privilege to be here with you. Before I begin, 1 must first note that the views 1 express today are my own and do not necessarily reflect those of the SEC as an institution or of the other Commissioners.

With the completion of most of the Sarbanes-Oxley initiatives, I have looked forward to getting up here to speak about the matters that we at the SEC now have before us - I'm used to giving speeches about what we've done regarding Sarbanes Oxley, so it's a pleasant change of pace to talk about other issues before the SEC. Certainly, as you all know, we now have a new Chairman, and at our agency, the Chairman, in large part, drives our agenda and initiatives. So, to be clear, our current issues will likely change, depending upon the direction that Chairman Donaldson elects to go.

In many ways, my time in government reminds me of the movie *Groundhog Day.* That's the movie in which Bill Murray plays the guy who is doomed to wake up and relive Groundhog Day over and over, regardless of all that he tries to do to change the outcome and get off what seems to be a hamster wheel.

As Sarah mentioned, I guess that I am what you might call a recidivist SEC employee - in 1990, I came to work at the SEC under Richard Breeden, stayed on with Arthur Levitt, then came back to work with Harvey Pitt and now Bill Donaldson. A dozen years ago, the major issues that we faced at the SEC included corporate governance, proxy reform, shareholder communications, executive compensation disclosure, accounting for stock options, harmonization between US GAAP and international accounting standards, accounting for and valuation of financial instruments, revenue recognition, dual regulation of securities products by the SEC and the CFTC,

and ... this is the real kicker ... the effect of the war in the Persian Gulf on the markets. Any *of* that sound familiar? Each one of those is still with us today, either never having left, or like a boomerang or Jason in *Friday the 13th*, back again.

This past weekend at home, by eerie coincidence, I came across a speech by Richard Breeden when he spoke to this Council on April 2, 1990 on - **guess** what? - Corporate Governance and the growing role of institutions in the markets. That speech basically kicked off what was a very effective couple of years of the SEC's dealing with those issues and, I think that the record shows, making great progress on proxy-related issues. Frankly, it is also bittersweet as you will see it shows how much further **we** have to go. Just to indicate how much the world has changed in the past decade, the statistics that then-Chairman Breeden **cited** in **his** speech seem almost quaint. U.S. equity markets had grown during the 1980s by about 400% to $3 trillion. Even after the bursting of the 1990s bubble, the market stands today at a capitalization of about $17½ trillion. The size of the 1990s bubble itself, at about $7 trillion, was more than twice the entire market cap of 1990. Back in 1990, some questioned whether American economic competitiveness was up to the challenge from the Japanese and Europeans. Believe it or not, some people even advocated aspects of the Japanese corporate governance model **as** a paradigm for the US., despite Boone Pickens' Japanese experience. What **a** difference time **makes.**

The makeup of the marketplace has continued the trends established in the 1980s. Institutions hold a greater percentage of equities - the **Fed** estimates it at 49%, up from 41% in 1991 and four times what it was 40 years ago, Management owns around 21%. While the percentage of individual ownership of equities continued to decrease in favor of institutions, the greatest change during the 1990s was the number of households that own equities, basically through growth of mutual **funds** and holdings in pension funds and 401(k) plans. Today about 52% of households own stock; while in 1989, it was only 32%. That is a stunning increase and helps to explain why corporate governance is such a hot political topic in the wake of Enron, WorldCom, and now HealthSouth, for probably the first time in 70 years. Thousands of Americans have lost their jobs, savings, and retirement prospects.

If anyone ever had doubts, the past couple of years have been the best indication that corporate responsibility is essential for a strong stock market. The end of the bubble **of** overexuberance, especially in the telecom and technology sectors, was certainly inevitable. But, the instances of corporate mismanagement, malfeasance, incompetence, and outright criminality that came to light - like flotsam and debris that is left on a beach as the tide recedes - have exacerbated the understandable reluctance *of* investors to go **back** into the market. There certainly is a lot of money on the sidelines. The ability of the market to regain its footing and become less volatile will depend largely on three factors:

- Investors' belief in the transparency and reliability of the financial data they receive;

- Investors' belief that management, who are supposed to **be** acting **as** stewards of stockholder property, have integrity and are acting in the owners' interests to maximize value, not in their own interest to fill their pockets at the owners' expense; and

- Investors' belief that the directors as elected representatives of the owners of the corporation - and the auditors as their hired watchdogs - minding the business as if they owned it.

The problem, of course, is that our **model** of corporate governance has systemic problems that have been developing for years. Oftentimes, directors have been too beholden to management. Ross Perot once quipped at an SEC conference on corporate governance that we held in 1992: "Again and again in big corporate America . . .[managers] pick a bunch of house cats that will not cause any trouble...[Management] will bring you in, and show you a slide projector saying: the world is square, there is no gravity . . . everybody in favor say 'aye.' Aye. The motion carries." Consistent with our *Groundhog* ***Day*** theme, recent problems have demonstrated that this issue has yet to be solved.

It is **a** fundamental economic principle - one reason that communism is such an abject failure - that nothing beats private ownership rights for the effective management *of* assets. Owners care about their property. That is the reason that it is so important to have the interests of those who manage property on behalf of owners aligned with the interests of owners. That is a benefit of the Sarbanes-Oxley Act. Fundamentally, the Act acknowledges the importance of stockholder value. **It** takes steps *to* strengthen the role of directors as representatives of stockholders and reinforces the role of management **as** stewards of the stockholders' interest.

An engaged, "house-cat-free" board of directors would have less of a chance of being subject to a CEO's stealing shareholder property **by** using the company as a personal piggybank or management's being tempted to use questionable accounting practices. However, this approach will only be successful if the investing public is aware of the importance of qualified, owner-oriented, and business savvy directors and the risks associated with different levels of internal safeguards designed to prevent manipulation and to protect the shareholders.

I do not think anyone here would dispute the critical role of directors in our system of corporate governance. A less clear consideration is what **is** the appropriate role of **a** company's shareholders? **As** our economy has **grown,** ownership has become even more dispersed. **And,** in our economy, the bottom line **is** that *most* shareholders own stock fur investment, not *for* operational control. Yet, critical management decisions affect that investment. So, shouldn't shareholders have more **say** than simply whether they should buy, hold, or sell their stock? Just as with socialism, the danger is that **if** a large number of dispersed people supposedly own something, then in reality no one owns it and oversees **it**.

Digging back into history again, a dozen years ago the SEC had received

rulemaking petitions from CalPERS and the United Shareholders Association recommending a restructuring of the proxy rules to (1) establish confidential voting in order to protect shareholders from management efforts to coerce their vote, (2) afford shareholders access to corporate proxy statements to nominate board candidates and influence other fundamental aspects of corporate governance, and (3) establish clear guidelines that would permit sharehotders to communicate among themselves without fear of violating these rules.

Again, is this *Groundhog* ***Day?*** You ail know that CalPERS and AFSCME have asked us to refuse no action requests regarding resolutions that would allow groups of shareholders owning at least 3% of a company's stock to **be** able to place a nominee on the proxy for **a** board seat. We **as** a commission will be considering this issue shortly, **so I** cannot comment directly on **it.**

But I can say this: at the heart of all of these current proposals and those of a dozen years ago lie strong shareholder concerns that management is free under current rules to dominate the proxy agenda, influence shareholder votes through its exclusive ability to examine balloting results, and unilaterally use corporate funds to subsidize solicitations.

Because the proxy system provides the principal mechanism for exercising corporate voting power in this country, the proper functioning of the Commission's proxy rules **is** an important part of preserving the attractiveness of corporate equity in our financial markets.

The Commission has taken steps through its rulemaking authority in the past to try to strike a balance between freer shareholder communications and investor protection concerns, including under the Williams Act. Are those concerns still balanced, given market and governance developments over the past decade? Did we ever have an appropriate balance to begin with? I am **a** firm defender of constitutional protections for freedom of speech and private property rights. **Should** we take this opportunity to re-examine the proxy process and especially 13(d), (f) and ***(g)?*** The challenge in this connection is for us is to come **up** with a mechanism to separate those shareholders who **do** not have a control intent from those who **do,** especially since undisclosed accumulation of financial power has long been a congressional concern.

One thing that I know for sure: the SEC will remain vigilant to protect the rights of shareholders to exercise **the** corporate franchise through the proxy process.

This brings me **to** the issue of the current shareholder proposal process. While I am not aware that there is **a** formal initiative to reassess the role of shareholders in corporate matters and the rules governing shareholder communications with boards, I personally believe that the time may be ripe to re-examine **this** area.

I understand that your briefing materials refer to Rule 14a-8 under the Securities Exchange Act of 1934 as "the rule everyone loves to hate." While I **hate** to use the word "hate," I must confess that I, too, have misgivings

about the current state of the shareholder proposal process. Simply put, stockholders own the corporation and should have the ability to have their opinions aired to their employees in management, including at the annual stockholders' meeting. That dues not seem too much to ask.

In addition, there is an inordinate amount of resources - both public and private - that is devoted each year to determining whether proposals may be excluded from the shareholder proxy statement. As an example, since the start of the current fiscal year on October 1, 2002, the SEC staff has received approximately 474 letters from corporations asking us to agree that they may exclude shareholder proposals from proxy statements. This number exceeds the total number of letters the SEC staff received in the entire prior fiscal year. To address and respond to this overwhelming level of no-enforcement requests, the Division of Corporation Finance must utilize significant staff time during proxy season. These staffers typically otherwise spend their time reviewing corporate filings, an area in which the SEC is chronically short on resources. So, I'd 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 proposal process.

Then, there is the "ordinary business exception," which corporations can use to exclude shareholder proposals that otherwise comply with appropriate procedural requirements. The policy underlying the "ordinary business exception" is consistent with the policy of most state corporate laws: the resolution of ordinary business problems should be confined to management and the board of directors because it is impracticable for sharehotders to decide how to solve such problems at an annual shareholders meeting. My misgivings regarding this exception have nothing to do with its purpose - I recognize that every corporate decision cannot realistically be taken by shareholders without paralyzing the corporation - but, instead, I feel that often this exception has been relied upon, long after a matter can any longer be deemed "ordinary."

Clearly, the concerns that I raise regarding the shareholder proposal process are not new. Should the taxpayers be funding a referee in essentially private disputes between shareholders and their employees? We certainly are cheaper overall than sending the disputes to the courts. On the other hand, considering that we have enforcement authority and these are no-action requests, taking ourselves entirely out of the process probably is unrealistic.

Certainly, in principle, shareholders should have a general right to have their proposals presented in their proxy ballots; yet, the reality is that *all* shareholder proposals simply cannot be placed on proxy ballots. It is my understanding that the cost of a page in a proxy solicitation can be several hundred thousand dollars - even up to a million dollars for some companies. So, despite my preference, the SEC Is, unfortunately, in the middle and must do its best to ensure that shareholder interests are addressed, yet balanced against the costs imposed.

Now that I've expressed my misgivings, what can be done to reform the process? Well, I must confess that people with a better understanding of

the process than I, have given reform a gallant try many times -- most recently in 1997 and 1998. So, standing before you today I do not have the answer. A dozen years ago I probably was a bit crazy to have suggested a process modeled on the voter petition and ballot initiative procedures found in a number of States; now, with the growth of the Internet, something like web-based referenda may be achievable, although there are many obstacles. Under such a format, management would explain, in the following year's proxy statement, whether and how the company addressed any referendum issue that obtained a sufficient level of support. Such a process could be balanced with changes to the current Rule 14a-8 process. Still, others have advocated a "lottery" or "first in" system to determine whether to include "shareholder proposals" in proxy statements. And, of course, the most meaningful issue regarding shareholder proposals is real access by shareholders to nomination of directors.

The viability of these ideas must be fleshed out through the appropriate processes. I do, however, hope that this is an area that the SEC can take up again, and, if we do, I look forward to the input of all of you here in helping to fashion a better process.

Hedge Funds

I know that another area that is of great interest to many of you and that has received significant attention in the press is the SEC's initiative concerning hedge funds. There has been significant growth recently in the United States, as well as the world, in the number of private investment funds and in the amount of assets in these funds. Because these funds typically are not registered as investment companies with the SEC, and frequently, their investment advisers are also not registered, there is not much that we know about this area. To gain a better understanding of the issues currently affecting these funds, the Commission last June commenced a formal fact-finding investigation in this area. This investigation sought to enhance our understanding of these vehicles and their operations.

The Division of Investment Management is currently in the process of this fact-finding, and, just yesterday, the Chairman announced that there will be two days of roundtable hearings on hedge funds on May 14th and 15th. Going forward, I expect the staff will have a comprehensive record to present to us in the near future.

Mutual Fund Oversight

Recently, we issued a release seeking comment on additional ways in which mutual funds and investment advisers would be encouraged to comply with the federal securities laws. In particular, we asked for comment on such possibilities to supplement SEC oversight of mutual funds and investment advisers, including:

- requiring that advisers and funds obtain periodic compliance audits from third party compliance experts;

- relying on independent public accountants that audit fund financial statements to examine fund compliance controls in connection with the audit;
- the formation of one or more self-regulatory organizations to oversee the activities of funds and/or advisers; and
- a requirement that advisers obtain fidelity bonds.

I am aware that the Council has concern over this request - your briefing materials indicate "alarm" over the self-regulatory comment request. I, too, have concerns regarding this concept - not the least of which is whether we have authority to empower a new self-regulatory organization for advisers. Still, the number of funds, advisers, and assets under their control has grown significantly. The SEC's resources and the resources we have been able to allocate to our fund and adviser programs have not grown commensurately. Accordingly, even though I may, too, have some concerns, I believe we would be remiss not to at least *raise* the issue, and seek input from the public. The comment period on this matter is still open - as I always do, I encourage your input and hope that you will express your "alarm" publicly.

Public Company Accounting Oversight Board

Finally, while I noted earlier that we have completed the bulk of the Sarbanes-Oxley initiatives, we still have certain matters that we must address, and, of course, we will have to fine-tune the Sarbanes-Oxley rules that we have completed. As part of Sarbanes-Oxley, Congress mandated that the SEC establish the Public Company Accounting Oversight Board to oversee the audits of public companies that are subject to the securities laws.

The mandate to establish the Oversight Board - and for the SEC to amend its auditor independence rules - arose because the accounting profession itself fell down on the job largely failing to adopt what are essentially professional ethical obligations *that should have* and *could have* been adopted by the accounting profession. Further, I believe that the problems in that profession - and certainly a significant cause of the recent scandals - can be attributed to a culture that has fostered audit relationships that are too cozy with clients. As Sarah Teslik once noted, "If fifth graders picked their teachers, fifth graders would get A's."

Chairman Donaldson stated in his confirmation hearings that the selection of a Chairperson for the Oversight Board is his number one priority. In response, the SEC has adopted a process for conducting its search for the Chairperson, including soliciting input from a variety of sources, and establishing vetting and interviewing procedures. Further, we issued a statement, summarizing the mandatory and desirable criteria that we believe a Chairperson should possess and that we will evaluate during the selection process. The Oversight Board has a difficult and important job to do, and we at the SEC must ensure that *all* of the Oversight Board's members are working to achieve its mission. Accordingly, we are currently

in the process of following the adopted appointment procedures, and I look forward to the appointment of a Chairperson for the Oversight Board in the near future.

So, those are some of the current matters that are before us. I've only touched on **a** few, and certainly I look forward to working with Chairman Donaldson and my other colleagues on the many other issues facing us in our role *of* the *investors'* **advocate,** including -

- analyst independence issues;
- continued scrutiny of how our corporate governance rules under Sarbanes-Oxley are faring, including our rule proposal regarding audit committee listing requirements;
- continued reforms to our market structure;
- the convergence of global accounting principles;
- the need to forge **a** new era of co-ordination **with** our fellow federal and state regulators; and
- a long-neglected need to bring our **basic** rules regarding disclosure and investor interests from a 1930s-based mentality into the 21st century.

With the forthcoming panel, I hope to elaborate on these matters and some of the additional issues before us, and to respond to the many questions that you no doubt have.

Thank you for your time.

http://www.sec.gov/news/speech/spch032703psa.htm

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U.S. Securities and Exchange Commission

Statement by SEC Commissioner: Remarks at Open Meeting Regarding Shareholder Access Proposal

by

Commissioner Paul S. Atkins

U.S. Securities and Exchange Commission

Commission Open Meeting
Washington, D.C.
October 8, 2003

This is an important day for corporate governance, as my colleagues have said. I would like to stress at the outset that today is an important step in a process. It could significantly enhance corporate governance efforts, and it could provide meaningful reform that will benefit investors. I salute the Chairman in engaging this debate so that the various issues and interests can be addressed.

Shareholder frustration about the lack of appropriate input in the director nomination process is not a novel problem. As the Chairman said, as early as 1942, the SEC considered this issue but did not implement changes. This issue was taken up again in 1977 and 1992. In each of these distinct time periods, each marked by different SEC members and staff, no significant changes were made to the SEC's shareholder access rules. In fact, I have direct personal experience in this area, having been at the SEC in 1992 under Chairman Breeden when we last made major changes to the proxy solicitation and shareholder communication rules — rules that have stood the test of time, although they were severely criticized at the time.

And so here we are again, further along in the direct access process than we have ever been, but still left trying to fashion a fair mechanism to a recurring shareholder complaint. I join the Chairman and my colleagues in thanking the staff of the Division of Corporation Finance for their hard work. You have endeavored to "thread the needle", and you have done a great job in putting this proposal together.

A threshold issue is one that I take very seriously. What authority does the SEC have to regulate the nomination and selection of corporate directors in this way? I see two concerns that need to be addressed. First, since this is not a disclosure provision, does the Securities Exchange Act give us the ability to impose substantive rules on director selection? Second, although

the staff has tried to draft around this issue, are we indirectly preempting state law, which traditionally governs the selection of directors? I recognize that the Sarbanes-Oxley Act authorizes the SEC to take action in certain corporate governance matters that are traditionally within the state law realm. But, I should note that Congress was in the main rather careful in how it authorized and directed the SEC to act in this governance area. I understand that if this rule is adopted, some will challenge it on authority grounds. We must consider these issues thoughtfully during this process, and not cast them aside as mere technicalities.

Shareholder access is an issue where there is much controversy and many reasonable people disagree. Alan — you've done a great job here, but I can guarantee that just about everyone you ask will dislike some part of this proposal.

I appreciate fully the different sides of this debate. One side of me — call it the free market side — believes that owners of a corporation should decide for themselves how they wish to govern themselves and choose their representatives to oversee management, who are their employees. Let the chips fall where they may, without government telling the owners how to do it. The best protection is that a majority of shareholders must decide any of this, so let the majority of owners rule.

The other side of me — call it the pragmatist or the paranoid side — can recognize the fears expressed by many that allowing untrammeled shareholder access to the company's proxy card with only procedural safeguards might open the floodgates to the special interest groups seeking to hold a company hostage until their pet "stakeholder" issues are addressed.

Commissioner Glassman has also raised a point to consider during the comment process that the best course of action now might be to be patient and wait to see how the recent governance reforms enacted by Congress, the SEC and SROs play out.

I have also heard complaints that permissive shareholder access rules might facilitate the creation of special-interest directors — meaning directors that are nominated by a certain block of shareholders to represent that block's interests in one particular issue. This is a troubling proposition — arguably even contrary to existing statutory and common law — and it has certainly NOT been successful in Europe.

When we first started to look at this issue, I was deepty concerned that we might frame the discussion on choosing a wholly arbitrary number as we looked to decide what percentage of shareholders should be necessary to achieve greater access to the proxy. With such an approach, I feared that we would not have spent enough time considering whether shareholder access *is* a good idea and whether it might be a necessary improvement,

The triggering mechanism first suggested by the staff in July and now elaborated in the current proposal is a creative idea. It provides an objective standard rather than some arbitrary numerical threshold. It

suggests that the permissive access rules, the corporate world equivalent of upsetting the apple cart, would only apply in limited cases — cases in which a company is obviously not appropriately responding to its owners' requests.

BUT, and this is critically important, as we move through the comment process, we need to focus on the details like: (1) how should we set the triggers?; (2) how should votes be counted?; (3) who can make nominations?; and (4) who can be nominated? Here, more than ever, the devil is in the details.

This is a unique proposing release. 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.

We know that this proposal is geared to addressing so-called "problem" companies. This proposal is NOT geared towards reshaping the proxy contest landscape or, more importantly, to challenge the fundamental concept that managers, and not stockholders, manage the affairs of the corporation.

It is for this reason that we do not know the appropriate levels of shareholder ownership or the number of withheld votes that are necessary to trip the triggers that we have proposed. As the proposal notes, we have studied some data that is available to us to determine how often these triggers might have been activated in the past. This data is of limited use, of course, because, if these proposals are adopted, we will be at a new beginning — Day One, if you will. We will have created new standards that will themselves change shareholder and corporate behavior. We have done our best to propose appropriate guidelines based on what we know now, but I think it is fair to say that we need help from the public to let us know how we did.

I should also note that there is a tendency for government to build on and further "refine" regulatory projects. For this reason, we need to speak clearly *as to* our philosophical basis *for* this rule. This *is* critical — we do not want to open the door to a slippery slope that will eventually lead to a situation that has "morphed" out of recognition from what we originally intended when we considered this very difficult issue.

These are significant issues but I do not want to undercut the significance of how far we have come with this proposal. We are further along in this process than we have ever been, and the staff has tried to balance the various interests. I support the recommendation of putting this proposal out for comment, and I am optimistic that public input will help us fill in the blanks.

http://www.sec.gov/news/speech/spch101003psa.htm

 Modified: 10/10/2003

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U.S. Securities and Exchange Commission

Speech by SEC Chairman:

Introductory Remarks at the October 8 Open Meeting: Proxy Access Proposal

by

Chairman William H. Donaldson

U.S. Securities and Exchange Commission

Washington, D.C.
October 8, 2003

The first item the Commission will consider today is whether to propose rules following the recommendations contained in the staff's report, issued in July, regarding a limited requirement for certain companies *to* include shareholder nominees in their proxy materials.

Board unresponsiveness, sometimes tied to corporate governance weaknesses, demonstrates the need for shareholders to have a more meaningful voice in the proxy process. That is difficult under current rules. Shareholders typically are provided proxies allowing a vote only on company-nominated candidates, and disclosure in company proxy material is limited to those candidates. Also, most companies use plurality rather than majority voting for director elections, so candidates are elected regardless of whether a minimum percentage of shareholders approve. Therefore, company nominees are nearly always elected to the board, regardless of the number of shareholders who object to their candidacy.

While shareholders can conduct a proxy contest to elect their nominees, such contests require shareholders to bear the substantial expenses associated with preparing and disseminating proxy materials that comply with our current rules. These costs can frustrate shareholders' attempts to exercise their legal right to nominate directors. Meanwhile, the company's board does not bear the cost of disseminating information about - and soliciting proxies for - its nominees. Instead, the board's proxy solicitation is funded with the company's assets.

Shareholders unable to fund a contest may instead nominate directors at the annual meeting, subject to compliance with applicable state law requirements, as well as the restrictions contained in a company's governing instruments. Yet because companies solicit proxies for their nominees under our current rules, most shareholders vote before the meeting instead of voting in person. Accordingly, a nominee presented at an annual meeting but not included in a proxy solicitation has little chance of receiving the support needed to win election to a company's board.

And though shareholders may recommend candidates to a company's

nominating committee to be included in the slate of nominees presented in the company's proxy material, many shareholders have said this Is not effective, as companies rarely nominate their candidates.

On at least three previous occasions, dating back to 1942, the Commission has considered the issue of shareholder nominees. However, a decision to publish for comment the package of rules recommended to us this morning would mark the first time the Commission has ever taken the step of formally proposing rules to include shareholder nominees in company proxies.

This is a significant step towards fixing current proxy rules. These current rules may, at times, contribute to present conditions where company nominees are favored over the voice of shareholders. This can leave shareholders with proxy material whose disclosure does not adequately reflect the slate of nominees permitted under governing state laws. Today's proposal seeks to address this problem.

The staff and the Commission have received a significant amount of public input on this matter. Based on that input, the staff has developed a package of rule proposals that attempts to strike an important balance between shareholders who seek a more active voice in the proxy process, and those who have legitimate concerns about the impact of these proposals on the oversight, management, and operation of public companies.

Although today's proposals would require shareholder nominees to be included in proxy materials, the requirement would be limited to nominees of security holders who

- demonstrate their significant, long-term interest in the company, and
- are not seeking control of the company's board of directors.

Also, the proposal would apply only to those companies where there is evidence of ineffectiveness in the proxy process.

I'd like to thank all of the members of the staff who have worked on this proposal. They have done excellent work in a tight time frame.

We all recognize that the issue of shareholder nominees in a company's proxy materials is a very serious matter. There are varied and deeply held views on the questions before us, and - if the Commission proposes these rules today - we look forward to considering the comments of all groups that would be affected.

bttp://www.sec.gov/news/speech/spch100803whd.htm

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UNOFFICIAL TRANSCRIPT: SEC OPEN MEETING (OCTOBER 8, 2003)*

SEC Open Meeting Agenda

Wednesday, October 8, 2003, 9:30 a.m.

Item 1: Security Holder Access to the Nomination Process
Office: Division of Corporation Finance
Staff: Lillian C. Brown, Grace K. Lee

The Commission will consider whether to propose amendments to certain Rules, Schedules and Forms under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 that would require companies, under certain circumstances, to include in their proxy materials security holder nominees for election as director.

Chairman Donaldson: Good morning everyone. This is an open meeting of the United States Securities and Exchange Commission. We have two items on our agenda this morning.

The first item the Commission will consider today is whether to propose rules following the recommendations contained in the Staffs Report issued in July regarding a limited requirement for certain companies to include shareholder nominees in their proxy materials. Board unresponsiveness, sometimes tied to corporate governance weaknesses, demonstrates the need for shareholders to have a more meaningful voice in the proxy process. That is difficult under current rules. Shareholders typically are provided proxies allowing a vote only on company-nominated candidates, and disclosure in company proxy material is limited to those candidates. Also, most companies use plurality rather than majority voting for director elections, so candidates are elected regardless of whether a minimum percentage of shareholders approve. Therefore, company nominees are nearly always selected to the board regardless of the number of shareholders who object to their candidacy. While shareholders can conduct a proxy contest to elect their nominees, such contests require shareholders to bear the substantial expenses associated with preparing and disseminating proxy materials that comply with our current rules. These costs can frustrate shareholders' attempts to exercise their legal right to nominate directors. Instead, the board's proxy solicitation is funded with the company's assets. Shareholders unable to fund the contest may instead nominate directors at the annual meeting, subject to compliance with applicable state law requirements as well as the restrictions contained in the

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* This is an unofficial transcript of the Open Meeting. A webcast of the Open Meeting is available at http://www.sec.gov/news/openmeetings.shtml (last visited Dec. 17,2003).

company's governing instruments. Yet, because companies solicit proxies for nominees under current rules, most shareholders vote before the meeting instead of voting in person. Accordingly, a nominee presented at an annual meeting, but not included in a proxy solicitation, has little chance of receiving the support needed to win election to a company's board. And though shareholders may recommend candidates to a company's nominating committee to be included in the slate of nominees presented in a company's proxy material, many shareholders have said that this not effective as companies rarely nominate their candidates.

On at least three previous occasions, dating all the way back to 1942, the Commission has considered the issue of shareholder nominees. However, a decision to publish for comment the package of rules recommended to us this morning would mark the first time the Commission has ever taken the step of formally proposing rules to include shareholder nominees in company proxies. This is a significant step towards fixing current proxy rules. These current rules may at times contribute to present conditions where company nominees are favored over the voice of shareholders. This can leave shareholders with proxy materials which disclosure does not adequately reflect the slate of nominees permitted under governing state laws. Today's proposal seeks to address this problem. The Staff and the Commission have received a significant amount of public input on this matter. Based on that input, the Staff has developed a package of rule proposals that attempts to strike an important balance between shareholders who seek a more active voice in the proxy process and those who have legitimate concerns about the impact of these proposals on the oversight, management and operation of public companies. Although today's proposals would require shareholder nominees to be included in proxy materials, the requirement would be limited to nominees of security holders who (a) demonstrate their significant long-term interest in the company and (b) are not seeking control of the company's board of directors. Also, the proposal would apply only to those companies where there is evidence of ineffectiveness in the proxy process.

I want to thank all of the members of the Staff who have worked on this proposal. They've done an excellent job in a very tight time frame. I'd like to mention just a few of these people by name: Alan Beller, Marty Dunn, Lilly Brown, Grace Lee in the Division of Corporate Finance, Larry Harris, Jonathan _____ and Zane Williams in the Office of Economic Analysis, Susan Nash and Paul _____ in the Division of Investment Management, and Giovanni Prezioso, Meredith Mitchell, David Frederickson and Bobby Cater in the Office of the General Counsel.

We all recognize that the issue of shareholder nominees in a company's proxy material is a very serious matter. There are varied and deeply-held views on the question before us and, if the Commission proposes these rules today, we look forward to considering the comments of all groups that would be affected.

And now I'd like to turn to Alan Beller, the Director of the Division of Corporate Finance, and his colleagues to further explain the proposal. **Alan.**

Alan Beller: Thank you, Chairman Donaldson.

Before we turn to the details of the proposal, I want to add my thanks to the Chairman's, to all the other Divisions at the Commission who have helped Corporate Finance to get this proposal to you this morning. I would also like to thank people who are sometimes the unsung heroes of this process, and that is the counsels in the various Commissioner's offices who have been extremely helpful to us in making comments and in being very thoughtful about the proposal, so I'd like to thank them as well. And now, I'd like to turn this over to Lillian Brown to read ow opening statement.

Lillian Brown: Good morning.

On April 14th, the Commission directed the Division of Corporation Finance to review the proxy rules relating to the selection of corporate directors and provide a report and recommended changes to the Commission. In connection with this directive, the Commission issued a press release in which it solicited public input on this review. In response to this request, the Commission received over 690 comment letters, the majority of which expressed support for the Commission's decision to direct the review and urged the Commission to adopt rules that would grant security holders greater access to the nomination process and greater ability to exercise their rights and responsibilities as owners of their companies.

On July 15th, the Division provided to the Commission a report and recommendations for proposed changes to the proxy rules relating to the election of directors. In their report, the Division recommended changes in two areas: new disclosure related to nominating committee functions and security holder communications with boards of directors and enhanced security holder access to the proxy process relating to the nomination of directors.

On August 8th, the Commission proposed new disclosure standards that would implement the first Division recommendation by requiring more robust disclosure of the nominating committee processes of public companies, including the consideration of candidates recommended by security holders, as well as more specific disclosure of the processes by which security holders may communicate with the directors of the companies in which they invest.

Today, we provide for the Commission's consideration proposed rules that would implement the second of the Division's recornmendations by creating a mechanism that would, in certain circumstances, require public companies to include in their proxy materials the names and certain other information regarding security holder nominees for election as director. The proposed procedure would include limitations on the companies to whom the procedure would apply, eligibility requirements for security holders submitting

nominations, eligibility requirements for nominees, and limits on the number of nominees that must be included in the company proxy materials. This limited access, which would not be available where security holders were seeking control of a board of directors, would apply only in those instances where security holders are permitted by applicable state law to nominate the candidate for election as a director. In addition, this mechanism would be available only where there is evidence suggesting that security holders believe that the company has been unresponsive to their concerns as they relate to the proxy process.

In particular, we recommend that the Commission propose new rules that would apply to all companies that are subject to the Commission's proxy rules, including both operating companies registered under Section 12 of the Exchange Act and investment companies registered under Section 8 of the Investment Company Act. Because foreign private issuers are exempted from the requirement to comply with the Commission's proxy rules, the procedure would not apply to those issuers. The procedure would be applicable only to those companies in which one of two triggering events has occurred, each of which we believe would provide an indication of shareholder concerns and would remain available for two years thereafter. These events would be the receipt of withhold votes from more than 35% of the votes cast with regard to one or more directors or a shareholder proposal submitted by a security holder or group of security holders that have held more than 1% of the company's voting securities for one year which requests that the company become subject to the procedure and which receives support from a majority of the votes cast on that proposal.

Companies that are subject to the procedure would be required to include in their proxy materials the names of security holder nominees for election as director where the security holder or group of security holders making the nomination has beneficially owned more than 5% of the company's securities for two years with an intent to maintain that ownership through the annual meeting at which the related election of directors will occur and is eligible to report its ownership of company securities on Exchange Act Schedule 13G, rather than Exchange Act Schedule 13D, and has filed that schedule thus evidencing a lack of intent to control the company.

Any person nominated also must meet specified criteria, including that the nominee's candidacy or, if elected, board membership is consistent with applicable law and regulation, the nominee satisfies the objective, independent standards of a national securities exchange or a national securities association applicable to the company, the nominee does not have specified relationships with the nominating security holder or any member of the nominating security holder group, and the nominating security holder or any member of the nominating security holder group may have no direct or indirect agreement with the company regarding the nomination of the nominee.

The number of nominees a company would be required to include in its proxy materials would vary depending upon the size of its board of directors.

Boards with 8 or fewer directors would be required to include up to one security holder nominee. Boards with 9 to 19 directors would be required to include up to two nominees. And boards with 20 or more directors would be required to include three nominees.

Where a company receives more security holder nominees than it is required to include in its proxy materials, the nominees to be included would be those put forward by the nominating security holder or group with the largest ownership. In addition, the proposed procedure would include provisions that would require filing with the Commission of all soliciting material and apply Rule 14a-9 to that material; make clear that a beneficial owner who acquires or holds a registrant's securities in connection with a nomination under the procedure would not lose Schedule 13G eligibility solely as a result of making a nomination, soliciting under the procedure or having a nominee elected to the board; and exclude a nominating security holder group from the definition of a 10% holder for Section 16 purposes, subject to the general condition of the rule that they not have the purpose or effect of changing or influencing control of the issuer, although individual security holders that own 10% or more continue to be subject to Section 16.

Although we are not recommending that they be included in the procedure as proposed, we recommend that the proposing release discuss and request public comment on the following alternatives: limiting the procedure to only those larger companies that are defined as accelerated filers for purposes of the deadlines for filing periodic reports under the Exchange Act, and including as a triggering event a company's non-implementation of a shareholder proposal that was submitted under Exchange Act Rule 14a-8 with regard to any topic by a shareholder who has held more than 1 percent of the company's voting securities for one year and received a majority of the votes cast at an annual meeting with regard to that proposal.

After considering carefully the range of views on this issue, we believe that the recommended proposals, by requiring a company to include additional information in its proxy materials, provide an opportunity for security holders to participate more meaningfully in the proxy process for the nomination and election of directors without unduly burdening public companies at which such access may not be warranted. Accordingly, the Division recommends that the Commission propose and seek comment on the rules that we provide for your consideration today.

We are happy to answer any questions that you may have.

Chairman Donaldson: Before I turn the questioning over to my fellow Commissioners, I would like to direct one question to you, Alan, and to any of your colleagues who may want to chime in, to give us a little bit of a feel for the discussions that you all have had beyond what is put forth here in terms of proposed rules, to explain how the proposed procedure avoids the election of special interest directors who might be beholden to shareholders that nominated them rather than to all shareholders. And secondly, how do you anticipate that the presence of

directors elected under these rules will affect the operations of corporate boards? Will the new directors have a disruptive effect? Will the presence of one or two new directors have a sufficient impact? I know you've discussed this; I'd like to hear your comments on it.

Alan Beller: Sure. On the first point, this is certainly a concern that was expressed in the comment letters that the Division and the Commission received in connection with the report we prepared, the issue of special interest or single issue directors being nominated and perhaps elected as a result of this procedure. I think we recognize that there are people out there who have that concern. I think, frankly, more importantly, we have tried very hard to craft this proposal as a proposal where, if there is evidence of ineffectiveness or shareholder dissatisfaction with the proxy process insofar as it relates to the nomination of directors and significant shareholders with a long-term interest believe that they can improve that process by identifying what I would call better directors for the company, this procedure whereby the company would have to include those nominees would be available to them. If, on the other hand, they are seeking control or even if they are seeking representation of their interests on the board, I believe we already have a procedure to allow them to run a proxy contest in that case. This procedure is really not designed for them. The two principal respects in which we have tried to cabin the procedure in that way are: one, the requirements that the nominating group clearly fall on the side of not seeking to exercise or influence control; they would have to be eligible to file on 13G and not 13D. We have limited the numbers, and we'll talk about that in a moment. But secondly, there are requirements that the nominee be separate in certain senses from the nominating shareholder group. What we are recommending is a proposal where they cannot be affiliates, they can't be employees, they can't have received fees from members of the nominating group, and in this way we believe we've addressed this issue so that the nominees will be people that nominating shareholders believe will be better directors, will better serve the interests of all shareholders, but should not be single interest ... single issue or special interest directors. There has been a great deal of discussion, as you know, on that point, both with members of the Commission and with members of the public who have been sending us letters and meeting with us and so forth.

On the second issue, one has to make some judgments as to what will happen. I don't think one can predict with certainty. I think again there is certainly comment we have received from corporations and from corporate groups that even a small number of directors who are not vetted by the nominating committee and put on a board as part of an overall group selected by the nominating committee could lead to disruption in the boardroom. I think, on the other hand, there are people who have spent a lot of time in boardrooms who believe that where there is a common purpose to act in the best interests of the company as members of a board of directors, that should not be the case. Will it never be the case? One can obviously not say that with anything like certainty, but it should not be the case in our view. On the other hand, it

is certainly one of the things that we are seeking comment on, or are recommending that we seek comment on, as part of this proposal.

The other thing I guess I would say there is that we have tried very hard in what we are recommending to you today to have the procedure operate for corporations, where as I said before, there is evidence that there is ineffectiveness or dissatisfaction by shareholders with the proxy process and allow them to put nominees or to require the company to put nominees in their proxy materials. For some number of companies, the issues of smooth operation and collegiality -- while they are important values for a board of directors to have -- they are not necessarily the only values. And in certain circumstances, if there is evidence of ineffectiveness, maybe they are not the most important values. And by limiting the operation of the procedure we are trying to target it where if there is a little bit of a shake-up of the board culture in Company A, the possibility that that shake-up is not necessarily detrimental has been demonstrated by the events that would cause the procedure to operate.

Chairman Donaldson: Thank you.

Comm. Glassman: Thank you, Mr. Chairman. I'd like to begin by thanking the Staff for your hard work on this proposal. With your usual creativity, you have artfully crafted a well thought-out proposal that tries to address some widely differing interests. The issue we are attempting to address with this proposal is a very real one. The mess of corporate scandals still fresh in our memories reveals some very serious problems at some companies. Not the least of these was the fact that there were some very complacent and ineffective boards of directors. A closed nomination process dominated by powerful CEOs and the entrenchment of directors led in some instances to an unhealthy coziness between ostensibly independent directors and the executives whose performance they were supposed to oversee. When a board acts as a rubber stamp for management, that clearly is not necessarily acting in the best interest of shareholders. One option for shareholders who feel disenfranchised is to vote with their feet and sell their shares. For a variety of reasons, including indexing, the need for portfolio diversification and tax implications, that's not always practical. An alternative solution is to give a majority of the shareholders a more direct say in who is nominated to the board, and that's what we're here to talk about today.

As we've already seen, this is going to be a very controversial proposal. My understanding of the two main points of view is as follows. One is that shareholders own the company, so they should be able to directly nominate at least some of the members of the board. And it's difficult to argue with the notion that a majority of shareholders should have a say in board nominees. The other point of view is from the company's perspective. An effective board needs to work together constructively to oversee management and provide input on the strategic direction of the company.

If the shareholder-nominated board member results in a divisive board, that creates a significant distraction for management and for the board. I've been on several non-profit boards over the years and have experienced complacent boards, divisive boards and collegial but constructive boards, and in my experience, the latter is the most effective. So, in my view, the ideal impact of this proposed rule would be to ferret out the complacent boards, allow a majority of shareholders to put on those boards someone who will be constructive but not divisive, and leave the effective boards alone. The challenge, of course, is how we accomplish that.

One thing I can say unequivocally is that no matter what we ultimately do or don't do, not everyone will be happy with the outcome. The goal of the comment period is to ask questions to determine the appropriate balance between the differing points of view. For me, the issue is what represents the best interests of all of the shareholders. As an aside, there seems to be an impression in the current environment that just because something is opposed by corporate America, it's good for shareholders. However, that's not always true. If the results limit the viability or competitiveness of our companies, especially in global markets, that's not good for shareholders. So I have a number of issues that I want to make sure are addressed in the comment period, and I know many of these are covered in the release, which I am told may have broken all records in terms of the number of questions asked.

The first issue is the timing. Through the new Sarbanes-Oxley rules and listing standards, we have just placed serious new corporate governance requirements on companies, which should be a wake-up call to any remaining complacent boards. So my question is, and what I'd like to get some comments on, shouldn't we see how these rules work before imposing yet another set of requirements? And I'd also like to get comment on whether this would be unduly burdensome on smaller companies and whether the proposed or potential cutoff in the release is an appropriate one or if it should be higher.

My next issue is the threshold votes required to trigger the rule. Some argue that including ownership thresholds of one or five percent in the proposed triggers is unduly restrictive. However, even five percent is insignificant from a governance standpoint, that is, in terms of shareholder vote required for corporate action. Yet under the proposal it would take only one percent of the outstanding shares to set the process in motion. That step in itself can impose significant costs -- implicit if not explicit -- on the company and on the remaining 99 percent of shareholders. So my question is, are the trigger percentages fair to the remaining shareholders? To be more sure that it's truly the intent of the majority of shareholders to give the significant authority to a small minority, and to see if there is a reasonable likelihood that the effort will succeed, I would have proposed that the rule require the affirmative vote of a majority of the shares outstanding before the company would be subject to the new process. And with respect to director elections, I would at a minimum have proposed to require withheld votes fi-om at least 50% of the votes cast. I want to make sure that we get comments on those alternatives. I also think

that the proposal to allow shareholders to nominate two candidates to a nine-member board may go too far, especially without any experience yet regarding how this will actually work. *So* I want to make sure we get comments on whether the number of nominees is appropriate or too high. Another concern I have is the uneven application of the rule. It seems to me that a primary reason the Commission has authority over the proxy process is to ensure that there is a fair and uniform process for all companies. Yet there is no doubt that this proposal would apply unevenly and potentially create regulatory arbitrage since whether or not it applies depends on the law in the company's state of incorporation, and, even worse, companies would be able to exempt themselves from the rule in states where they can amend the bylaws or articles of incorporation to prohibit shareholder nominations. There are good reasons for including the limitation that our rules would apply only if consistent with the state law, but I do think **it's** fair to question whether having the rule in this area if it applies unevenly is a good idea, and I want to encourage comment on that issue.

Despite what I perceive are some serious concerns, I support putting this proposal out *for* comment because I think the debate is important. Even though our intentions may be good, though, the consequences of being wrong could be very serious. We need to give them more than lip service as these serious concerns are raised. In fact, I recommend (and I know the Staffs already thinking about this) but I recommend a public roundtable discussion during the comment period. Ultimately, if I **am** convinced through the comment process that our final proposed rule will improve the bad companies and not hurt the good companies, I will wholeheartedly support it. Obviously if I **am** not convinced of that, I won't.

I want to thank the Staff again for your incredibly hard work. This is one of the most difficult issues we've had to deal with since I've been here in terms of trying to resolve competing interests, and **as** usual you have done terrific work. I look forward to the comments and to further healthy debate on this issue. Thanks.

Chairman Donaldson: Thank you, Commissioner Glassman. I think many of your observations **have** been heard, and I think maybe what we ought to do is move on to Commissioner Goldschmid and then we'll come back . . . .

Comm. Glassman: No, I have no questions.

Chairman Donaldson: Okay.

Comm. Goldschmid: Let me provide the optimistic view. This is a proud historic day at the Commission. We are in the process of shifting the balance of power between corporate managements and shareholders. No longer will managements be able to ignore dissatisfied majorities of shareholders. Shareholders under a free market system not only supply capital but have the right economic instincts. They understand the system. They want corporate efficiency, honesty, productivity **and** profitability. In **a** macro sense, the shareholder

interests are consistent with the nation's need. If all goes well, active, independent directors will effectively represent these basic shareholder interests. But, and this is the critical reason for us being here today, what happens when corporate senior managers are unimaginative, ineffective or wrong-headed, and a compliant board of directors allows them to remain in a painful or disastrous course? What realistically can dissatisfied shareholders do? A proxy contest jumps to mind, but the bottom line on proxy contests is that absent special circumstances, there are virtually no contested director elections in the United States. The costs are large and the risks too high. In general, shareholders are given an opportunity to vote only on director candidates nominated by the company. The Commission and Staff have carefully crafted new rules -- my favorite is the direct access proposal – that I believe will largely negate legitimate concerns in the business community about, for example, disruption and special interests. The proposed rules will, however, give dissatisfied majorities of shareholders a means of playing a meaningful role in the election process. Many have understandably urged us to go further and faster. Others, particularly in the business community, think we're going much too far. But the truth, at least as I see it, is that while we are acting with care and prudence, in the weak, dead-wood company situation, the corporate governance dynamic will enormously improve. No longer will ineffective or unconscionably compensated CEOs with compliant boards be relatively safe. The shareholder votes in Year One and the election process in Year Two will provide critical stimulants for change in public corporations where a majority of shareholders have indicated the need for change. If adopted, the rules proposed today will dramatically alter the balance between corporate managements and shareholders. The proposed rules will help to restore investor confidence and faith. And with everyone else, Alan, we've got to say thank you to you and the Staff. You and Marty and Lillian and the others have done a superb job. You've crafted with care and thoughtfulness, and we are very much in your debt.

I do have a few questions. First, I guess we ought to focus on the 35% that Commissioner Glassman mentioned. Why use that number rather than a majority?

[Long pause]

Alan Beller: I'd say that's a number which for purposes of the proposal was derived principally by, I suppose, a two-step process. One was looking at the data, such as it is available to us, with respect to the percentage of withheld votes for directors across a sampling of our public companies. The most widely available sources, as the release points out, deal with average withheld votes across an election as opposed to director by director. We have done some additional sampling ... or the Office of Economic Analysis has. People in Corp. Fin. are literate but not numerate. The Office of Economic Analysis has helped us with some additional sampling, which I think suggests, impressionistically at least, that if you look at withheld votes for individual directors, there is obviously some spike in some cases but not ... it's not all

that far off, so ... if you look at 35% you're somewhere in the, depending upon the sample you look at, the 2-3-4% range as I recall. Zane, is that it?

Zane Williams: It may be slightly lower than that, but that's ... that's about right.

Alan Beller: Two to three percent range of companies. That seems to be a responsible number. I think the second step is we recognize that "just vote no" campaigns and withheld votes are ... their incidence is perhaps impacted today by the fact that they send a message but don't have any practical consequences. If we were to adopt a rule, if you were to adopt a rule that had a withheld vote level it would (one could reasonably predict) increase the incidence of "just vote no" campaigns. It would also, I think, increase the incidence of corporations fighting harder against them if the consequences were to trigger the proposal whereby they have to add information about shareholder nominees. We've come to 35 as a good starting point looking at the current data, with the recognition that there will be behavior modification on both sides, and Commissioner Glassman is absolutely correct. We're certainly looking for comment, including quantitative comment to the extent we can get it, to hone that number to the degree that that's appropriate. But that's the process. If you go to 50% looking at the current numbers, you've basically got a null set.

Zane Williams: Yes, it was very low.

Alan Beller: And, so basically you're aiming at an indicator of very broad shareholder dissatisfaction, I think. I think that certainly anecdotally is correct.

Comm. Goldschmid: Let me push you on another one. The one percent needed to get the process moving in direct access proposals. 14a-8 allows any shareholder with $2,000 and a year of holding to make a shareholder proposal. We're now using a 1% trigger. Why are we doing that? Although I do know the answer.

Alan Beller: I think we're doing that because ... I think we believe that being ... I know there are groups that would like us to be bolder here, but I think we were convinced that we should be cautious in this area and that starting the process whereby a company would become subject to this procedure is, in our view, therefore itself a significant step. It will impose costs, not just financial costs, but costs in terms of time and attention of the company and its management, and we therefore believed that setting a threshold which certainly is not terribly high and can be achieved by relatively small numbers of shareholders, by institutional shareholders banding together, where they feel it's appropriate, would be a more appropriate way to start this procedure than allowing any shareholder to do so in the manner of a shareholder proposal. It seems to us to be a bigger step than that. Having said that, I will repeat that we certainly understand that there is another side to that argument, and we recognize it and ask questions about it in the release.

Comm. Goldschmid: And it certainly helps to meet the Chairman's concern about disruption or too many contests. But is it fair to small investors or shareholders?

[Long pause]

Alan Beller: It does not keep smaller shareholders or investors from doing anything that they can do today under 14a-8. It indeed does not prevent them from putting in such a proposal under 14a-8 although it would not become a triggering event unless they got other significant support. Given that the nomination procedure that would follow such **a** vote is necessarily, I think, as **a** practical matter going to be a procedure dominated by long-term institutional shareholders, having it started by one or two shareholders who are not sort of part of that group seems to us to be a disconnect that I think is not wise at this stage.

Comm. Goldschmid: And there certainly will be shareholder participation. You need majority votes and everyone gets to vote, so for the key votes in Year One and Year Two, every shareholder will be voting, participating.

Alan Beller: Indeed, the entire goal of this proposal is to give all shareholders ultimately better information about nominees and who they can vote for. And that goes, as you say, for every shareholder, and neither of the triggering events will occur -- nor will elections of the shareholder-nominated directors occur -- without broad support across the various classes of shareholders.

Comm. Goldschmid: Will we have these triggering events in effect for the 2004 proxy season?

Alan Beller: I'm very glad you brought that up because it was not something we covered in our opening statement. The release **...** the proposed ... the rule that we recommend you propose provides that a triggering event **...** the starting date for a potential triggering event is January 1st, **2004.** If that rule were adopted, it would mean that shareholder meetings after that date, if they had the requisite percentage of withheld votes or if they had **a** majority-approved direct access proposal, those would be triggering events under our proposal for the next two years. That would mean that even if the Cornmission were ultimately to adopt this rule for say, for example, the 2005 proxy season, triggering events from the 2004 proxy season would cause this proposal to be applicable.

Comm. Goldschmid: I guess I should ask about why a two-year process. Also, again, I have some idea of the answer.

Alan Beller: Again, **I** think this speaks to the concerns that both Chairman Donaldson and Commissioner Glassrnan have expressed and are certainly expressed on one side of the debate that is going on outside the building directed at all of **us.** If the premise is a correct one, that this procedure should be available to shareholders of companies where there is some evidence of ineffectiveness or dissatisfaction, the two-step process seemed to us to be the best way to get that evidence. There is frankly another way, a one-step way of proceeding, but if you are looking for significant evidence of ineffectiveness or dissatisfaction to start the process, I honestly think that 5% is not the right number, and so there is that trade-off. If you got rid of the first step, I think

you would have to be thinking about much larger thresholds for nominating shareholders, and this seemed to us to be a better way to genuinely gage whether that ineffectiveness or whether there is evidence of that ineffectiveness.

Comm. Goldschmid: It is powerful evidence to have a majority of shareholders saying, "We don't have confidence. We are dissatisfied." Okay, one last question. Legal authority to do this?

Giovanni Prezioso: Let me try to speak to that one because it is an issue we've given a fair amount of thought to and have tried to work with Alan on it. I think that from our perspective, I know Alan agrees with this, we believe that the Commission does have sufficient authority to proceed with this rulemaking. We looked at the structure of the rule, and as has been discussed, it's crafted consistently with the structure of the statute and other rules the Commission has adopted. It works by mandating inclusion of material in the proxy solicitation -- in some sense it's similar to 14a-8 in that regard. Second, in terms of its objectives, it's clearly directed towards the core objective of Section 14(a), which is fair corporate suffrage. And, as has been discussed already here, each of these triggering events and the parts of the rule that make things happen has been thought through and balanced by the Staff. Third, I think it's already been noted as well, the Staff has been very careful in drafting this proposal to make sure it doesn't interfere inappropriately with state law rights, neither creating new voting rights nor eliminating any existing voting rights. So it is not the case where we have to worry about those kinds of concerns. Naturally, at the end of the comment process the Commission will have to look back at this question of authority in light of the record and so forth, but my own view is that I'm quite confident that the Staff can structure an effective proposal within the Commission's existing authority at that time.

Comm. Goldschmid: The state, I take it, could take away (as indicated) the power of shareholders to nominate, but I must say that would be shocking development if it occurred.

Giovanni Prezioso: I think that Alan can speak to that as well, but it would be surprising I think for states to move in that direction, and the Commission might have to look at those sets of issues if the world changed in that direction. But I think that's way off. . . not where we hope things were going.

Alan Beller: We completely agree with that, with all of that.

Comm. Goldschmid: Thank you very much.

Chairman Donaldson: Mr. Atkins.

Comm. Atkins: Thank you, Mr. Chairman. I agree with you and my colleagues that this is an important day for corporate governance. And I'd like to stress at the outset that today is an important step in the process. It could significantly enhance corporate governance efforts, and it could provide a meaningful reform that will benefit investors ultimately, and I salute the Chairman in engaging this

debate so that we can hear the various issues **and** interests and address them through our notice and comment process.

Shareholder frustration about the lack of appropriate input in the director nomination process is not a novel problem. **As** the Chairman said, **as** early **as** 1942 the SEC considered this issue but did not implement any changes. This issue was again taken up in 1977 **and** in **1992, and** in each of these distinct time periods -- each marked by different SEC members and staff, for the most **part** anyway -- no significant changes were made to the SEC's shareholder access rules. In fact, as with Marty Dunn, I have direct personal experience in this area, having been at the SEC back in 1992 when we last made changes to the proxy solicitation and shareholder communication rules. And those are rules that have stood the test of time, although they were also severely criticized at the time. And so here we **are** again, further along in the direct access process than we have ever been but still left to try to fashion a fair mechanism to this recurring shareholder complaint.

I join the Chairman and my colleagues in thanking the Staff of the Division of Corporation Finance for your hard **work.** You've endeavored to thread the needle, and I think you've done a great job in putting this proposal together.

A threshold issue is one that I will take very seriously throughout this process, and Commissioner Goldschmid just addressed that. What authority does the SEC have to regulate the nomination and selection of corporate directors in this way? I see two concerns that need to be addressed. First, since this is not a disclosure provision, does the Securities Exchange Act give us the ability to impose substantive rules on director selection? And second, although the Staff has tried to draft around this issue **as** Giovanni discussed, ***are* we** indirectly preempting state law, which traditionally governs the selection of directors? I recognize that the Sarbanes-Oxley Act authorizes the SEC to *take* action in certain corporate governance matters that are traditionally within the state-law realm, but I should note that Congress **was,** in the main, rather careful in how it authorized and directed the SEC to act in this governance area. I understand that if this rule is adopted, some will challenge it on authority grounds, so we must consider these issues thoughtfully during this process and not just cast them aside as mere technicalities.

Shareholder access is an issue where there is much controversy, and many reasonable people disagree. Alan, I think you and your colleagues have done a great job here, but I can guarantee that just about everyone you ask will dislike some **part** of this proposal. I already see some scars there on **parts** of your body from the process, even before it's officially begun.

I appreciate fully the different sides of this debate. On one side, one side of me, call it the free market side, believes that owners of a corporation should decide for themselves how they wish to govern themselves and choose the representatives to oversee management, who are in fact their employees. ***So*** let the chips fall where they may without government telling the owners how to do it. The best protection is that a majority of shareholders must decide on

any of this, so let the majority of owners rule. So the other side of me, call it the pragmatist or the paranoid side, can recognize the fears expressed by many that allowing untrammeled shareholder access to the company's proxy card with only procedural safeguards might open the floodgates to special interest groups seeking to hold a company hostage until their pet stakeholder issues are addressed. Vocal splinter groups could displace the majority's interest to the distraction and detriment of the corporation, and pretty much similar to what's happened on the class action litigation side, where intimidation and coercion reign. Commissioner Glassman has already raised a valid point: that the best course of action now might be just to be patient and wait to see how recent governance reforms enacted by Congress, the SEC and the SROs may play out.

I've also heard complaints that permissive shareholder access rules might facilitate the creation of special interest directors, meaning directors that are nominated by a certain block of shareholders to represent that block's interest on one particular issue. That's obviously a troubling proposition, arguably even contrary to existing statutory and common law, and it is certainly has not been successful in Europe.

When we first started to look at this issue, I was deeply concerned that we might frame the discussion on choosing a wholly arbitrary number as we looked to decide what percentage of shareholders should be necessary to achieve greater access to the proxy. With such an approach, I feared that we would not have spent enough time considering whether shareholder access is in fact a good idea and whether it might be a necessary improvement. The triggering mechanism that the Staff first suggested back in July and now that you all have elaborated in the current proposal I think is a very creative idea. It provides an objective standard rather than some arbitrary numerical threshold. It suggests that the permissive access rules -- the corporate world equivalent of upsetting the apple cart -- would apply only in limited cases, cases in which a company is obviously not responding appropriately to its owners' request. But, and this is critically important, as we move through the comment process, we need to focus on details like how should we set the triggers, how should the votes be counted, who can make nominations, and who in fact can be nominated. Here, more than ever, the devil is in the details.

As has been stated before, this is a unique proposing release. I can't in fact remember a release that has so many pages of questions seeking public input. More than half of the substance of this release is a request for comment. And why is that? Because again, the devil is in the details of this proposal. And frankly, as we sort of discussed, we don't have all the information that we need to work out the details.

We know that this proposal is geared to addressing so-called problem companies. This proposal is not geared towards reshaping the proxy contest landscape or, more importantly, to the challenge the fundamental concept that managers -- not stockholders -- manage the affairs of the corporation. So it is for this reason that we don't know the appropriate levels of stockholder

ownership or the number of withheld votes that are necessary to **trip** the triggers that we've proposed. **As** the proposal notes, we have studied ~~some~~ data that is available to us to determine how often these triggers might have been activated in the past. This data is limited, of course, and because once these proposal are adopted we will be at a new beginning, "day one," if you will. We will have created new standards that will themselves change shareholder and corporate behavior. So we have done our best to set appropriate guidelines based on what we know, but I think it's fair to say that we need help from the public to let us know just how well we've done.

I should also note that there is a tendency for government to build on and further "refine" regulatory projects. For this reason, we need to speak clearly as to what our philosophical basis is for this rule. This is critical that we don't want to open the door to a slippery slope that can morph out of all recognition from what we originally intended when we considered this very difficult issue.

So, with the Chairman's indulgence, I have a few questions. So Alan, you note that this proposal will only apply in state jurisdictions where shareholders are allowed to nominate directors. Do you have a sense of how many states allow or prohibit the nomination of directors?

Alan Beller: I don't have a precise sense. There is a small number of states where the right apparently does not exist or is unclear. The principal states . . . the states where most of America's . . . certainly large public corporations . . . are incorporated, including Delaware, apparently does have such **a** right. We have done a little digging there and some of the other major states. But there are, as I said, there is a small number where the right is either unclear or apparently does not exist.

Comm. Atkins Well, as I just talked **a** little about the authority issue, and maybe Giovanni might want to talk about this, but I was wondering if you could discuss how the Business Roundtable decision of the D.C. Circuit back in the late 1980s interrelates with this proposal.

Giovanni Prezioso: Sure. A couple of things I need to note in that regard. First, as you know, the Business Roundtable decision relates not solely to Section 14(a) of the Exchange Act but also to Section 19 and was in the context of Commission action to effect self-regulatory organization rules. And so you are actually working in a different context in terms of the structural piece of the statute that we are looking **at.** Second, to the extent that that piece involves matters of state law and the Commission's regulation interfering with matters of state law, it has already been noted, but there has been real effort here not to modify substantive state law rights **and** to be sensitive to the concerns identified in that case.

I think it is interesting in that case, the language discussing the Commission's authority under Section 14(a) is actually quite suggestive of broad authority to do various things, albeit not the particular one-share, one-vote rule that was in place, that was the subject of that particular litigation. And so, when we've

looked at it, we don't find that it is or should be construed as inconsistent with what the Staffs trying to do today.

Comm. Atkins: Well, as proposed, we have a sliding scale of the number of directors that can be nominated by shareholders. So, Alan, I was wondering if you could describe how you arrived at that number of nominees for the particular company boards?

Alan Beller: I guess we thought about a couple of things. One, sort of at one extreme, a thread running through this entire proposal is **we** are not . . . this is not a procedure that is intended to relate to control or changes in control. So the number of directors involved should be well less than a majority in all cases. That was sort of on one side. I think on the other side, I think the basis for the Division's recommendation is to try to resolve the tension between having a voice that is meaningful where a triggering event has occurred and a majority wants to elect other directors put up by one of these shareholder nominating groups, and the other side of the tension is I think we are cognizant of the. . . you want to have that voice heard, and you want to have that voice meaningful, but you don't want to . . . we want to be careful in face of the argument that there is **a** potential for disruption. And the comment has suggested that that potential goes **up** as the number of directors that could be nominated or elected pursuant to this process goes up.

So we had those concerns. We then looked at, again, the OEA has been extraordinarily helpful in collecting some data. I think, Zane, this is for listed companies as I recall, so they would be the larger companies. They would be, this is certainly if you were to end up in the accelerated filer universe, I think this is very good proxy for the accelerated filers. I think it is probably **a** less good proxy for the total universe because there are many smaller companies with smaller boards. But as the release points out, there are roughly half, a little less than half, in the 8 or less category, 4 to 8, and there are a little more than *50* percent in the 9 to 19 category. And there are **a** very **small** and shrinking number of companies that have boards of 20 or more; I think five years from now there probably won't be any unless there is some other development that we couldn't predict. ***So*** this proposal would result in one or two directors in virtually all . . . maximum of one or two directors . . . in virtually all cases. And, as I say, it was trying to balance the desire for a meaningful voice against the desire not to have a number that began to **look** like control or too large **a** number. You know, the tipping point **for** the discussion is presumably in two of nine, which is the smallest board in which you would have two directors under our proposal. But that's the thought process we went through, and obviously we are looking for comment on whether we were thinking correctly and whether there ***are*** other considerations we should consider. But that is the thought process that is the basis of the recommendation.

Comm. Atkins: Okay. I would be remiss if I would not call on our economist over here, ***so*** I was wondering, Larry, where . . . you know, obviously we're not focusing today on the general proxy contest area, but this is arguably . . . as you and

other economists like Milton Friedman have argued . . . is probably the best way to hold managements accountable. Do you have any general remarks about this, or concerns?

Larry Harris: Sure. I would note that while we spent the entire morning so far discussing the implications of the application of the proposed procedures, we haven't talked anything about the impact of simply the existence of these procedures. I think that the real benefits from what we propose today, if adopted, **will** come from merely the threat that these procedures might be used. And through that threat, we will get better corporate management, and all of our fears about how the procedure might actually be used will be cut off simply by the actions of more responsible management facing the possibility of outcomes that they might not entirely find favorable, and that's all for the best.

Comm. Atkins: Thank you.

Chairman Donaldson: Commissioner Campos.

Commissioner Carnpos: Thank you, Chairman Donaldson. I also would like to join my fellow Commissioners in congratulating the Staff and the Chairman for bringing this matter **up,** and I think I must say that I believe that there is a measure of courage to take on a subject like this that has as many interests, and **has as** many varying views and is felt as strongly by as many groups. **As** for the issue of timing, I believe it **is** very straightforward. We have a large number of shareholder interests who have said that this is a problem, and in spite of other things that we are doing to help corporate governance, I think our agency is . . . it's important for our agency to be responsive **and** to deal with matters that constituents claim is a problem.

I think it's important to understand in all this discussion exactly what this proposal is and is not. This proposal is not a broad general shareholder access mechanism that is being proposed. It is a limited, measured response for allowing shareholders greater access to the proxy system in **a** very specific set of circumstances that has been discussed, where it appears that the circumstances of the procedures for proxy, for the **proxy** process, are broken.

The other situation that has to be understood is that it is not easy or not without cost for shareholders to undertake the efforts that are being allowed here should we go forward with this particular proposal and ultimately adopt some version of it. Again, this is a very carefully thought-out situation. It doesn't give shareholders in many instances everything they want. Shareholders' interests I'm sure in many cases would like to **have** more. At the same time, the Staff and the Commission have to be very cognizant of disrupting corporate processes. And so this is **a** balanced situation. I hope that the interests and the comments that come back will realize **exactly** what context this is in, and that this is a measured situation. There are other protections to shareholders, as Allan Beller went into great detail about, and none of those particular rights, whether **it** goes to **seeking a majority** or

seeking control, or seeking to put in a proposal through 14a-8, are going to be hampered or restrained or dealt with at all by this particular proposal.

Certainly, corporate and issuer concerns are part of the mix here. I believe what is very important is essentially the issue that Larry Harris just mentioned and others have mentioned in the discussion today. And that is that, essentially, existing companies and boards of directors have a lot to do with whether these procedures are every implemented. There are two proxy seasons before any of these things would ever happen. And it certainly seems to me that corporate interests and existing boards and issuers could undertake programs to deal with communications, to deal with shareholder concerns, and essentially make it unnecessary to ever use these particular procedures.

Again, I believe that giving essentially a minority director, or you're giving shareholders a right to elect through a process a minority director, does not fundamentally change the balance. I think it's an important additional item to encourage good corporate governance. I think along with the Sarbanes-Oxley proposals that we made and implemented by the direction of Congress, this particular situation also creates parts, and completes part of the puzzle here, to make companies responsive to their owners, which again is the system we have in the U S. by law.

So, this is just to echo what my colleagues have said. This is a classic situation of balance. Essentially, it has all the earmarks of a classic compromise. Everyone that's interested in this area essentially walks away from this equally unhappy with something. Which again is the situation that we find ourselves in, and it's also why ultimately it should be Something that goes forward.

I believe the companies -- to take the corporate situation for a minute — ultimately have much to gain from being accountable to shareholders. It is true that in many companies shareholders are often the parties that directors have the least contact with. At a minimum, this particular procedure, this particular process, if implemented by the Commission, would end up promoting that type of communication. And we have done some of those things previous to this anyway in terms of promoting communication, promoting procedures to be published as to how shareholders can access directors.

I support the proposal. I believe that this again is a measured step that has value to shareholders. It may not go as far as many shareholders and shareholder interests would like, but it is extremely valuable. It also is something that I don't believe the corporations and the corporate interests should fear. I don't believe that having a minority director that has been nominated through this process is a bad thing, per se. It is not at all evident to me that a director, through this process, which again does not represent a special-interest type of nomination, would as a rule be disruptive. Presumably, the fiduciary duties and all the other common interests of making

that company successful would also guide the particular nominee from the shareholder.

Like the rest of my colleagues, I look forward to the comments. I'm sure if we had 600 last time, maybe we'll have a thousand this time. I agree with Commissioner Adkins that the devil is in the details. But I think this is a very good framework from which to promote the discussion. I think the percentages are a very good estimation of what would work. And I for one don't have much fear of this being sustained legally should it ever **be** challenged. And again, I commend the Staff. It's hard work. I think it took some courage. I salute the Chairman for promoting this process and not being scared off by it. And I believe again we promote the public interest in this whole process. I think all the questions have been pretty well vented at this point, so I will restrain myself. Thank you.

Comm. Campos: Thank you Commissioner Compos.

Alan Beller: I do want to put one thing on the public record. There's been a lot of comment by each of the Commissioners about the importance of the comment process and the importance of the comments we get here. I don't think we have said, and.I would like to say it in the open meeting, that we're recommending a ***60***-day comment period to give people a good amount of time to express their views. ***So*** it will be 60 days from publication of the proposal in the Federal Register.

Chairman Donaldson: Thank you, Alan. We have not only the Division of Corporate Finance here. We have the Chief Counsel, and we have the Office ***of*** the Chief Economist. I'd like to ask whether you or any of your staff have anything you'd like to add. Particularly the Chief Economist, who I cut off abruptly at the beginning. I don't know whether you have said what you want to say, but please. . .

Larry Harris: Commissioner Adkins gave me the opportunity.

Chairman Donaldson: Thank you. And do any of the Commissioners have anything they want to add?

Comm. Glassman: The only thing I would add, since I go first and I never get to react to anybody else's . . . I don't think we're coming at this that differently. We all see it as a balancing act. Some of **us** see the glass half full, some of us see it half empty. But at the end of the day, I think we all really want to get comments, which will help us make our decision as to what's the most appropriate way to go forward on this.

Chairman Donaldson: Thank you. Well, I think we're at that point. I will ask the question: Do the Commissioners vote to approve the Division's recommendation?

[Assent]

I think **we** all do. And **again,** many thanks to you **all here** and behind you for your help here. Thank you very much.

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U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Remarks on Governance Reforms and the Role of Directors before the National Association of Corporate Directors

by

Commissioner Cynthia A. Glassman

U.S. Securities and Exchange Commission

Washington, D.C.
October 20, 2003

Good morning, and thank you John and all of you for inviting me to this conference. I think we would all agree that director education has taken on even greater importance in the post-Sarbanes-Oxley world. The National Association of Corporate Directors provides an invaluable service by putting on programs like this. The NACD's comments on our rule proposals have also been constructive and helpful in improving many of the Commission's rules, and I thank you for your productive input.

Let me begin with the standard disclaimer that my comments today reflect my own views, and do not necessarily reflect the views of the Commission or its staff.

If there is one thing we can all agree on, it is that times have changed for corporate directors. In the early 1930s, management guru Peter Drucker was working at *Fortune* magazine when Alfred Sloan hired Paul Garrett as the first public relations officer for General Motors. When Drucker asked Garrett what his main job was, the story goes, Garrett replied: "To keep *Fortune* away from GM."[1] Nowadays, if you go to any executive suite and pose the same question to a senior officer, director or the cadre of lawyers and accountants that surrounds them, the more likely answer would be: "To keep the SEC away from our company."

The reality, however, is that it is primarily shareholders, not the SEC, who have increased the need for antacids in the executive suite and boardroom. To be sure, the Commission has brought a number of significant accounting fraud cases. In those cases, however, our focus is on illegal conduct. In the current environment, the American shareholder is up in arms about things like poor performance, excessive executive compensation or unresponsive management, even when they aren't illegal. Like the makers of Hebrew National hot dogs, corporate America has to answer to a higher authority.

Looking back on the last year or so, I think all of our lives were very balanced. They were 50 percent Sarbanes and 50 percent Oxley. Most of you are living under the rules, and already are all-too-aware what they are. To put them in context, we need to answer a fundamental question: What is the Board's role in a system of corporate governance that separates

ownership from control? The separation of ownership and control is a delicate balancing act that relies on both explicit and tacit agreements among managers, directors and shareholders. I would like to discuss that balance, and the unique ways in which it has worked and, in some *cases,* not worked, and also talk about our recent initiatives toward increasing the shareholder's voice, and how those reforms could affect the role of corporate directors.

Separation of Ownership and Control: The Board's Role

The separation of ownership and control is one of the most ingenious innovations of capitalism. Historically, it allowed geographically dispersed owners, each perhaps with only a fractional interest in the overall enterprise, to pool their resources in an efficient manner. It also greatly reduces the cost of capital by allowing for efficient secondary markets. A key characteristic of those markets is that changes in ownership do not affect the continued viability *of* the company. The separation also allows owners to place the company's management into the hands of professional managers who, the theory holds, will have the training and specialization needed to run a complex organization. The law imposes on these managers an obligation to act in the best interests of all of the shareholders as a group. Separating ownership from management also limits the influence of the parochial interests of a small group of shareholders, or even a single shareholder.

Separating ownership and control is not, however, without potential problems. Most directly, it gives rise to some very difficult agency issues. Managers who run corporations have a high degree of discretion over shareholder assets, but do not in their role as managers bear the investment risk of making poor decisions. In Las Vegas lingo, they are playing with other people's money. Managers also have at least one very powerful conflict of interest - their own self-interest or greed. As Berle and Means observed in their 1932 classic study of the corporation, "[t]he separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge . . . ."[2] The potential divergence of interests is one of the main reasons the law imposes fiduciary duties on managers to act in the best interest of shareholders, and to scrupulously avoid self-dealing.

From the shareholders' perspective, I think it is fair to say that, even in the current environment, they do not want the responsibility to oversee the company's affairs. If one takes the mutual fund industry as a case study, it appears that even the largest shareholders tend to be passive investors, much more concerned with the return on their investment than how it is generated. 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.

It is by design that, despite owning the company, shareholders are a relatively weak constituency. Throughout modern corporate history, the law has purposely erected barriers to shareholder participation in corporate management, since such participation, it was thought, would grind the wheels of progress to a screeching halt.

So, if shareholders as a group - whether because of fractional interests or legal barriers - do not have the means *to* monitor the performance of management, then who is minding the store? That's where all of you come

into play. The director's role is to act in the shareholders' place to hire and oversee management's handling of the corporation's affairs. Boards members obviously are far fewer in number than shareholders, which makes it easier to make collective decisions. Unlike shareholders, directors also must act in accordance with fiduciary duties, which limits parochial interests. The Board's position as guardian of shareholder interests is absolutely fundamental to corporate governance because it provides the check on management that helps prevent potential agency problems from becoming actual agency problems.

Given the vital function of the Board, it should not be surprising that Sarbanes-Oxley and other reforms the Commission has proposed focus on - you guessed it! - the board of directors. For the most part, Sarbanes-Oxley and Commission and SRO rules re-affirm the primacy of the Board in overseeing corporate affairs. There are, however, several areas where boards of directors have been seen - to be frank - as abdicating their responsibilities. These include oversight of financial reporting, executive compensation and Board nominations. Some reforms in these areas also seek to affirm the Board's role and enhance its efficiency in carrying out the oversight function. Importantly, others *seek* in some ways to reduce the Board's role in favor of more direct participation by shareholders. Our reforms in the areas of financial reporting tend to be more on the continuum toward increasing the Board's effectiveness, while our recently proposed Board nomination reforms would tend to give some power back to shareholders.

Financial Reporting

In the area of financial reporting, one of management's most important functions is to provide full and accurate information to the company's owners and potential owners. For nearly thirty years, the audit committee has been evolving into the primary way by which the Board carries out it obligation to protect shareholders' rights to this information. Sarbanes-Oxley further recognized the primacy of the audit committee in this role by requiring that audit committees of listed companies: be entirely independent; be directly responsible for hiring and firing auditors; have procedures for addressing complaints regarding financial reporting; and have the ability to engage advisers who are independent of management and the auditors.

The Commission also adopted rules requiring disclosure of whether the audit committee has an audit committee expert. The goal of this rule is not to have the audit committee re-audit the financial statements, but rather to have at least one person with real expertise who can help assure that the audit committee and the Board ask the right questions.

I have spoken to many executives and directors who say it is now more difficult to find people *to* serve on the audit committee. While there have been some unintended consequences of Sarbanes-Oxley, I don't think that narrowing the audit committee pool can be counted among them. The audit committee expertise requirement, for example, raises the bar - and that *was* intended.

I have also heard that the candidate pool has shrunk because qualified individuals cannot serve on as many Boards given the increased responsibilities. Maybe I'm missing the point, but I think that is the point. I frankly question whether it was ever possible for an executive with a full time job also to do an effective job as the member of three or four Boards

or audit committees. The days of the trophy Board, where distinguished citizens are given directorships because of their status rather than qualifications, hopefully are gone for good. Also gone should be the days of the "Old Board Network" where the deal was "you name me to your Board and I'll name you to mine." While I do not underestimate the value of collegiality in the boardroom, the focus needs to shift from finding directors who work best with the CEO, to finding directors who add the most value for shareholders, although the two may not be mutually exclusive. As one corporate governance expert has observed, "What was once an honorary way to cap off a career is now a real job with real expectations and a time commitment of at least a few hundred hours a year. It's very different now than six golf games and a few meetings a year."[3]

Executive Compensation

Executive compensation is another area in which many shareholders feel the Board has not been meeting its obligations. While the separation of ownership and management means that the wealth opportunities of managers and owners will not always be perfectly aligned, there is something wrong when managers achieve unthinkable riches, especially when the owners' investment disappears. A complete disconnect between performance and compensation is a stark red flag that something is wrong with the system.

Executive Compensation should not be a get rich quick scheme. Hopefully you hire your senior executives for the long-term; and if that is the case, then the goal should be to compensate them fairly over the full term of their employment. As the shareholders' surrogate you should ask yourselves whether the shareholders are getting their money's worth from executive pay, and whether you are providing proper incentives for longer-term performance goals.

I am not necessarily advocating regulatory reforms in this area. The market is usually the best way to deal with these issues. If reforms do come, it will be because shareholders are not getting the information they need to evaluate the issue. Companies should make sure there is full and open disclosure about executive compensation in their filings, even if it means going beyond the minimum requirements of our rules. If you are embarrassed to disclose what you are doing, that is a good sign you are not on the right track.

The Nomination Process

All of the measures I have discussed so far attempt to clarify directors' responsibilities and give Boards the tools necessary to do the job effectively. Sarbanes-Oxley, however, does not speak to one very important piece of the puzzle - namely, how to get the right group of people to serve as directors. After all, only if the right people are on the Board will the reforms be carried out as the statute intends.

In the critical area of director nominations, it is somewhat anomalous that the Board itself has almost exclusive control over who serves as a director. Although the situation has worked without significant problems at many, and maybe most, companies, there is an obvious risk that entrenchment will lead to complacency. A widespread sense has developed that the nomination process is not so much being run by the Board as dominated by powerful CEOs. At some companies, it appears that the CEO hires the Board instead of the Board hiring the CEO. It is this situation that gave rise

to the current calls for revolution.

In the past, more shareholder voting took place in person at annual meetings that were **widely** attended by shareholders, so nominations from the floor had real meaning. Today, most voting is done through proxies delivered before the meeting, so floor nomination are too late to garner significant votes. Largely **as a** result of the massive corporate scandals, **but** also more generally because of unresponsive Boards, there **has** been **a** sense lately that the regulatory obstacles to shareholder participation in the nomination process are not optimal in terms of protecting shareholders.

In response to this concern, the New York Stock Exchange and Nasdaq market are finalizing significant changes that will affect the way nominating committees operate. For one thing, the new rules will require that **all** nomination decisions be made by independent members of the Board. Removing the CEO from the formal process, and putting it in the hands of non-management directors, is more likely to resutt in **a** process where the Board **acts** as the owners' surrogate. If the independent directors are truly independent and take the responsibility seriously, then that is a significant step that should improve the effectiveness of the nomination process and quality of nominees.

For the reforms to be effective, however, the directors who **serve on** the nominating committee will have to **be** truly independent. Much of the focus in defining independence **has** been on whether the director **has** financial relationships with the company that are likely to compromise his or her independence. In my view, personal relationships with **the** CEO - living in the same community, kids at the **same** school, moving in the same social circle - are just a5 likely to undercut independence. **In** deciding who serves on the nominating committee - and any other committee where independence is required, for that matter - you should not hesitate **to go** beyond what the **rules** require to find members who are truly independent in the broadest sense of that **word.** The **NYSE** and **Nasdaq** standards would both require Boards to make **an** affirmative finding that there are no factors materially affecting independence. That **is** a step in the right direction if Boards meet the spirit of those standards. **Regardless** of **whether** shareholders **like** some or **all** of the Board's director candidates, they should demand, and Boards should deliver, **a** process that puts the decision in **the hands** of independent directors whose loyalties to shareholders are beyond question.

In addition, because sunlight is often the best cleanser, the Commission recently proposed rules that would make the nomination process **more** transparent. If adopted, our rules would require companies to disclose how they go about selecting directors, and provide information about **if** and how shareholders **can** participate in the process.

Finally, as all of you are well aware, the Commission recently put out for comment proposed rules that would allow shareholders to include nominees on the company's proxy card if certain triggering events occur. The issue the Commission is trying to address with that proposal **is a** very real one. **A** closed nomination process dominated **by** powerful CEOs, and the entrenchment of directors, **led** to an unhealthy coziness in some instances between ostensibly independent directors and the executives whose performance they were supposed to oversee. When the **Board** acts **as a** rubber-stamp for management, it does not necessarily **act** in the best interest of shareholders.

The access proposal is a natural response to the widespread perception among some shareholders that the nomination process has been co-opted by management. Given that perception, it is not difficult to understand why they would want to do the job themselves. Unlike other reforms that seek to improve the way the Board functions, this proposal removes some of the regulatory barriers to effective shareholder participation in the proxy process for electing directors. As such it represents a potential redistribution - rather than a reaffirmation - of the Board's current role.

One obvious question is: Do shareholders need access to the proxy? If shareholders feel that a company is poorly governed and unresponsive, the must readily available and commonly used remedy is to vote with their feet and put their hard-earned capital where it will earn a better return. If enough shareholders vote no-confidence by selling their shares, the cost of the firm's capital will increase to the point where it will either reform or it will go out of business. For several reasons - including indexing and tax consequences - selling is not an attractive option for all shareholders. It is those shareholders who most need a road to reform from within.

Under our new proposal, the theory goes, a small percentage of large, long-term shareholders - with nothing but the best interests of the company and all fellow shareholders in mind - will act in a neutral and unbiased manner to further the corporation's interests by nominating a candidate for the Board who is better than management's nominee. I agree with this proposal in theory, but to paraphrase no lesser an authority than Homer Simpson, "Communism works . . . *in theory*."

I know that there are some very serious concerns about our latest proposal and the potential effects it will have on the corporate boardroom. As I noted when the rule was proposed, I share many of these concerns. Our purpose, as stated in the proposing release, is to open the process "where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process."[4] While that is a noble goal, and while I agree that the rule could have a positive effect on some poorly governed companies, I am concerned that the rule's reach will not be so limited. To use a military analogy, we may be dropping a cluster bomb when a surgical strike is more appropriate. I am also very concerned about the potential competitive effects the proposal could have, especially for companies that compete in global markets. I am sure all of these issues will be addressed during the comment process, and I urge you to give us your views.

However, the reaction of many companies to the proposal needs to be more constructive. Some companies are denying that there is any problem, which is akin to denying that there is a six-thousand pound elephant in your living room. The proxy access proposal is a symptom that there may be a bigger problem. There is a palpable feeling that the corporate boardroom has become too clubby. Some of the most scandalous behavior we have seen does not involve accounting fraud, but rather more subtle instances of executives treating the corporation as their own private fiefdom. There is not a Board out there that could not stand a little forthright introspection on governance issues.

So I'll leave you with this question: Rather than circling the wagons to oppose regulatory reform, why not try to be more proactive and deal with valid shareholder concerns? Why not approach your biggest and most active shareholders - whether or not you think your company has governance issues - and see if there are ways to make the nomination process more transparent and accessible? If enough companies undertake

their own meaningful reforms, then the perceived need for more SEC action may not be as great. And, regardless of whether or not the access rule eventually is adopted, fostering a more cooperative relationship with shareholders in the area of Board nominations will pay dividends in the long run. After all, they are not only the company's owners, they are your bosses.

Thank you. I'd be happy to take your questions.

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[1] Peter Hay, *The Book of Business Anecdotes* 145 (Wing Books 1993 ed.).

[2] Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 6 (McMillan 1932).

[3] Ben White, *More Politicians, Executives Say "No, Thanks" to Director Seats,* Wash. Post p. El, E4 (February 27, 2003) (quoting Dana R. Hermanson, research director at the Corporate Governance Center at Kennesaw State University).

[4] *Security Holder Director Nominations,* Exchange Act Rel. No. 48626 (October 14, 2003).

http://www. sec.gov/news/speech/spch102003cag.htm

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News

Proxy Rules
Proposed Proxy Access for Shareholders May *Go* Too Far, SEC's Glassman Tells NACD

Securities and Exchange Commissioner Cynthia Glassman confirmed Oct. 20 that she believes that the SEC's proposal to give sharehoiders greater participation in the director nomination process may go too far in attempting to redress situations in which the board of directors is a rubber-stamp for management.

"To use a military analogy," Glassman told the National Association of Corporate Directors, "we may be dropping a cluster bomb when a surgical strike is more appropriate." Glassman spoke only for herself and not for her fellow commissioners or the SEC staff.

Earlier this month, the SEC voted unanimously to seek public comment on the proposal, which would allow shareholders to include nominees on the company's proxy card if certain triggering events occur (1 CARE 972, 10/10/2003). At the time, Glassman said that if she ultimately is "convinced" that the proposed rule would "improve the bad companies and not hurt the good companies," she will wholeheartedly support it.

In remarks to the NACD in Washington, Glassman said, "Our purpose, as stated in the proposing release, is to open the [director nomination] process 'where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process.' While that is a noble goal," she continued, "and while I agree that the rule could have a positive effect on some poorly governed companies, I am concerned that the rule's reach will not be so limited."

"Real Issue,' 'Serious Concerns.'

The "very real" issue the proposal *is* intended to address, according to Glassman, is a "closed nomination process dominated by powerful CEOs, and the entrenchment of directors, [which] ted to an unhealthy coziness in some instances between ostensibly independent directors and the executives whose performance they were supposed to oversee."

While she expressed "very serious concerns" about the SEC proposal, Glassman also encouraged companies to be more constructive and more proactive and to deal with valid shareholder concerns. She suggested that companies approach their largest and most active shareholders to see if there are ways to make the nomination process more transparent and accessible. "If enough companies undertake their own meaningful reforms, then the perceived need for more SEC action may not be as great," Glassman said.

Also on the topic of director nominations, Glassman noted that New York Stock Exchange and Nasdaq Stock Market corporate governance listing standards soon to be issued require that all nomination decisions be made by independent members of the board. She cautioned that the reforms will not be effective unless the directors on the nominating committee are truly independent. Glassman urged companies to go beyond "what the rules require to find members who are truly independent in the broadest sense of that word."

The new NYSE and Nasdaq standards, she explained, would both require boards to make an affirmative finding that there are no factors materially affecting a director's independence. Glassman suggested that a personal relationship with the CEO, as well as a financial relationship

with the company, could materially affect independence.

In the area of executive Compensation, Glassman said a director should ask himself or herself whether "the shareholders are getting their money's worth from executive pay" and whether the board is providing "proper incentives for longer-term performance goals." The SEC commissioner hinted, "If [regulatory] reforms do come, it will be because shareholders are not getting the information they need to evaluate the issue." Disclosure of executive compensation in a company's SEC filings, Glassman said, should be "full and open ... even if it means going beyond the minimum requirements of our rules."

The text of Glassman's speech to the NACD is on the SEC's Web site at http:/&vww.sec.gov/news/speech/spch102003cag.htm.

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Staff Report:
Review of the Proxy Process Regarding the Nomination and Election of Directors

Division of Corporation Finance
July 15,2003

This is a report of the Division of Corporation Finance. The statements in this report are those of the staff and are not statements of the Securities and Exchange Commission.

I. INTRODUCTION

Earlier this year, the American Federation of State, County and Municipal Employees Pension Plan requested that the Commission review the Division of Corporation Finance's no-action position in letters issued to six Companies. The AFSCME Employees Pension Plan had submitted a shareholder proposal to those companies that would have required the companies to include in their proxy materials the nominee of any shareholder or group of shareholders beneficially owning 3% or more of the companies' outstanding common stock. The Division allowed the companies to exclude the proposals under Securities Exchange Act of 1934 Rule 14a-8(i)(8) because the proposals "relate[d] to an election for membership on the company's board of directors or analogous governing body."[1] The Commission let stand, rather than review, the determination of the Division.

Although the Commission determined not to review the Division's position, on April 14,2003, the Commission issued Press Release No. 2003-46, announcing that it had directed the Division to formulate possible changes in the proxy rules and regulations and their interpretations regarding procedures for the election of corporate directors. As we discuss

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[1] Exchange Act Rule 14a-8(i)(8).

below, increased shareholder participation in the processes related to elections has been a topic of interest and debate over the past 60 years. In particular, shareholder access to a company's proxy materials has been addressed previously by the Commission, outside commenters and shareholder advocates. This staff report summarizes prior Commission action and discusses alternatives for increasing shareholder participation in the **proxy** process regarding the nomination and election of directors and otherwise improving the proxy process in this area. Finally, the discussion of each alternative closes with a list of questions that are among those that the Commission could consider or submit for public comment if it were to propose that alternative.[2]

11. BACKGROUND

A. Prior Commission Action

The Commission first addressed the issue of shareholder access to a company's proxy materials for the nomination of directors as early as 1942, when it requested that the **staff** review the proxy rules and submit to **the** Commission recommended changes.[3] The Commission solicited comments on the staff proposals, including **a** proposal to revise the **proxy** rules to provide that ". . . minority stockholders be given an opportunity to use the management's **proxy** material in support of their own nominees for directorships."[4] According to testimony of Chairman Ganson Purcell before the House Committee on Interstate and Foreign Commerce, **the** staff had proposed that "stockholders be permitted to use the management's proxy statement to canvass stockholders generally for the election of their own nominees for directorships, as well as for the nominees of the management."[5] Under the proposal, **a** company would not have been required to include more than twice as many candidates on the proxy **as** director positions to be filled.[6] The Commission did not adopt rules to provide this access.[7]

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2 **As** is evidenced in the attached Summary of Comments, commenters provided their views on a number of topics that are related to director elections that are not addressed specifically in the body of this staff report. These topics include amending New **York** Stock Exchange Rule **452,** which allows brokers to vote shares where the beneficial owner has not provided voting instructions 10 days prior to **a** scheduled meeting, and evaluating the impact of proxy advisory services on institutional investor voting. The Division has considered these issues in developing its recommendations and will address such issues, **as** appropriate, if the Commission directs the Division to draft proposed rules based on the Division's recommendations.

3 *See Securit[ies] and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R 1821, and H.R. 2019 Before the House Comm. on Interstate and Foreign Commerce,* 78th Cong., 1st Sess., **at 17-19** (1943) (testimony of Chairman **Ganson** Purcell).

4 Release No. **34-3347** (December **18, 1942).**

5 *Securit[ies] and Exchange Commission Proxy Rules: Hearings, supra* note *3,* at 19.

6 Id., at 157

7 The Cornmission did not provide an explanation for its determination, stating simply that, "a number of the suggestions proposed by **the staff** were not adopted," including the suggestion related to shareholder access to the company's proxy material. Release No. **34-3347** (December 18, 1942).

In 1977, the Commission again focused on shareholder access to a company's proxy materials regarding the nomination and election of directors during its broad review of shareholder communications, shareholder participation in the corporate electoral process. and corporate governance generally. In anticipation of public hearings held in September of 1977, the Commission, without formally proposing rule changes, requested comment on a number of issues, including whether "... shareholders [should] have access to management's proxy soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors."[8] In addition to this overarching question, many of the other issues raised in the releases relating to the 1977 review remain issues that the Commission will have to address if it proposes to provide shareholder access to company proxy materials.

After the 1977 hearings, the Commission proposed and adopted amendments to the proxy rules. These amendments did not relate directly to shareholder access to a company's proxy materials regarding the nomination and election of directors. The Commission, however, did adopt a requirement that companies state whether they have a nominating committee and, if so, whether the nominating committee will consider shareholder recommendations. Although the Commission stated its intent to address "some of the more complex questions which have been raised in this proceeding relating to corporate governance and the means by which corporations can best account to shareholders and the public" and determine "what further action, if any, is appropriate with respect to shareholder communications and shareholder participation in the corporate electoral process generally," the Commission did not take further action on shareholder access to company proxy materials.[9] According to a 1980 staff report to the Senate, the staff concluded that, due to the emerging concept of nominating committees, the Commission should not propose and adopt a shareholder access rule at that time.[10] The staff report recommended,

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8 Release No. 34-13482 (April 28, 1977), in which the Commission also asked:

a) what criteria should be applied to nominating shareholders;
b) what disclosures should be required of nominating shareholders;
c) whether shareholder nominations are permissible under state law; and
d) whether a meaningful distinction can be drawn between control and non-control nominations.

See also Release No. 34-13901 (August 29, 1977), in which the Commission published the final schedule of issues to be considered at the hearings, which included:

a) whether shareholders should have access to the company's proxy soliciting materials for the purpose of nominating directors;
b) whether shareholder nominations are permissible under state law and consistent with Congressional intent in enacting Exchange Act Section 14(a);
c) what type of rule would be most appropriate and what criteria should be applied to nominating shareholders;
d) whether the proxy rules should apply to soliciting activities by a nominating shareholder; and
e) whether nominating shareholders should be subject to the then-existing rules governing election contests.

9 Release No. 34-14970 (July 18, 1978). See also Release No. 34-15384 (December 6, 1978).

10 The Task Force on Corporate Accountability was formed as an outgrowth of the review of the proxy rules that began in 1977. The work of the Task Force culminated in the Staff Report on Corporate Accountability, completed and presented to the Senate Committee on Banking, Housing, and Urban

however, that the staff monitor the development of nominating committees and their consideration of shareholder recommendations.'[11] The staff report further cautioned that, if an insufficient number of companies adopted nominating committees or the efforts of these committees with regard to shareholder nominations proved insufficient, Commission action might be necessary.[12]

In the broad proxy revisions adopted in 1992,[13] the Commission briefly revisited the shareholder access issue in connection with amendments to the bona fide nominee rule set out in Exchange Act Rule 14a-4, which provides that no person shall be deemed a bona fide nominee "unless he has consented to being named in the proxy statement and to serve if elected."[14] In adopting the Exchange Act Rule 14a-4 amendments, the Commission noted "... the difficulty experienced by shareholders in gaining a voice in determining the composition of the board of directors," but stated the following with regard to shareholder access to the company's proxy materials:

> Proposals 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. This would essentially mandate a universal ballot including both management nominees and independent candidates for board seats.[15]

Rather than mandating a "universal ballot," the Commission revised the bona fide nominee rule to allow shareholders seeking minority board representation to "fill out" a partial or "short slate" with management nominees, thus making it easier for shareholders to conduct an election contest in a non-control context. For example, if a shareholder wishes to nominate only two candidates to a seven person board, Exchange Act Rule 14a-4(d) permits the shareholder to choose five of management's nominees to fill out his or her ballot, provided that the shareholder does not name those management nominees on his or her proxy card, but instead names only those management candidates that the shareholder is opposing. Although the shareholder still must disseminate and file a separate proxy statement and proxy card, he or she can now, in essence, allow shareholders to vote for some of management's nominees on the shareholder's proxy card.

Affairs. *Division of Corporation Finance, Securities and Exchange Comm'n, Staff Report on Corporate Accountability (Sept. 4, 1980) (printed for the use of Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.),* at A60-65.

11 The *Staff Report on Corporate Accountability* states: "...all nominating committees should be open to suggestions of nominees from shareholders." *id.*, at A56.

12 *Id.*, at A6O-65, *A69.*

13 *See* Release No. 34-31326 (October 16, 1992).

14 Exchange Act Rule 14a-4(d).

15 Release No. 34-31326 (October 16, 1992).

Currently, Shareholders who wish to effect a change in the composition of a board of directors may conduct an election contest, as noted briefly above, nominate a candidate at an annual meeting, or recommend candidates to a company's nominating committee or group of directors fulfilling a similar role. Election contests can require substantial expenditure by the shareholder, who must prepare and disseminate proxy materials that comply with the Commission's proxy rules. Shareholders may instead nominate directors at the annual meeting. subject to compliance with applicable state law requirements, as well as any requirements contained in the company's governing instruments; however, most shareholders vote through the grant of a proxy before the meeting instead of voting in person. Accordingly, a nominee presented at an annual meeting has little chance of receiving sufficient support. Finally, although shareholders generally may recommend candidates to a company's nominating committee or group of directors fulfilling this role, shareholders have indicated that this is not effective, as companies rarely nominate candidates recommended by shareholders.

B. Summary of Public Recommendations for Greater Shareholder Involvement in the Election of Directors

In Press Release 2003-59, issued on May 1,2003; the Commission solicited public views on the Division's review of the proxy rules and regulations relating to the nomination and election of directors.[16] The majority of commenters supported the Commission's decision to direct this review. Reflecting concern over the lack of accountability of corporate directors and recent corporate scandals, the commenters generally urged the Commission to adopt rules that would grant shareholders greater access to the nomination process and greater ability to exercise their rights and responsibilities as owners of their companies. In addition, many commenters noted that the current director nomination procedures afford little meaningful oversight to shareholders.

The 690 commenters who responded to the solicitation were comprised of the following:

- 424 individuals;
- 165 unions, pension funds, institutional investors, and institutional investor associations;
- 24 social, environmental, and religious funds and their related service providers;
- 18 law firms and attorneys;
- 16 associations;
- 10 corporations and corporate executives;
- 10 shareholder resource providers;
- 8 investment advisers and managers;

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16 *See* Release No. 34-47778 (May 1, 2003). In addition, the Division spoke with interested parties representing shareholders, the business community and the legal community, including individuals from the Amalgamated Bank LongView Funds, the American Bar Association Task Force on Shareholder Proposals, the American Federation of Labor and Congress of Industrial Organizations, AFSCME, the American Society of Corporate Secretaries, Automatic Data Processing, Inc., The Business Roundtable, the California Public Employees' Retirement System, the Committee of Concerned Shareholders, the Connecticut Retirement Plans and Trust Funds, CorpGov.Net, Hermes investment Management, the International Brotherhood of Teamsters, Laborer's International Union of North America, and the United Brotherhood of Carpenters and Joiners of America.

- 5 academics;
- 5 other shareholder groups;
- 2 governmental representatives; and
- 3 miscellaneous commenters.

The vast majority of cornmenters supported modifying the proxy rules and regulations related to the nomination and election of directors. Commenters who did not support such a modification included all of the corporations and corporate executives, most of the legal community, and the majority of associations (mostly business associations).

Few commenters provided specific suggestions about how the proxy rules should be reformed to allow shareholders to access proxy materials to nominate directors. Of those commenters who did submit detailed proposals, the level of specificity in those proposals ranged from merely suggesting minimum shareholder ownership thresholds for submitting director nominations to outlining extensive proposals for general proxy reform.

Most of the individual investors who commented indicated that they consider the current process for the nomination and election of directors to be an ineffective means of providing shareholders with the rights of company ownership, but very few offered detailed proposals. Shareholder groups who supported some level of proxy reform stated that, aside from providing shareholders with access to the election process to nominate director candidates who would represent investors' best interests, such reform also would have the effect of making all corporate directors more responsive to shareholder concerns. An explicit or implicit reason behind the desire for reform in several comment letters was that reform was particularly necessary in those cases where the proxy process and shareholder communications were ineffective.

Commenters who opposed proxy reform to provide shareholders with access to company proxy materials to nominate directors advocated a cautious approach with regard to any changes to the nomination and election process. In this regard, the commenters posited that such access would be "terribly disruptive to the corporate governance process" and the Commission instead should give the Sarbanes-Oxley Act of 2002 and proposed listing standard changes "a chance to operate before making such a fundamental change to the director nomination process."[17] In addition, some commenters also questioned the Commission's authority to adopt shareholder access rules under Exchange Act Section 14(a).

A few of the commenters opposing shareholder access to company proxy materials recommended that the Commission instead consider requiring enhanced disclosure about nominating committees or revising Exchange Act Rule 14a-8(i)(8) to allow shareholder proposals to establish a process for shareholder nominees on a company-by-company basis.

For an expanded discussion of the comments received, please refer to the Summary of Comments, attached as Appendix A.

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[17] Alston & Bird LLP.

III. ALTERNATIVES

Based on the public comments, the principal alternatives for increasing shareholder involvement in the nomination and election of directors, some of which could be employed in combination with others, appear to include the following:[18]

- requiring companies to include shareholder nominees in company proxy materials;
- requiring companies to deliver nominating shareholder proxy cards along with company proxy materials;
- requiring expanded disclosure regarding companies' nominating committees, the nominating process, and nominating committee consideration of shareholder recommendations, with possible requirements under applicable listing standards that nominating committees consider shareholder recommendations;
- requiring expanded disclosure regarding shareholder communications with board members, with possible requirements under applicable listing standards that companies provide shareholders with increased access to, and direct communications with, boards of directors; and
- revising Exchange Act Rule 14a-8 to allow shareholder proposals relating to a company's nomination process.

A. Alternative A – Require Companies to Include Shareholder Nominees in Company Proxy Materials

Under this alternative, a company would include on its proxy card the shareholder nominee or nominees and would include specified information, such as biographical information, about the shareholder nominee in the proxy statement. Arguments for and against each of the company's and the nominating shareholder's candidates could be included either in a word-limited form in the proxy statement or wholly outside the proxy statement, for example, on one or more designated websites. All soliciting materials, including website postings, would be filed electronically with the Commission, as is currently the case for definitive additional soliciting materials. In addition, all disclosure and communications would be subject to the prohibition against false and misleading statements in Exchange Act Rule 14a-9.

To the extent that the Commission determines to propose new rules based on this alternative, it may want or need to consider the following topics, among others:

- whether there should be triggering events for enhanced shareholder access;

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18 The Division's review of the proxy rules and regulations focused on operating companies. However, investment Companies generally are treated like operating companies under the proxy rules. Ultimately, the Commission will need to determine, and request comment on, how any changes to the proxy rules should apply to investment companies.

- if enhanced shareholder access is based on triggering events, whether there should be time limits following these events for the enhanced access;

- whether to impose nominating shareholder eligibility requirements, such as percentage of company stock held and length of time held thresholds;

- whether to allow aggregation of shareholders into groups for purposes of forming a "nominating Shareholder";

- whether there should be limits on the number of directors or percentage of the board that may be nominated by shareholders and/or hold office at **any** given time under a shareholder access rule;

- whether there should be a process for assuring that shareholder nominees are qualified to serve on the board;

- whether there should be independence standards for the shareholder nominee, both from the company and from the nominating shareholder;

- requirements applicable to any related solicitations, both for formation of a shareholder nominating group and for election of a shareholder nominee;

- the extent of shareholder nominee disclosure, if any, to be included in the company's proxy materials;

- possible conflicts between any rule changes and controlling state corporate law, federal law, or listing standards;

- whether nominating shareholders, including groups, should be deemed to have a "control" purpose that would create additional beneficial ownership filing and disclosure requirements;

- whether to adopt an exemption from Exchange Act Section 16 reporting requirements for nominating shareholder groups; and

- whether to create **a** safe harbor *to* provide that nominating shareholders would not be deemed "affiliates" of the company **solely** as a result of using a shareholder access **rule** to nominate **a** candidate.

Two fundamental considerations in proposing any shareholder access rule, which are reflected in the list **above,** are when the rule may **be** used and by whom. In addressing the former, the Commission would need to determine whether the proposal should require one or more types of **triggering** events to occur before **a** sharehotder could invoke the rule to nominate **a** director or directors. The result of conditioning the operation of a proposal on triggering events would be to focus the impact of the rule on those companies where there are objective criteria showing that the proxy process may be ineffective. This approach could address the concerns of

some commenters regarding the adverse impact of such a proposal on all public companies. Although a triggering event requirement would add additional complexity to the operation of the rule, it also would limit the use of a shareholder access rule to situations where the proxy process may otherwise have failed to permit shareholder views to be adequately taken into account. The clear purpose of such a shareholder access proposal, particularly where conditioned on triggering events, would be to improve the proxy process.

Triggering events could include a company's failure to act on shareholder proposals that receive majority votes or the receipt of significant percentages of "withhold" votes in director elections." Another tri ering event could be approval of a shareholder proposal to activate the shareholder access rule? Though other triggering events could be used, including economic performance, *e.g.*, lagging a peer index for a specified number of consecutive years," the Division is of the view that any triggering event should be more closely tied to evidence of ineffectiveness in the proxy process.

A related issue if the Commission proposes a shareholder access rule that uses triggers based on percentage of withhold votes or shareholder proposals is whether the use of *these* triggers would result in increased numbers of Shareholder proposals and "vote no" campaigns by shareholders who are attempting to trigger the nomination procedure.[22] With regard to "vote no" campaigns, the Division has been advised that the possibility of triggering Exchange Act Schedule 13D reporting requiremerits currently may have a chilling effect on shareholders who otherwise would organize such an effort. Accordingly, the Commission may wish to consider whether the Commission or the Division should issue an interpretation stating its views with regard to "vote no" campaigns and beneficial ownership reporting. A similar interpretation may be appropriate with regard to the application of the proxy rules to these activities.

The second consideration, shareholder eligibiiity, generated a great deal of comment from the public. While some believe that all shareholders should be able to access a company's proxy materials for the purpose of nominating directors, others advocate share ownership

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19 In the election of directors, shareholders may vote for or withhold authority to vote for each nominee rather than vote for, against or abstain as is the case for other matters to be voted on by shareholders. See Exchange Act Rule 14a-4(b)(2). As discussed in footnote 25 and accompanying text, below, withhold votes have little or no effect under plurality voting.

20 For example, a shareholder who does not believe that the proxy process has been effective at a company in which that shareholder holds stock could submit a proposal through Exchange Act Rule 14a-8 to request that the company comply with the shareholder access procedure. Although most proposals are precatory in nature, a majority vote on such an "opt-in" proposal could trigger a shareholder access rule. This alternative would require a revision to Exchange Act Rule 14a-8 *to* reflect shareholders' ability to submit such a proposal under the rule (provided that the shareholder and the proposal otherwise meet all procedural and substantive requirements).

21 Other triggering events could include being delisted by a market, sanctioned by the Commission, indicted on criminal charges, or having to restate earnings more than once in a specified period.

22 In "vote no" campaigns, a shareholder or group of shareholders attempts to persuade other shareholders (*e.g.*, through press releases or website postings) to vote against a proposai or "withhold" their votes for certain or all of a company's nominees for director.

thresholds ranging from the $2,000 threshold required to submit an Exchange Act Rule 14a-8 proposal to substantial share ownership percentages (*e.g.*, from 3% to 10% or more) of a company's outstanding common stock. Those who advocate no threshold or a nominal dollar amount argue that the imposition of a threshold would unfairly advantage larger shareholders who already may have the resources to run their own slates using the existing rules for contested elections. Those who advocate a larger share ownership threshold contend that, to use company funds to nominate a candidate, a nominating shareholder should have a substantial stake in the company. In addition, advocates of a larger share ownership threshold point out that the composition of the board of directors is critical to a corporation's functions and, accordingly, shareholders should have to satisfy a substantial threshold in order to use any new shareholder access rule.

The eligibility thresholds recommended most frequently were 3% and 5%. For example, the Council of Institutional Investors, which has expressed its support for shareholder access to company proxy materials, advocated that "a long-term investor or group of long-term investors owning in aggregate at least 5% of a company's voting stock" should have access to company proxy materials to nominate "less than a majority of the directors," The CII expressed the position that nominating shareholders must have owned their stock for "at least three years" and company proxy materials and related mailings should provide "equal space and equal treatment" of shareholder nominees. The AFL-CIO, another supporter of shareholder access to company proxy materials, has recommended that the Commission adopt new rules granting shareholder access to those who have held a minimum of 3% of the company's shares, where a majority of those shares have been held for more than one year. Under this recommendation, nominating shareholders could nominate the greater of two directors or one-third of the nominees standing for election at a particular meeting, but in no case a majority of the board.

The determination of the appropriate eligibility threshold for share ownership will affect not only who may use the rule, but also the reporting requirements to which nominating shareholders may be subject. For example, a share ownership eligibility threshold of 5% or greater raises the issue of subjecting a nominating shareholder group to the beneficial ownership reporting requirements of Exchange Act Section 13(d) or Exchange Act Section 13(g).[23] Thus, some may argue that a benefit of establishing an eligibility requirement of less than 5% would be that nominating shareholders or shareholder groups will not necessarily become subject to the disclosure obligation imposed by Exchange Act Schedule 13D or Exchange Act Schedule 13G. On the other hand, there may be more benefit in establishing a threshold percentage that would trigger the beneficial ownership reporting requirements to ensure that nominating shareholders or shareholder groups provide notice of their intentions in the form of a beneficial ownership report filed electronically with the Commission. In addition, a possibility with regard to the shareholder nomination alternative is to create a new "passive investor" category of filer who could nominate a director and still use the short-form Exchange Act Schedule 13G, provided that the filer could certify that he or she did not acquire or hold the securities with a control purpose or effect and could also confirm that he or she (or the nominating shareholder group to which he or she belongs) had held the subject securities for the minimum holding period specified under a

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23 Any shareholder who acquires, directly or indirectly, beneficial ownership of greater than 5% of an equity security registered under Exchange Act Section 12 must report such ownership on Exchange Act Schedule 13D or, if eligible, on Exchange Act Schedule 13G. *See* Exchange Act Rule 13d-1.

shareholder access rule. This certification of non-control intent and eligibility for shareholder access could provide additional certainty that shareholder access was being used for the **intended** purpose and not to facilitate a surreptitious contest for control.

For shareholder groups with holdings of 10% or more, **an** additional consideration is Exchange **Act** Section 16, which provides, among other things, that a director or officer of a company with a class of equity securities registered under Exchange Act Section 12, or a shareholder who beneficially owns more than 10% of such a class of equity securities, must report the amount of securities owned and **any** changes in such ownership. Because the rules under Exchange Act Section 16 define beneficial ownership for purposes of determining who **is** a 10% owner by reference to the definition under Exchange Act Section 13(d), a shareholder who is a member of a "group" will be deemed to own beneficially the securities **owned** by the other members of the group. Accordingly, a shareholder who is not otherwise subject to Exchange **Act** Section 16, but who joins a nominating shareholder **group** that holds, in the aggregate, greater than 10% of **a** company's equity securities, may be viewed as owning the aggregate amount and, therefore, be subject to Exchange Act Section **16.** Although Exchange Act Rule 16a-1**(a)(**1) provides that specified institutional investors who hold for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business shall not be deemed beneficial owners of the securities for Exchange Act Section 16 reporting **purposes,** there is no similar exception for passive investors who do not also fit within one of the institutional investor categories listed in Exchange Act Rule 16a-1(a)(1). Therefore, any 10% or greater eligibility requirement for nominating shareholder groups may trigger additional reporting requirements by the members of the nominating shareholder group, as well as possible short-swing profit liability under Exchange Act Section 16(b) and the short sale prohibitions in Exchange Act Section 16(c).

Another consideration in evaluating any eligibility threshold greater than 10% is the operation of shareholder rights plans (poison pills) under state law, which frequently are triggered by beneficial ownership of 15% or greater. Thus, if nominating shareholders or shareholder groups beneficially own 15% or more of a company's shares, nominating shareholders may trigger applicable poison pill provisions under state law.[24]

In considering rules mandating shareholder access to company proxy materials regarding the nomination and election *of* directors and how best to structure those rules, the Commission will need to consider the scope of its authority under the federal securities laws. In this regard, several commenters raised questions about the Commission's authority to adopt such rules. The Commission historically has been found to have significant authority to adopt rules in the **proxy** area, and that **authority** has been found to extend beyond mere disclosure. However,

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[24] **Other, more general effects of any shareholder** access **rule may include changes in companies' policies with respect to the election of directors. In the Commission's 1977 request for comments in connection with its review of shareholder communications, shareholder participation in the corporate electoral process, and corporate governance, commenters asserted that granting shareholders enhanced access to the proxy would be effective only if bundled with cumulative voting for and/or the annual election of directors. An indirect effect of implementing the enhanced shareholder access alternative could be that companies would adopt corporate governance policies to insulate incumbent board members. Companies also may attempt** *to* **avoid use of a shareholder nomination procedure by limiting shareholder nominations** *to* **the extent allowed under state or federal law.**

Commission **authority** in this area is not unlimited, as indicated by some court decisions taking a more narrow view of the Commission's authority. The Division believes that Exchange **Act** Section 14 provides an appropriate basis for Commission authority to provide for a properly crafted rule in this area. A detailed analysis of authority issues will depend on the contours of an actual rule proposal.

Advantages and Disadvantages

Much of the public input that we have received suggests that shareholder access to a company's proxy materials would be the most direct and effective method of giving shareholders a meaningful role in the nomination and election process. This input also suggests that another result would be to make corporate boards more responsive and accountable to shareholders, as well as, in many instances, more diverse. This alternative has been advocated on a number of occasions over the last 60 years and would certainly give shareholders **a** new and more cost-effective **way** to effect change in the management of their companies. **As** it stands today, shareholders generally are given an opportunity to vote only on those candidates nominated by the company. In addition, many companies use plurality rather than majority voting for board elections, which means that candidates can be elected regardless of whether they receive more **than** 50% of the shareholder vote.[25] Accordingly, all board nominees generally are elected, regardless of the number of "withhold" votes by shareholders. Many shareholders, therefore, view the proxy process as ineffective and the election of directors as **a** mere formality or "rubber stamping" of the board's choices.

Currently, **a** shareholder or group of shareholders that is dissatisfied with the leadership of a company must undertake a proxy contest, at its own expense, to put nominees before the shareholders for **a** vote. **A** board's nominees, on the other hand, do not bear the cost of their candidacies, which are funded out of corporate assets. While shareholders can recommend **a** candidate to a company's nominating committee, shareholder comments suggest that this rarely is effective and that, in some cases, it may be difficult for shareholders to gain access to members of company boards and their committees.

On the other hand, the business community and many of its legal advisors commented that giving shareholders access to company **proxy** materials could turn every election of directors into a contest, which would be costly and disruptive to companies and could discourage some qualified board candidates from agreeing to appear on a company's slate. Because the composition of the board of directors is fundamental to a company's corporate governance, the current filing and disclosure requirements applicable to shareholders who wish to propose an alternate slate are, in the view of these commenters, more appropriate than the shareholder access alternative. Also, shareholder nominees who are elected to the board could alter the dynamics of the board and cause **the** board to become fragmented and less efficient. In particular, corporate commenters **have** posited that a shareholder access rule would result in "special interest" board members who represent particular causes rather than the interests of the company and its

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[25] **Under plurality voting, the candidate with the greatest number** of **votes is elected; therefore,** in **an** election **in which** there **are the same number** of **nominees as there are board positions open, all nominees will be elected.**

shareholders overall. Finally, while nominating committee members have a fiduciary duty to act in the company's best interest, commenters noted that nominating shareholders would not have this same duty. Accordingly, it is argued that candidates advanced by a nominating shareholder may not be as qualified to serve on a board as a company nominee. Although this concern may be mitigated if a shareholder access rule were drafted to require all shareholder nominees to be screened through the board's nominating committee, such a provision could create additional problems of its own, *e.g.*, nominating committees may not want to take on the duties and any attendant liabilities associated with recommending a shareholder's nominee. In any event, it likely would be difficult to ensure that the same screening criteria are applied to management and shareholder nominees, and shareholders may view the screening process as a deterrent to nominating candidates.

A shareholder access proposal could require that shareholder nominees meet applicable independence requirements from companies. The proposal also could impose limitations on relationships between nominating shareholders and their nominees, as well as disclosure requirements regarding nominee interests. These types of requirements could narrow the potential pool of persons who could be nominated by shareholders, but they would also, at least in part, address some of the concerns regarding nominees who would represent the interests of particular shareholders or be "single-issue" directors.

Refinements to a shareholder access proposal could affect the balance of advantages and disadvantages in important ways. For example, requiring triggering events to occur before allowing enhanced shareholder access to the proxy process would be expected to significantly restrict the number of companies where access is available. It would also, therefore, be expected to limit the number of companies subject to the perceived risks of frequent proxy contests, chilling effects on board nominees, and altered board dynamics. While it would restrict access, access based on triggering events would limit the proposal to only those companies where specified criteria may suggest that the proxy process has otherwise not permitted adequate or effective access for shareholders in the past.

Potential Questions for Public Comment

1. Would adoption of modified proxy rules to give shareholders the ability to place shareholder nominees in a company's proxy materials conflict with state law, *e.g.*, state law requirements applicable to the expenditure of corporate assets or nominating procedures?

2. Should any new rule require a triggering event to occur before shareholders would be able to use the shareholder nomination process? If so, what events should trigger the access? Should there be a time limit on the access? If so, how long after a triggering event should shareholders be able to use the nomination process, (*e.g.*, two years, three years)? How should shareholders be notified that a triggering event has occurred?

3. What, if any, eligibility requirements should the Commission impose on nominating shareholders? For example, should nominating shareholders be required to beneficially own a specified dollar amount or percentage of company securities, *e.g.*, 3% of voting securities, in order to place a nominee on the company's proxy card? Should this

percentage be higher or lower (*e.g.*, 1%, 5%, 10%)? Should nominating shareholders be required to have held their shares continuously for a minimum period of time? If so, what is the appropriate length of time, (*e.g.*, one year, two years, three years)?

4. Should shareholders be permitted to aggregate their holdings in order to meet any ownership eligibility requirement to nominate directors? If so, must all members of a nominating shareholder group individually satisfy the minimum holding period?

5. Should all or any of the proxy rules apply to soliciting activities by shareholders attempting to form a nominating shareholder group? If so, what rules? For example, should this type of soliciting activity be exempted from the proxy rules, subject to limitations on the number of shareholders solicited and/or the content of the soliciting materials?

6. In order to avoid the use of a shareholder nomination procedure in contests for corporate control, should there be a limit on the number of directors or the percentage of the board that shareholders may nominate? Should there be a limit on the number of shareholder-nominated directors that could hold office at any given time? If so, what limitations are appropriate? Would such a limitation conflict with state law? Should there be other requirements to ensure the "non-control" purpose of those using a procedure of this type?

7. What independence standards should apply to shareholder nominees? Should they be independent of the company? If so, under what independence standard? Should nominating shareholders be required to establish the nominee's independence, *e.g.*, by certifying to the company that the nominee is independent? Should shareholder nominees be independent of nominating shareholders? If so, under what independence standard?

8. Should nominating shareholders be independent of the company? If so, under what independence standard?

9. Should there be required qualifications for shareholder nominees? If so, should shareholder nominees be screened by the company's nominating committee? Should the nominating committee be able to reject shareholder nominees based on objective criteria related to the nominee's qualifications?

10. Is there a risk that companies will form "fnendly" nominating groups to ensure that a candidate of the company's choice is nominated through any new shareholder access rule? If so, should the Commission adopt rules to address this possibility? For example, should a nominating shareholder be required to confirm that it is acting solely on its own behalf and not that of the company? Should the company be required to disclose any communications between board members and nominating shareholders?

11. Should companies be exempted from a shareholder nomination procedure for any election of directors in which another party commences, or evidences its intent to commence, a solicitation in opposition as defined in Exchange Act Rule 14a-12(c)? If so,

should the period in which shareholders may use the nomination process be extended to the **next** year (assuming **a** time limitation)?

12. What requirements should **apply** to soliciting activities conducted by nominating shareholders? For example, what filing requirements and specific parameters should apply to any such solicitations? Should all soliciting materials be filed with the Commission on the date of first **use?**

13. Should all soliciting activities be limited to one or more designated websites? If so, who should **pay** for the websites?

14. What shareholder nominee and/or nominating shareholder disclosure, if any, should be included in company **proxy** materials and/or be made available on a designated website? For example, should nominating shareholders be required to provide biographical information about the nominee? Should nominating shareholders be required ***to*** provide "participant" disclosure similar to that required in a traditional election contest?[26] Should nominating shareholders be entitled to space in **a** company's proxy materials to campaign for the shareholder nominee? If so, should there be a word limit on the nominating shareholder's disclosure? What would **be** an appropriate word limit?

15. Should nominating shareholders, including groups, be deemed to have a "control" purpose that would create additional filing **and** disclosure requirements under Exchange Act Section 13(d)?

16. Would Exchange Act Section 16 reporting and short-swing profit liability deter the formation of nominating shareholder groups with greater than 10% beneficial ownership? If so, should nominating shareholder groups be exempted from reporting under Exchange Act Section 16(a)?

17. Should the Commission create a safe harbor that provides that nominating shareholders will not be deemed "affiliates" of the company solely **as a** result of using a shareholder nomination **procedure?**

18. What would be **the** cost to companies if the Commission adopted **proxy** rules giving shareholders access to companies' proxy materials to nominate directors? Who should bear that cost?

19. What direct or indirect effect would enhanced shareholder access have on companies' policies relating to the election of directors? For example, will companies be more or less likely to **adopt** cumulative voting policies and/or elect directors annually?

20. What impact would **this** alternative have on small businesses? Would this alternative

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[26] **For example, a participant, as defined in Instruction 3 to Item 4(b) of Schedule 14A, must describe any substantial interest in the matter to be acted on at the meeting and disclose his or her name, business address and occupation.** ***See*** **Item 5(b) of Schedule 14A.**

have a disproportionate impact on small businesses as compared to other public companies?

21. Would shareholders without access to electronic media be disadvantaged in making their voting decisions by having certain information available only on a website? **Would** this represent a significant change from current requirements?

22. Do large and small shareholders share the same interests? If not, how do they differ and how would each be served under a shareholder access rule?

23. Is a shareholder access rule consistent with Congressional intent regarding Exchange **Act** Section 14(a)?

B. Alternative B – Require Companies to Deliver Nominating Shareholders' Proxy Cards with Company Proxy Materials

A variation on the above alternative has been noted by the individual members of the ABA's Task Force on Shareholder Proposals. Under this variation, the Commission could propose new rules requiring companies to include a nominating shareholder's proxy card along with the company's proxy materials and proxy card. Similar to the shareholder access alternative discussed above, as Alternative **A,** this alternative could be limited to situations where a triggering event has occurred. **A** company would be required to note briefly in its proxy materials that a shareholder or shareholder group had nominated a candidate to the board of directors, that the shareholder's proxy card is included in the company's mailing, and that additional disclosure about the shareholder nominee may be found on a specified website. **Any** disclosure related to nominating shareholders and shareholder nominees, in addition to any campaigning for shareholder nominees, would appear on nominating shareholders' websites and would be filed electronically with the Commission. Similarly, a company's soliciting materials could be required to appear on the company's website. **As** with communications under the enhanced shareholder access alternative, all disclosure and communications would be subject to the prohibition against false and misleading statements in Exchange Act Rule 14a-9.

This alternative differs from the enhanced shareholder access alternative discussed above, in that it would not result in shareholder nominees appearing in the company's proxy materials. Instead, a company would absorb the cost of mailing a nominating shareholder's proxy card.[27] Because this alternative would involve the mailing of both a company and a shareholder proxy card, rather than one company card that includes shareholder nominees, this alternative would be equivalent to running a "short slate" (nominating fewer candidates than there are available board seats) without the disclosure and filing requirements associated with a traditional proxy contest.

Another potential difference between this alternative and the enhanced shareholder access

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[27] **Note that, under Exchange Act** Rule **14a-7, a company currently may decide to mail a shareholder's proxy materials rather than provide** the **shareholder with its shareholder list; however, under** the **current rules, a company mails the shareholder's proxy materials separately** from **the company materials, at the shareholder'sexpense.**

alternative relates to disclosure by nominating shareholders. Currently, no person engaged in a solicitation may deliver a proxy card to a shareholder unless the shareholder is concurrently given, or has previously received, a definitive proxy statement." Under this alternative, a company would mail a nominating shareholder's proxy card, but shareholders would not concurrently receive proxy statement disclosure about the shareholder nominee. Any new rule would, therefore, need to allow a means to provide shareholders with the disclosure required to make an informed voting decision between board nominees and shareholder nominees. As noted above, one possibility would be to allow shareholders to provide all biographical and other appropriate information about their nominees on a designated website.

Advantages and Disadvantages

As with the enhanced shareholder access alternative, this alternative would decrease substantially the cost for shareholders to nominate a candidate to the board of directors, in that a nominating shareholder would not be required to print and mail a full proxy statement satisfying the requirements of Exchange Act Schedule 14A. Instead, a company would incur the mailing cost of distributing the nominating shareholder's proxy card and the nominating shareholder could place all required disclosure and other communications on a website. In addition, if all shareholder nominee disclosure appeared outside the proxy statement, companies would avoid the printing and mailing costs of expanding the proxy statement to include this disclosure. Also, a separate proxy card may mitigate any state law concerns related to a shareholder's right to nominate directors by imposing a mailing requirement on the company rather than a requirement that a company give shareholders access to the company's proxy materials.

On the other hand, this alternative could be viewed as a substantial departure from our current requirement that specified disclosure be included with, or precede, the delivery of a proxy card to Shareholders. In addition, this option has many of the same potential disadvantages raised in the comments with regard to an enhanced shareholder access proposal, including the possibility that the new rule could turn every election of directors into a contest, thus disrupting a company's operations, requiring substantial expenditures of corporate funds, discouraging qualified nominees from agreeing to run for election, and fragmenting boards. As discussed with regard to the enhanced shareholder access alternative, however, the use of triggering events would address, at least in part, some of the more serious disadvantages perceived by the corporate community.

Potential Questions for Public Comment

With a few exceptions, most of the questions applicable to an enhanced shareholder access proposal would also be relevant to this alternative. The following additional questions may also be appropriate:

1. Should all soliciting activities and/or disclosure be limited to one or more designated websites? If so, who should pay for the websites? Is a designated website an adequate

[28] *See* Exchange Act Rule 14a-4(f).

means to provide shareholders with required disclosure? Why or why not? For example, would shareholders without Internet access be disadvantaged?

2. Should disclosure relating to shareholder nominees and nominating shareholders be provided on a website in advance of, or simultaneously with, a company's mailing of a nominating shareholder's proxy card? If not, what effect would this have on shareholders' ability to make informed voting decisions? If so, how should shareholders be made aware that such information is available on a website? For example, should shareholders receive notice through a company's proxy statement alone or should the nominating shareholder be required to provide separate notice? If a nominating shareholder is required to provide such notice, when should the notice be provided and by what means, (*e.g.*, in a press release)?

3. What would be the cost savings to companies and shareholders of this alternative as compared to an enhanced shareholder access proposal?

4, Should a nominating shareholder pay the additional costs to the company for printing and mailing an additional proxy card?

C. Alternative C - Nominating Committee Disclosure

Another alternative that would provide shareholders with increased information and access to the nomination process would be to require expanded disclosure in company proxy statements regarding a company's nominating committee and the nominating process. This could be in addition to possible changes to the markets' listing standards to require nominating committees to consider shareholder nominees. While companies currently are required to disclose whether they have a nominating committee and, if so, whether the nominating committee considers shareholder nominees, the Commission could expand this disclosure requirement to require the committee to report on how many nominees were submitted by shareholders (or by shareholders meeting certain qualifications) for the current election and, for any such nominees who are not included on the company's proxy card, a report on the committee's reasons for not nominating those candidates. The Commission also could propose rules requiring companies to disclose to shareholders infomation that would make the nomination process more accessible and understandable, such as a description of the qualifications the company looks for in director nominees, its process for developing and considering nominees, and how the board initially became aware of, or associated with, each of its nominees.

As described below, both the New York Stock Exchange and the Nasdaq Stock Market have proposed revised listing standards that would require listed companies to have independent nominating committees; however, they have not proposed any changes that would require nominating committees to consider shareholder nominees. Accordingly, to effectuate this alternative using a means other than Commission disclosure rules that are based on the beneficial impacts of transparency, markets would need to add such a requirement to their listing standards,

Background

The current disclosure requirement related to nominating committees was proposed and adopted in connection with the Commission's 1977 review of the proxy rules.[29] In addition to soliciting comment on shareholder access to company proxy materials, the Commission requested comment on whether more disclosure requirements related to the nomination process and nominating committees would be appropriate.[30]

The Commission put forth a series of questions relating to nominating committee disclosure in preparation for the 1977 public hearings. As is the case now, some commenters favored increased shareholder access to the nominating committee and increased disclosure relating to the actions taken by the nominating committee rather than direct shareholder access to a company's proxy statement.[31] In particular, commenters recommended that the nominating committee be required to consider shareholder nominees, that outside directors comprise all or a majority of nominating committees,[32] and that shareholders be advised of "the existence and purpose of such committee and its standards for director qualifications."[33] Other recommendations were that shareholders be encouraged to suggest nominees to the committee and that nominating shareholders be iven adequate notice in order to undertake an election contest if the nominee were rejected! In addition, some commenters thought that the nominating committee should issue a report to shareholders concerning its determinations.[35] Advocates of the nominating committee alternative emphasized that this approach would limit conflict and enable the committee to ensure that the proxy statement included a limited number of shareholder nominees.[36] They also asserted that the committee was better equipped than shareholders to ensure that the nominees were qualified.[37] These alternatives, as well as the arguments for them, are very similar to those advanced by representatives of the business community and legal community who have provided their views in the course of the current review.

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29 See Release Nos. 34-14970 (July 18, 1978) and 34-15384 (December 6, 1978). The nominating committee disclosure currently is required under Item 7 of Schedule 14A.

30 *See* Release Nos. 34-13482 (April 28, 1977) and 34-13901 (August 29, 1977).

31 *See Staff Report on Corporate Accountability, supra* note 10, at A53-57

32 *See* Re-Examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Summary of Comments (1978), at 65.

33 *Staff Report on Corporate Accountability, supra* note 10, at A54.

34 *See* Summary of Comments, *supra* note 32, at 65.

35 *id*

36 *See* Summary of Comments, *supra* note 32, at *65; Staff Report on Corporate Accountability, supra* note 10, at A55-56.

37 *Id.*

Commenters favoring disclosure in **1977** thought that it would encourage shareholders to contact nominating committee members with their recommendations; however, the 1977 cornenters were less supportive of disclosure relating to the nominee selection process. the criteria to be applied by the nominating **committee** in selecting nominees, and the required qualifications of nominees.[38] Those who did **not** support expanded nominating committee disclosure stated their concern that companies would merely make "self-serving 'boilerplate"' disclosures.[39] This concern, in particular, has been repeated **by** some of the commenters who have provided their views in the course of the current review. The general sentiment of these commenters seems to **be** that, though increased disclosure might be helpful if it were not merely boilerplate, it would not be sufficient on its own to adequately provide shareholders with a meaningful role in the proxy process relating to the nomination and election of directors, at **least** where the process was otherwise inadequate in reflecting shareholder input.

When it proposed amendments to the **proxy** rules to include the current disclosure requirements related to nominating committees, the Commission stated generally its belief that the new disclosure requirements would facilitate improved accountability.[40] Specifically, the Commission stated that:

> … information relating to nominating committees would be important to shareholders because a nominating committee can, over time, have **a** significant impact on the composition of the board and also can improve the director selection process by increasing the range of candidates under consideration **and** intensifying the scrutiny given to their qualifications. Additionally, the Commission believes that the institution of nominating committees can represent a significant step in increasing shareholder participation in the corporate electoral process, **a** subject which the Commission will consider further in connection with its continuing proxy rule re-examination.[41]

Although the Commission received positive feedback on its proposed nominating committee disclosure requirements, some commenters argued that the disclosure was designed to encourage companies to establish nominating committees rather than to provide useful disclosure to shareholders.[42] The Commission noted this concern, but adopted disclosure requirements related

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38 *See* **Summary of Comments, supra note 32, at 75**

39 ***Id.***

40 **See Release No. 34-14970 (July 18, 1978).**

41 *Id.*

42 *See* **Release No. 34-15384 (December 6, 1978). In particular, cornenters argued that the requirement that companies disclose "whether" they had nominating committees was inappropriately designed to encourage the formation of such committees. Conversely, commenters in 1977 expressed support for such a requirement. See Summary of Comments, supra note 32, at 74.**

to nominating committees substantially as proposed.[43]

In light of the fact that nominating committee disclosure was advanced as, and ultimately adopted as, an alternative to shareholder access to a company's proxy statement in 1978, some likely will argue that any attempt now to facilitate shareholder access to the nomination and election process through nominating committee disclosure will not be any more effective than the existing disclosure has been in facilitating shareholder nominations.[44] At a minimum. any new disclosure requirements would need to strengthen substantially those adopted in 1978. As noted above, possible new listing standards requiring nominating committees to fully consider all qualified shareholder nominees could bolster the effectiveness of this alternative.

Disclosure

The current proxy statement disclosure about whether a company has a nominating committee and will consider shareholder nominees could be expanded to require a discussion of

- where a company does not have a nominating or similar committee, why the board of directors believes that it is in the best interest of the company not to have such a committee;
- the nominating committee charter, if any;[45]
- nominating committee member independence;
- the criteria used by the nominating committee to screen nominee candidates, including shareholder recommendations;
- the nominating committee's policy with regard to the consideration of shareholder recommendations;
- the qualifications the nominating committee beiieves company directors, or a given director, should have;
- the nominating committee's process for developing and considering nominees;
- the source of each of the board's nominees, including the use of third-parties to identify potential nominees;

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43 *See* Release No. 34-15384 (December 6, 1978).

44 See, *e.g.*, AFSCME, in which AFSCME contends that "[e]vents that have transpired since the 1977-78 rulemaking . . . demonstrate that reliance on disclosure and nominating committees – whose members, while meeting the legal standard necessary to be considered independent, are nominated by incumbent directors – has not remedied the passivity common to corporate boards."

45 Companies also could be required to make available to shareholders a copy of the nominating committee charter, if any.

- the process by which shareholders can recommend a nominee; and

- if the nominating committee receives **a** recommended nominee from **a** shareholder who **has** beneficially owned a specified amount (*e.g.*, 1%) of the company's voting common stock for a specified period (*e.g.*, at least one year) and the nominating committee chooses not to nominate that candidate:

  - who recommended the candidate;

  - why the nominating committee did not include the candidate **as** a nominee; and

  - whether each member of the nominating committee believes that it was in the **company's** best interest not to nominate the candidate and, to the extent members **of** the nominating committee do not have such belief, why the candidate was not included as a nominee.

*NYSE **and** Nasdaq **Proposed** Rule Changes*

On April **11,2003** the Commission published a notice for comment regarding proposed rule changes submitted by the NYSE.[46] In the commentary on its proposed rule change, the NYSE describes nominations as "among the board's most important functions."[47] The NYSE proposes to amend its listing standards in an effort to help restore investor confidence by addressing director independence and strengthening corporate governance practices. One of the features of the proposed rule changes **is** the requirement that listed companies have **a** "nominating/corporate governance committee composed entirely of independent directors."[48] The proposed rule provides that these committees have **a** written charter that addresses:

- the committee's purpose – which, at a minimum, must be to: identify individuals qualified to become board members and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board **a** set of corporate governance principles applicable to the corporation;

- the committee's goals and responsibilities – which must reflect, at a minimum, the board's criteria for selecting new directors and oversight of the **evaluation** of the board and management; and

- an annual performance evaluation of the committee.[49]

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46 *See* **Release No. 34-47672 (April 11,2003).**

47 *Id.*

48 ***Id.***

49 *Id.*

The Nasdaq Stock Market also has submitted a proposed rule change, which was published for comment by the Commission on March 17, 2003.[50] Although the proposed changes to the Nasdaq listing requirements also address director independence and nominating committee standards, they do not include a requirement that the nominating committee have a charter. Nasdaq's proposal would require, with certain exceptions, that either a majority of independent directors or a nominating committee comprised solely of independent directors nominate directors.'[51]

These proposed rule changes demonstrate the current focus on the importance of the nominating process and the nominating committee. In addition, they represent a substantial difference from 1978, when the Commission proposed and adopted the current disclosure requirements for nominating committees. As the *summary* of comments relating to the 1978 proposals demonstrates, much of the input received from commenters and participants in the 1977 hearings focused on the need for outside directors on the nominating committees. The combination of independence standards and, in the case of the NYSE, the charter requirement, represent a strengthening of the nominating committee that may well support the efficacy of the nominating committee disclosure alternative. The proposed rule changes do not, however, require that candidates recommended by shareholders be considered.

Advantages and Disadvantages

An advantage to this alternative is that it could serve as a vehicle for shareholders to influence board composition without requiring extensive changes to the proxy rules or implicating state law issues surrounding the nomination and election of directors. As is noted frequently by members of the business community from whom we have received input, this option could provide shareholders with access to the board and to the nomination process without involving contested board seats. On the other hand, this option would not ensure that shareholder recommended candidates are included in the company's proxy materials, and commenters raise the concern that some companies may include boilerplate disclosure in their

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50 See Release No. 34-47516 (March 17, 2003).

51 Under the proposed Nasdaq listing standard, nominating committees of three or more directors may include one director who is not independent, provided that he or she is not a current officer, employee or family member of a current officer or employee, and "exceptional and limited circumstances" cause that individual's membership to be in the best interests of the company and its shareholders. In this case, the board would have to include disclosure in the next annual meeting proxy statement describing the nature of the relationship that causes the director not to be independent and the reasons for the "best interests" determination. Such members could serve for no more than two years. A second exception would allow a director to serve who owns 20% or more of the company's common stock or voting power, who is not independent by virtue of his or her position as an officer, if the board determines that the individual's membership on the nominating committee is in the best interests of the company and its shareholders. The board would have to disclose the nature of the director's relationship and the reasons for including that individual on the nominating committee. Finally, those companies that meet the definition of a "controlled company," would be exempt from the requirements related to director independence, including the nominating committee requirements. A "controlled company" is a company of which more than 50% of the voting power is held by an individual, a group or another company. These companies would have to disclose in their annual meeting proxy statements that they are controlled companies. Id.

proxy statements to satisfy any expanded disclosure requirements. Some undoubtedly will argue that this alternative to shareholder access has been tried and, over the past 25 years. has not led to a change in the ability of shareholders to have their candidates nominated, though this position would not take into account the proposed new listing standards and other changes that have occurred since 1978.

*Potential **Questions for Public** Comment*

1. Would increased disclosure related to the nominating committee and its policies and criteria for considering nominees be an effective means to improve shareholder involvement in the nomination process, board accountability, board responsiveness, and corporate governance policies?

2. If so, what disclosure would be most useful? For example, should a company disclose how many shareholder recommendations it considered, what criteria it applied to shareholder recornmendations, and why it rejected any shareholder recommendations? If so, would this type of disclosure raise privacy issues for rejected candidates, even if the candidates are not specifically named in the company's disclosure?

3. Do most corporations currently consider shareholder recommended candidates to the board? If so, do these corporations apply the same criteria to shareholder recommendations as to company nominees?

4. Would it be helpful if the markets amended their listing standards to require nominating committees to consider shareholder recommendations? Since not all companies would be subject to any listing requirements that require companies to consider shareholder recommendations, is this an appropriate result for those companies who are not listed?

5. Would this alternative be a less costly means to address issues of board accountability, board responsiveness, and corporate governance than an enhanced shareholder access proposal?

D. Alternative D – Disclosure Regarding Shareholder Communications With the Board

Similar *to* the nominating committee disclosure alternative, another alternative would be for the Commission to propose that companies be required to disclose what process, if any, companies have in place for Shareholders to communicate directly with board members. If the company has no such process, it would need to disclose this fact and the reason(s) it has no such process in place. As with the nominating committee disclosure, the impact of the disclosure would be more effective if coupled with a change in market listing standards. The NYSE's proposed listing standard amendments would require a means for shareholders to communicate directly with independent directors, as discussed in more detail below.[52]

[52] *See* Release No. 34-47672 (April 11,2003).

The Commission did not specifically consider this alternative in its 1942, 1977 or 1992 reviews of the proxy rules. Representatives from the business community have suggested that an alternative to an enhanced sharehoider access proposal would be to disclose current processes that companies have in place to provide shareholder access to board members, as well as to further expand and explore changes to listing requirements.

Shareholders have demonstrated ongoing interest in meeting with board members over the past proxy season. For example, two pension funds submitted proposals seeking greater shareholder access to corporate boards. The AFSCME Employees Pension Plan submitted a shareholder proposal to The Kroger Co. to amend Kroger's bylaws to provide for the creation of a shareholder committee to communicate with the board regarding sharehoider proposals under Exchange Act Rule 14a-8 that were approved but not adopted.[53] Several New York City pension funds[54] submitted shareholder proposals to Advanced Fibre Communications, Inc. and PeopleSoft, Inc. requesting that these Nasdaq-listed companies establish an "Office of the Board of Directors" to facilitate communications between non-management directors and shareholders, including meetings, based on the proposed NYSE standard?

Although Exchange Act Rule 14a-8 already creates a mechanism for shareholders to seek further access to the board, investors and investor advocacy groups have indicated that a change through listing standards would be more effective by allowing shareholders to communicate with board members about issues that may be significant but that constitute "ordinary business." Shareholder proposals, amendments to listing standards, and required disclosure relating to board communications would strengthen further the effectiveness of this alternative. There also has been some explicit and implicit suggestion that improved communications between shareholders and boards, and structural encouragement of those communications would lessen the need for more intrusive measures, such as reforms to the proxy process.

Disclosure

If the Commission chooses to propose disclosure requirements related to communications between shareholders and boards, the disclosure could address:

- whether or not the company provides a process for shareholders to send

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53 *The Kroger Co.* (April 11,2003). The Division did not grant a no-action position to Kroger regarding exclusion of the proposal under the ordinary business exclusion, as the proposal limited the nature of the communications to other than ordinary business matters.

54 The New York City Employees' Retirement System, the New York City Teachers' Retirement System, the New York City Police Pension Fund, and the New York City Fire Department Pension Fund submitted the proposals.

55 *Advanced Fibre Communications, Inc.* (March 10,2003); *PeopleSoft, Inc.* (March 14,2003). The Division granted a no-action position to PeopleSoft and Advanced Fibre regarding exclusion of the proposals under the ordinary business exclusion, as the proposals did not limit the nature of the communications to other than ordinary business matters.

communications to the board of directors;

- if the company does not have a process for shareholders to send communications to the board of directors, why the company does not have such a process and why the board of directors believes that it is in the best interest of the company not to have such a process;
- the manner in which shareholders can send communications to the board;
- identification of those board members to whom shareholders can send communications;
- if all shareholder communications are not sent directly to board members, the company's process for determining which communications must be relayed to board members;
- the number of times individual board members met with shareholders in the prior year; and
- any action taken by the board as a result of the communications.

*NYSE **Proposed Rule** Change*

As with the nominating committee disclosure, this alternative would be more effective if the markets amended their listing requirements to mandate a process to allow shareholders to communicate with board members. The NYSE's proposed changes to its listing standards address briefly the issue of greater access to the board.[56] Specifically, proposed Section 303A(3) states, "In order that interested parties may be able to make their concerns known to non-management directors, a company must disclose a method for such parties to communicate directly and confidentially with the presiding director or with non-management directors as a group."[57] Under the NYSE's proposal, that method could include shareholder communications and be analogous to any process established for communications with the audit committee required by Section 303A(7)(c)(ii), which states that the audit committee must "establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidentiai, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters."[58]

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[56] *See* **Release No. 3447672** (April 11,2003).

[57] *Id.*

[58] *Id.*

Advantages and Disadvantages

Representatives of the business community contend that an advantage of this alternative is that it may address issues of accountability and responsiveness without imposing the disruption and costs associated with the enhanced shareholder access alternative. In particular, they assert that the current proposed listing standards, Sarbanes-Oxley reforms, and the increasing popularity of, and responsiveness by companies to, shareholder proposals will resolve many of these issues.

Although investors and investor advocacy groups believe that this alternative would be helpful, they contend that it would not fully address any problems with boards' lack of accountability and responsiveness to shareholders. In particular, they note that larger minority shareholders already can meet with board members in many public companies and that this has not served to effectively change board behavior. Further, the existence of a process for shareholders to communicate with board members does not ensure that the board members will be responsive to shareholder concerns. Representatives of the business community also have indicated that the greater the number of communications with board members, the less likely it is that a board member may be responsive to a particular communication. Moreover, an intermediary may be necessary to screen voluminous communications.

Because not all companies would be subject to listing requirements that require companies to provide a means for shareholder communication with board members, the Commission would need to consider this alternative's lack of impact on unlisted companies. This could be a significant issue, as some groups contend that issues of accountability and responsiveness can be more problematic with smaller companies.

Potential Questions for Public Comment

1. Would increased disclosure relating to shareholder communications with board members be an effective means to improve board accountability, board responsiveness, and corporate governance policies?

2. If so, what disclosure would be most useful? For example, should companies disclose the specific policies in place with regard to shareholder communications with board members, how the communications are screened, and how the communications are relayed to board members?

3. Do corporations currently provide a means for allowing shareholders to communicate with board members? How effective have these methods been in improving board accountability, board responsiveness, and corporate governance policies?

4. Would it be helpful if the markets expanded upon existing listing standards or adopted new listing standards to allow shareholders to communicate with board members?

5. If so, what type of communications should be available to shareholders? A general e-mail account? The establishment of an office associated with the board of directors? In-person meetings with board members? Should there be any limitation on the type of

communications? Should there be a share ownership eligibility threshold in order to communicate with board members or to have access to a particular means of communication?

6. Should communications with board members that are addressed in disclosure rules or listing standards be limited to independent directors or should the communications extend to the entire board? Should only shareholders be able to communicate with board members or should all interested third parties be able to communicate **with** board members?

7. Because not all companies would be subject to any listing requirements that require shareholders to be able to communicate with board members, is this **an** appropriate result for unlisted companies?

8. Would this alternative be **an** effective and less costly means than an enhanced access proposal to address issues of board accountability, board responsiveness, **and** corporate governance?

E. Alternative E – Revise Exchange Act Rule 14a-8(i)(8)

Exchange Act Rule 14a-8(i)(**8**) allows companies to exclude proposals that "relate[] to an election for membership on the company's board of directors or analogous governing body." **As** evidenced by its determination regarding the AFSCME Employees Pension Plan nomination proposals discussed in Section I, the Division's analysis under Exchange **Act** Rule 14a-8(i)(8) focuses on whether the proposal either directly or indirectly may result in an election contest. If a proposal may have such **a** result, the Division's analysis permits a company to exclude the proposal.

An alternative to an enhanced shareholder access proposal would be to establish a new analysis under existing Exchange Act Rule 14a-8(i)(8) or an amendment *to* Exchange Act Rule 14a-8(i)(8) that wouid allow for inclusion of proposals seeking to establish a process to allow shareholders to access a company's proxy card in a non-control context. Under this framework, state law would require at least many of the proposals to be precatory, leaving the board to decide whether to implement a process to allow shareholders to nominate directors.[59] Exchange Act Rule 14a-8(i)(8) could continue to be a basis for exclusion of certain proposals, such **as** those that nominate a particular person to the board, proposals that **seek** to remove current directors from the board, and proposals that seek to indirectly affect an election of directors by questioning the business judgment, competence and service of a particular board member who is **up** for election.

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[59] **A** shareholder proposal that would mandatorily effect **a change** in the company's bylaws **may** violate **state** law and/or **a company's** governing instruments. ***See,*** *e.g., AOL Time* ***Warner Inc.***, Exhibit **B** **(February 28,2003) (legal** opinion from **Richards,** Layton & Finger regarding the **AFSCME Employees Pension** Ptan proposal submitted to AOL Time **Warner).**

*Impact on **Other Proxy** Rules*

Any change to Exchange Act Rule 14a-8(i)(8) or the Division's analysis of that rule to allow for shareholder proposals seeking access to the proxy card for the purpose of nominations, would have to **be** addressed in other proxy rules. **A** company's adoption of a procedure to allow shareholders to access company proxy materials to nominate directors, either through its own actions based on a precatory proposal or through a mandatory byiaw proposal, would:

- impact many of the same rules as the enhanced shareholder access alternative; and
- require clarification of the application of the requirements governing election contests, **as** defined by Exchange Act **Rule** 14a-12(c), to nominating shareholders.

As noted above, the majority of shareholder proposals under this alternative **likely** would be precatory. In such a case, the board could adopt a proposal that seeks to establish a process to allow shareholders to nominate directors. Because the board would decide whether to implement the process, the nomination of **a** candidate to the board by a shareholder likely should not be viewed as **a** "contest" as defined by Exchange **Act** Rule 14a-12(c). The Commission could take the position that the board's decision to implement a process to allow shareholders to nominate candidates to the board constitutes, in essence, board sanctioning of these nominees and, thus, there would not be a "contest" as defined by Exchange Act Rule 14a-12(c). This also may be analogous to bylaws that allow shareholders to recommend nominees to the board directly or on the floor at an annual meeting.

A mandatory bylaw proposal that forces the board to include shareholder nominees in company proxy materials could raise issues under state law. Further, if a mandatory bylaw proposal to allow shareholders to nominate directors is permitted, the Commission would need to determine whether a mandatory process that allows for shareholder nominees and board nominees on the company's card is **a** "contest" as defined by Exchange Act Rule 14a-12(c). This is a more difficult determination because, unlike precatory proposals, the board would not have discretion in implementing the process. **As** such, it is more difficult to make the argument that any shareholder nominees are sanctioned by the board.

***Advantages** and Disadvantages*

There are several advantages to this alternative. Exchange Act Rule 14a-8 proposals can be drafted individually to reflect the make up of a particular company **as** opposed to a "one size fits all!" access rule that applies to all companies, The exemption in Exchange Act Rule 14a-8 for proposals that would violate state law would eliminate any potential federal law or state law authority issues. Investor groups have questioned the intrinsic fairness of providing only larger minority shareholders (*e.g.*, 3% or 5%) with access to company proxy materials to nominate directors, given that these individuals can best afford the cost of conducting **a** contest **as** defined by Exchange Act Rule 14a-12(c). This alternative would provide shareholders with the flexibility to draft each proposal to establish different thresholds for ownership, length of holding period and other applicabie requirements, on which all of a company's shareholders could then vote.

There are, however, also disadvantages to this alternative. Investor groups supporting an enhanced shareholder access proposal have claimed that the impact on board accountability and responsiveness to shareholder concerns would riot be as significant under this framework. In the case of a precatory proposal, the board would not be required to implement the proposal. In the case of a mandatory bylaw proposal, it is unclear whether companies could avoid implementing this type of proposal by amending their governing instruments to require board approval of shareholder nominees. Further, because each proposal could be drafted differently, this alternative may create a complex structure that does not set clearly a universal standard for interpreting the proxy rules, as each proposal, and its effect, will need to be examined on a company-by-company basis. Finally, the flexibility offered by this proposal brings some disadvantages, as shareholder access could become subject to an array of confusing company-specific rules.

Potential Questions for Public Comment

1. Would revising Exchange Act Rule 14a-8 or its interpretation be an effective means of improving board accountability, board responsiveness, and corporate governance policies?

2. What are the potential benefits and detriments of granting access to company proxy materials through shareholder proposals? For example, would a company-by-company approach allow a shareholder to tailor a proposal to account for a company's characteristics such as board composition, record on accountability, responsiveness to shareholder proposals, and corporate governance policies? Would this be a less costly mechanism than an enhanced shareholder access proposal?

3. If a company establishes a process to allow shareholder access to company proxy materials to nominate directors for less than a majority of the seats, would the Division still need to provide interpretive guidance on the applicability of the proxy rules? If so, should shareholders who nominate a director under a procedure established in response to a shareholder proposal be subject to the proxy rules governing election contests? Should solicitations for the purpose of forming a shareholder group to nominate directors and/or other soliciting materials be exempt from the proxy rules? Should nominating shareholders, including groups, be deemed to have a "control" purpose that would create additional filing and disclosure requirements under Exchange Act Section 13(d)?

4. Would a proposal seeking a mandatory bylaw to establish a process to allow shareholders to nominate directors be appropriate under state law? Could a company negate the effect of a mandatory bylaw proposal to establish a process to allow shareholders to nominate directors by amending its governing instruments to require board approval of all nominees?

IV. RECOMMENDATION

The Division recommends that the Commission solicit public comment with regard to proposed changes in two areas – improved disclosure and improved shareholder access to the director nomination process. The Division, therefore, recommends that the Commission publish

proposals and solicit public comment with regard to the following actions:

- requiring more robust disclosure related to nominating committees and the nomination process;
- requiring specific disclosure regarding shareholder communications with board members; and
- requiring conditional shareholder access to a company's proxy materials for purposes of nominating candidates for election as director.

Accordingly, the Division recommends that the Commission, consistent with its authority under Exchange Act Section 14(a), proceed with the rulemaking process that we describe below.

Recommended Disclosure Enhancements

The Division recommends that the Commission propose and solicit comment on new requirements for disclosure in company proxy materials relating to nominating committees and the company's procedures, if any, for allowing shareholders to communicate with board members, as follows:

- ***Enhanced disclosure*** *regarding* ***a*** *company's nomination process, including:*
  - the nominating committee charter, if any;
  - nominating committee member independence;
  - the criteria used by the nominating committee to screen nominee candidates, including candidates recommended by shareholders;
  - the nominating committee's policy with regard to candidates recommended by shareholders;
  - the qualifications the nominating committee believes company directors, or a given director, should have;
  - the nominating committee's process for developing and considering nominees;
  - the source of each of the board's nominees;
  - how shareholders can recommend a nominee; and
  - if the nominating committee receives a recommended nominee from a shareholder who has beneficially owned greater than a specified amount of the company's voting common stock for a minimum specified period of time, and the nominating committee chooses not to nominate that candidate:

- who recommended the candidate;
- why the nominating committee did not include the candidate as a nominee; **and**
- whether each member of the nominating committee believes that it was in the company's best interest not to nominate the candidate.

- *Disclosure regarding shareholder communications with board members, including:*
  - the manner in which shareholders can send communications to the board;
  - identification of those board members *to* whom shareholders can send communications;
  - if **all** shareholder communications are not sent directly to board members, the company's process for determining those communications that **are** relayed to **board** members;
  - the number of times individual board members met with shareholders in the **prior** year; and
  - any action taken by the board as a result of the communications.

Shareholder Access to Company Proxy Materials

Recommended Structure for Shareholder Access to Company Proxy Materials

The Division recommends that the Commission propose and solicit public comment on new **proxy** rules that would **allow** a Shareholder or **a** group of shareholders to place their nominees in a company's proxy materials within the following parameters:

- applicable state corporate law must provide the company's shareholders with the right to nominate a candidate for election as a director;
- neither the candidacy nor the election of a shareholder nominee may otherwise violate, or cause the company to violate, controlling state law, federal law or listing standards;
- the **availability** of a shareholder nomination process should **be** premised upon the occurrence of one or more triggering events that are objective criteria evidencing potential deficiencies in **the** proxy process such that shareholder **views** – especially those of a majority **– may** not otherwise **be** adequately taken into account;
- there should be appropriate standards for independence of shareholder nominees;
- there should be minimum standards with regard to shareholdings and the length **of**

time those shares have been held by a nominating shareholder or Shareholder group; and

- there should be limitations on the total number or percentage of permitted Shareholder nominees.

Impact of Recommendation on Other Commission Rules

Proposal of a shareholder access rule could affect a number of existing proxy rules and regulations, as well as the reporting requirements for large shareholders and shareholder groups. Some of the key changes that the Commission may wish to consider if it proposes a shareholder access rule include the following:

- possible amendments to the proxy rules to address specifically soliciting activities in connection with the formation of a nominating shareholder group;

- possible amendments to the proxy rules to address specifically soliciting activities by the nominating shareholder(s) in support of the shareholder nominee;

- possible amendments to the proxy rules to facilitate solicitations by electronic means on one or more specified websites;

- possible amendments to the beneficial ownership reporting requirements to address specifically nominating shareholders and nominating shareholder groups;

- possible amendments to the insider transaction reporting requirements to address specifically nominating shareholder groups; and

- possible amendments to the definition of "affiliate" to address specifically nominating shareholders and nominating shareholder groups.

Attachments: Appendix A – Summary of Comments

11

U.S. Securities and Exchange Commission

Securities and Exchange Commission
Final Data Quality Assurance Guidelines

Introduction

Section 515 *of* the Treasury and General Government Appropriations Act for Fiscal Year 2001 (Public Law 106-554; H.R. 5658) ("Appropriations Act") directed the Office of Management and Budget ("OMB") to issue guidance to federal agencies on: (i) publishing their own guidelines for ensuring and maximizing the quality of information disseminated by federal agencies; and (ii) establishing administrative mechanisms allowing affected persons to seek and obtain, where appropriate, correction of information that does not comply with OMB or the agencies' information **quality** guidelines. Under the guidelines issued by OMB (the "Government-wide Guidelines"),[1] all federal agencies subject to the Paperwork Reduction Act (PRA)[2] are required to publish on their websites data quality assurance guidelines.

In accordance with the Government-wide Guidelines, the Commission has developed the following guidelines. These guidelines do not create a new mechanism for addressing policy decisions made by the Commission; rather, they describe the agency's internal procedures for ensuring and maximizing the quality of certain types of information disseminated by the Commission, In addition, they provide an administrative mechanism for correcting, when appropriate, information that does not comply with the Government-wide Guidelines or the Commission's guidelines.

Please note that the Commission's data quality guidelines:

- Are not a regulation and do not change any existing regulatory requirements or trigger any regulatory obligations;
- **Do** not create any legal rights or impose any legally binding requirements or obligations on the Commission or the public;
- Do not affect any otherwise available judicial review of agency action; and
- May be revised periodically

Definitions

For purposes of the Cornmission's data quality assurance guidelines, the following terms will have the meanings below. These definitions follow or are derived from the Government-wide Guidelines. Consistent with the

Government-wide Guidelines, we have **adapted** OMB's definitions in **ways** appropriate to the Cornmission's particular practices and programs.

- **Dissemination** means a Commission-initiated or sponsored distribution of information to the public. Dissemination does not include: (I) distributions limited to government employees or agency contractors or grantees; **(ii)** intra- or inter-agency use or sharing of government information; or (iii) responses to requests for agency records under the Freedom of Information Act, the Privacy Act, the Federal Advisory Committee Act or other similar law. Dissemination further does not include distributions limited to correspondence with individuals or persons, press releases (and similar communications in any media that announce or give notice of information the Commission has disseminated elsewhere), archival records, public filings or subpoenas or other documents prepared and released in the context of adjudicative processes.

- **Influential** is a specialized term that means certain scientific, financial or statistical information that the agency can reasonably determine will have or does have a clear and substantial impact on important public policies or important private sector decisions, Consistent with the scope of these guidelines, the term "influential" applies only to certain scientific, financial or statistical information and does not apply to policy decisions that the information may support. If a decision or action by the Commission is itself very important, a particular piece of information supporting that decision or action may *or* may not **be** "influential." In rulemaking, influential information is scientific, financial or statistical information that the Commission considers outcome-deterrninative with respect to one or more critical issues in a "major rule," as such term is defined in the Small Business Regulatory Enforcement Fairness Act of 1996. In most rulemakings, the Commission's decisions on critical issues will be based on a variety of information and considerations, and accordingly, no particular scientific, financial or statistical information by itself likely will be outcome-determinative. In non-rulemaking contexts, the scope and significance of the effect of the information on important public policies or important private sector decisions will determine whether the information is influential.

- **Information** means any communication or representation of knowledge, such as facts or data, in any medium or form, including textual, numerical, graphic, cartographic, narrative, or audiovisual forms. "Information" includes data posted on the Commission's website, but does not include the provision of hyperlinks to information that others disseminate. "Information" also does not include opinions, where the Cornmission or the author makes clear that what is being offered is the author's opinion rather than either fact or the Commission's views.

- **Integrity** refers to the security of the Commission's information, i.e., protection of the information from unauthorized, unanticipated or unintentional access or revision, to ensure that the information is not compromised through corruption or falsification.

- **Objectivity** refers both to: (i) presenting information in a proper context to set out that information in a clear, complete and unbiased manner; and (ii) ensuring that the substance of the information is accurate, reliable and unbiased.

- **Quality** is an encompassing term comprising utility, objectivity and integrity.

- **Reproducibility** means that "influential" information Is capable of being substantially reproduced, subject to an acceptable degree of imprecision. With respect to analytic results, "capable of being substantially reproduced" means that independent analysis of the original or supporting data using identical methods would generate similar analytic results, subject to an acceptable degree of imprecision or error.

- **Utility** refers to the relative usefulness of the information to its intended users.

Data Quality Assurance Guidelines

The Commission's guidelines reflect its procedures for reviewing and substantiating information to maximize the quality, including the objectivity, utility and integrity, of information before it is disseminated. In accordance with the Government-wide Guidelines, the level of quality assurance appropriate for information varies according to the relative importance of the information and the costs and benefits of requiring additional assurances for the particular information. The Cornmission's guidelines follow.

Basic Principles

- **Quality.** The Commission takes pride in the quality of its information and is committed to disseminating information that meets the Commission's already rigorous standards for objectivity, integrity and utility. Commission divisions and offices should treat information quality as integral to every step of their development of information, including its creation, collection, maintenance and dissemination. Before the Commission disseminates any information to the public, all aspects should be thoroughly reviewed **by** expert staff and appropriate levels of management. The Commission's internal review and approval policies and procedures should ensure, to the best of the Commission's ability, that the Commission's disseminated information and data are accurate and timely, appropriate for external consumption, uncompromised and useful to the public.

- **Integrity.** The Commission's Office of Information Technology has established policies for carrying out the Commission's information security program pursuant to the Computer Security Act of 1987, the Government Information Security Reform Act of 2000 and the Security of Federal Automated Information Resources, OMB Circular A-130 (February 8, 1996). The Commission's information security program should encompass those measures necessary to protect the Cornmission's information resources. These measures include providing, for each IT project: (i) the appropriate technical, personnel, physical, administrative, environmental and telecommunications safeguards; and (ii) continuity of operations through contingency or disaster recovery plans. The Commission's protective measures should cover the following information resources: data, applications, software, hardware, physical facilities and telecommunications. The Commission's information security program should assure that each automated information system has a level of security that is commensurate with the risk and magnitude of the harm that could result from the loss, misuse, unauthorized disclosure or improper modification of the information contained in the system.

- **Utility.** The Commission evaluates and determines the audience for whom the information to be disseminated is intended and will benefit. The Commission is committed to maximizing the utility of the information it disseminates to the public. To this end, information and the appropriate form and vehicle for its dissemination should be evaluated and reviewed by the relevant subject matter experts on a given project, along with appropriate levels of management within the Commission, before the information is disseminated to ensure its usefulness to the intended audience. This includes ensuring that the information is organized and written in a manner that facilitates its understanding and use by the intended audience. For example, the Commission issues investor alerts that are written in plain English to help investors understand complex and technical aspects of the securities laws. The information also should be reviewed to ensure its timeliness and continuing relevance for the intended audience.

- **Objectivity.** The Commission is committed to disseminating information that is accurate, clear, complete and unbiased both in its content and in its presentation. The relevant subject matter experts **and** appropriate levels *of* management shoutd review information before it is disseminated, among other things, to evaluate whether the information is accurate, reliable and unbiased, including an assessment of collection, generation, and analysts of relevant information and data. The review also should consider the presentation *of* the information to ensure that it is put in the proper context and presented in a clear, complete and unbiased manner. Where appropriate, in the context of certain rulemakings for example, the Commission also should identify the sources of supporting data so that the public can assess for itself the objectivity of those sources.

- **Influential Information.** Any information deemed to be "influential" as defined in these guidelines should be reviewed by subject matter experts within the Cornmission and appropriate levels of management to ensure adequate disclosure about underlying data sources, quantitative methods of analysis and assumptions used, to facilitate reproducibility of the information, according to commonly accepted scientific, financial or statistical standards, by qualified third parties.

General Categories of Information Subject to the Guidelines

- **Information Disseminated through the Regulatory Process -- With Notice and Comment.** Before the Commission disseminates a proposed or final rule, expert staff prepare drafts of the rule, which, where appropriate, are circulated to other staff members having direct or complementary subject matter expertise. The drafts are also reviewed by the Office of Economic Analysis and the Office of the General Counsel, and finally are reviewed and approved by the Commission. Proposed rulemakings generally include a public comment process pursuant to the Administrative Procedure Act ("APA"). These procedural safeguards assure a response to comments on the quality of information in the proposed rule and provide affected parties an opportunity to contest the final decision. The Cornmission will review any correction request about a pending rulemaking solely through the notice and comment process and not through the correction request procedures described below. If the final rule incorporates new facts or data that were not available for public comment, these new facts or data are subject to the correction request procedures.

- **Information Disseminated through the Regulatory *Process* -- No Notice and Comment.** The Commission sometimes disseminates information through its regulatory process that is not subject to the notice and comment requirements of the APA, including Commission interpretive releases, concept releases and policy statements. These types of documents express the opinions *of* the Commission, provide clarification *of* previous Statements by the Commission, or indicate a direction the Commission contemplates taking in the future with respect to various topics, including items that were the subject of prior rulemakings, where the Commission ha5 had the opportunity to monitor the effect of the rule on the public. The supporting data are gathered and analyzed, and the statements are drafted, reviewed and revised by the relevant staff experts within the Commission, including when appropriate the Office of Economic Analysis. In addition, further review is provided by appropriate levels of management and by complementary subject matter experts in other offices and divisions within the Commission, and, finally, approval is required by the Commission before dissemination to the public.

- **Statistical and Other Numerical Information Disseminated Outside of the Regulatory Process.** The Commission's divisions and offices from time to time prepare reports that display or rely on statistics and other data gathered hy the staff. Sometimes the Commission staff gathers its own data and stores the data in databases that the staff controls and maintains. Data are often gathered by the staff from public filings made with the Commission. Although the Commission cannot always independently verify the content of those filings, the public filers are subject to liability under the federal securities laws if the information in their filings is found to be false or materially misleading. On other occasions, the staff relies on data gathered from independent third parties and vendors who supply data that the staff, and when appropriate, the Commission, reviews, analyzes and disseminates. These data include fee collection estimates, trade, quote, order flow, volume and market value summaries, order execution and quality reports, and various special studies and research reports. Both internally generated and externally obtained data are subjected to internal analysis, data filters and screens, and are reviewed by the appropriate levels of management in the office or division responsible for disseminating the reports, as well as the Office of Economic Analysis when appropriate. In addition, this information may be reviewed by other offices and divisions within the Commission that may have complementary subject matter expertise. When appropriate, the data *or* the reports are also submitted to the Commission for review or approval.

- **Non-Statistical Information Disseminated Outside of the Regulatory Process.** The Commission disseminates many different kinds of information that do nut rely on statistical analyses and quantitative foundations, such as investor education materials. Each document is drafted by the responsible staff member(s), reviewed by appropriate supervisory levels and, when necessary or appropriate, reviewed and approved by the Commission before dissemination. Because of the varied nature of these materials, the Commission and it5 staff use that level of quality assurance commensurate with the importance of the information and the likelihood that it will be relied on by the public.

Information Outside the Scope of the Guidelines

Based on OMB's definitions of "dissemination" and "information," several types of information disseminated by the Commission and members of the Commission staff do not fall under these guidelines. Excluded categories include:

- Distributions intended to be limited to Commission employees or contractors, such as internal operating procedures, training manuals and requests for proposals.

- Intra- or inter-agency distributions or sharing of government information, such as the Commission's Annual Report, the Commission's annual budget and the Commission's plans and reports pursuant to the Government Performance and Results Act of 1993.

- Opinions of individual Commissioners and staff members, where the author's presentation states that the information is that person's opinion rather than fact or the Commission's views. These include articles, speeches, panel presentations, special studies and academic papers authored by staff members that state that the views expressed in their work are their own views and do not necessarily reflect the views of the Commission.

- Responses to requests for agency records under the Freedom of Information Act, the Privacy Act, the Federal Advisory Committee Act or other similar law.

- Correspondence with individual entities or persons, including staff comment letters, staff no-action letters, staff interpretive letters and staff deficiency letters.

- Press releases, including litigation releases, the SEC Digest, and similar communications in any media that announce or give notice of information the Commission already has disseminated elsewhere.

- Archival records maintained by the Commission public reference room and libraries.

- Information from third parties, for which the Commission is merely a conduit, such as public filings (both EDGAR and paper filings) and public comment letters. This exclusion includes information that the Commission has not authored or is not distributing in a manner that suggests that the Commission endorses or adopts the information, and the Commission does not indicate in its distribution that it is using or proposing to use the information to formulate or support a regulation, guidance or other Commission decision or position.

- Subpoenas, Commission orders, opinions, amicus briefs and other documents prepared and released in the context of adjudicative processes. Adjudicative processes also include factual allegations by the staff during the investigative and litigation phases of cases brought by the Commission's Division of Enforcement. Because there are well-established procedural safeguards and rights to address the quality of factual allegations and adjudicatory decisions, and to

provide persons with an opportunity to contest decisions, these guidelines do not impose any additional requirements on the Commission during adjudicative proceedings and do not provide parties to such adjudicative proceedings any additional rights of challenge or appeal.

Requests for Correction

The correction process is designed to provide a mechanism for affected persons to seek correction of information disseminated by the agency that does not comply with these and/or the Government-wide guidelines.

This administrative mechanism does not necessarily guarantee a correction in every instance. Rather, the decision of whether a correction is appropriate, and what degree of correction is appropriate, will be determined by the nature, completeness and timeliness of the information involved and any relevant factors such as the significance of the correction on the users of the information and the magnitude of the correction. Responses may be in the form of personal contacts by letter or telephone, form letters, press releases or mass mailings that correct widely disseminated errors or address a frequently raised request. The Commission need not respond substantively to frivolous or repetitive requests for correction, requests that concern information not covered by these guidelines or requests from a person whom the information does not affect.

With respect to proposed rules, the thorough consideration required by the APA process provides an adequate complaint and appeal process. A separate complaint and appeal process for information that is already subject to such a public comment process would be duplicative, burdensome, disruptive to the orderly conduct of the action and unfair to other public commenters who submitted comments during the applicable comment period. Accordingly, the notice and comment process is the exclusive means by which an affected person may address the quality of data in a proposed rulemaking.

In unusual Circumstances involving information related to a rulemaking, the Commission may consider an information complaint under these correction procedures to avoid the potential for actua! harm or undue delay. These circumstances include situations where: (1) the information is disseminated in advance of the rulemaking and no method is provided for public comment; (2) the agency receives the complaint after the comment period closes and it could not have been submitted earlier; (3) there will be a long delay before the proposed rule becomes final; (4) the information was disseminated for the first time in the final rule; and (5) the principal effect on the complainant is related to the information itself, rather than the rule.

In most instances, matters should be resolved at the appropriate division or office level within the Commission. Novel or highly complex matters may be sent *to* the Commission for review, at the discretion of the staff. If the matter is resolved at the staff level, the staff will use reasonable efforts to send its response to the requestor within 60 days of the date the office or

division received the request. If the resolution of the matter is particularly complicated or would benefit from consultation with other divisions or agencies, the staff will use reasonable efforts to send a response to the requestor within 90 days of the date the original office or division received the request.

Request Format. To be treated as a data quality correction request under these guidelines an# to help ensure the most expedient processing of the request, any affected person seeking correction of Commission-disseminated data should submit a request in writing (on paper or by email) and include as much of the following information as possible:

- A description of the facts or data the requestor seeks to have corrected;
- An explanation of how the requestor is an affected person with regard to those facts or data;
- The factual basis for believing the facts or data fail to comply with the Government-wide or Commission guidelines;
- A proposed resolution, including the factual basis for believing the facts or data in the requestor's proposed resolution are correct;
- The consequences of not implementing the proposed resolution;
- Any supporting documentation the requestor believes would be helpful in resolving the matter; and
- The requestor's contact information, including name, address, daytime telephone number and email address.

Requests should be marked *"Data Quality Correction Request"* on the first line of the envelope directly above the mailing address and on the correspondence itself, in the case of letters, or in the "Subject" line, in the case of email correspondence. Emails should be sent to the following address: dataquality@sec.gov. Letters should be addressed to:

United States Securities and Exchange Commission
Office of the Secretary
Attn: Data Quality
450 Fifth Street, NW
Washington, DC 20549-0609

Processing Data Quality Correction Requests. The Office of the Secretary should route the request *to* the head of the appropriate division or office within the Commission who should provide that: (i) the request is reviewed; (ii) any appropriate corrective action is taken; and (iii) a response to the request is made.

Requests for Staff Reconsideration. If the requestor does not agree with the response, the requestor may send a request fur staff

reconsideration of the original response. To help ensure the most expedient processing of the request, the request should be postmarked (or, in the case of email, date-stamped) within 20 days of the date of the initial response, or 90 days after delivery of the original request, whichever is later. The request for staff reconsideration should include a copy of the original request, a copy of the original response (if in writing) or a summary of the response (if oral), and a statement describing why the response to the original complaint did not comply with the data quality guidelines or why the requestor disagrees with the original response.

Reconsideration requests should be marked *"Request for Staff Reconsideration of Data Quality Correction"* on the first line of the envelope directly above the mailing address and on the correspondence itself, in the case of letters, or in the "Subject" line, in the case of email correspondence. Emails should be sent to the following address: dataquality@sec.gov. Letters should be addressed to:

United States Securities and Exchange Commission
Office of the Secretary
Attn: Data Quality
450 Fifth Street, NW
Washington, DC 20549-0609

Processing Staff Reconsideration Requests. The Office of the Secretary should route the staff reconsideration request to the Office of the Chief Counsel ("OCC") of the division or office that received the original request, If the OCC was involved in making the decision on the original request, or in producing the data that is the subject matter of the request, or if the division or office does not have an OCC, then the staff reconsideration request will be assigned to another objective official, The OCC or the designated official may seek the advice and counsel of other appropriate officials in rendering the decision. The OCC or the designated official should review the original response, determine if additional action is appropriate, and use reasonable efforts to send the staff's response to the reconsideration request within 30 days of the date the OCC or designated official received the request.

Effective Dates

These information quality guidelines will become effective on October 1, 2002. As provided in the Government-wide Guidelines, these guidelines apply only to information disseminated on or after October 1, 2002 regardless of when it was first disseminated. The fact that information disseminated by the Commission before this date is still maintained by the Commission (e.g., in publications the Cornmission continues to distribute on a website) does not make the information subject to these guidelines or to the request for correction process.

Privacy Act Statement. *The Commission is authorized to collect the information provided by the requestor under the Appropriations Act. The information is needed to process each request and to allow the Commission to reply appropriately. The requestor is not required to furnish the*

information, but failure to do so may prevent the request from being processed. The principal use is to process ***and respond*** *to the request, but the Commission may disclose information to a Congressional office, to the Department of Justice, a court or other tribunal when the information is relevant and necessary to litigation, or to* ***a*** *contractor or another federal agency to help accomplish a function related to these guidelines.*

Paperwork Reduction Act. *The Commission will* ***make*** *use of the OMB's Paperwork Reduction Act (PRA) clearance process to help improve the quality of information that the Commission collects* ***and*** *disseminates to the public. The Commission is already required to demonstrate in its PRA submissions to OMB the "practical utility" of* ***a*** *proposed collection of information. For all proposed collections of information that will* ***be*** *disseminated to the public, the Commission will consider whether the proposed collection of information will result in information that will be collected, maintained, and used in a way consistent with the Government-wide and Commission guidelines.*

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1 Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility and Integrity of Information Disseminated **by** Federal Agencies; Notice; Republication, 67 Fed. Reg. 8452 (February 22, 2002).

2 See sections 3504 and 3516 of the Paperwork Reduction Act of 1995 (44 U.S.C. §§ 3504, 3516). OMB was authorized to issue guidelines pursuant to its authority under the PRA.

http://www.sec.gov/about/dataqualityguide.htm

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MONEY

COVER STORY

United vows no disruptions ; Chapter 11 filing biggest for a U.S. airline

Marilyn Adams and David Kiley

The United bankruptcy; 1A; * Burning through cash: United is going through $20 million a day but has lined up $1.5 billion in financing. 3B; * West Coast flight: United customers sympathize with airline's employees. * Questions; answers: Passengers' questions answered on holiday bookings; frequent-flier miles and route changes. * US Airways' troubles: Carrier filed for Chapter 11 prctection in August. The effect on workers and shareholders has been dramatic; but passengers have barely noticed.; * Creditors brace: Analysts expect United will extract concessions from suppliers; lenders and less

United Airlines began flying Monday as a carrier under bankruptcy protection, promising customers smooth operations even as it faces unprecedented internal turmcil.

The world's second-biggest airline by revenue became the largest carrier ever to seek Chapter 11 protection from creditors.

The filing came Monday in U.S. Bankruptcy Court in United's hometown of Chicago after a unanimous board vote Sunday. Officials said Chapter 11 became the only option after United's application for a $1.8 billion federal loan guarantee was denied last week and the airline's high costs and debts threatened to ground it.

"This is a story about a company that's struggling to reinvent itself," Glenn Tilton, CEO of United parent UAL, said in an interview. Tilton said his goal was for United to emerge from bankruptcy protection in 18 months, bur industry observers said that's optimistic.

"This is going to be a very long bankruptcy and a very painful bankruptcy," said Darryl Jenkins of George Washington University's Aviation Institute.

Tilton acknowledged that in the future, the airline won't be the

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behemoth it is now. "We have to be smaller, nimbler, more responsive. We will have to compete in a more disciplined way with lower costs," he **said** outside the packed courtroom. "We will trim unprofitable routes and serve destinations with fewer people."

Court testimony Monday revealed how stark United's situation has become. UAL attorney James Sprayregen said United has $800 million in cash on hand for operations but was on track to run out by January. Without fresh capital, United's cash balance would have plunged to $300 million by the end of December, he said.

UAL's request to tap $800 million in special bankruptcy financing in 10 days was approved by Judge Eugene Wedoff, chief of the Bankruptcy Court. A group of lenders including J.P. Morgan Chase, Citigroup, Bank One and CIT Group is prepared to provide a total of $1.5 billion in financing.

The bankruptcy promises to be the most complex in airline industry history. The list of details about UAL's creditors fills 32,000 typed pages, Sprayregen said. Lawyers €or United's creditors packed the courtroom in downtown Chicago, and the 60 biggest unsecured creditors, who have the most to lose, are scheduled to meet Friday at a Chicago hotel.

"Make no mistake about it. This will be a difficult process. Sacrifices will have to be made by all constituents," said Sprayregen of law firm Kirkland & Ellis.

United announced no management changes Monday, although many industry watchers expect 2 shake-up. The airline's former president and chief operating officer were forced out in September when Tilton, a former Texaco executive, was hired as chairman and CEO. The airline announced that its officers and management employees would take pay cuts of about 11% starting next week.

Founded 76 years ago, United is a traditional, high-cost carrier that has historically catered to premium-fare business travelers. It maintains expensive hubs at Chicago, Denver, Washington, San Francisco and Los Angeles and operates routes throughout Europe, Latin America and Asia.

Since the **Sept.** 11 attacks, United has cut its **daily** flights **by** 25% and laid off about 20,000 employees. But the cost cuts haven't been enough to compensate for a precipitous falloff in high-fare

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business travel, United's relatively expensive labor contracts and the encroachment of low-fare airlines like Southwest and Frontier into United's markets.

Tilton said the airline's business plan going forward will include initiatives to compete against discount airlines, but he wasn't specific. "United has to appeal to a broader base of customers than we have," he said.

If United can streamline and keep pampering business fliers while competing for leisure travelers against cutthroat discount airlines, it could force major changes at other airlines.

Tilton boasted that the airline's operation Monday was flawless -- on time with no disruptions -- despite the filing. No immediate changes to United's flight schedule were announced. United's Mileage Plus frequent-flier program and Red Carpet Clubs weren't affected.

He stopped by Chicago O'Hare airport, United's biggest hub, to hug employees and thank passengers for their loyalty.

Paul Whiteford, chairman of United's pilots union, said employees are prepared to do their best to ''knock the crap out of the competition. We need to focus on keeping our customers."

Unique United

Tilton did not address a particularly sensitive subject: the future of UAL's controversial governance structure. United is the only airline with union representatives on its board of directors.

Through an employee stock plan established eight years ago, employees own 55% of UAL, and United's two most powerful labor unions, the International Association of Machinists and the Air Line Pilots Association, have board seats. Industry experts have blamed the unions' influence for many of United's problems, but union leaders blame poor management decisions and costly business blunders, like United's attempt to acquire US Airways two years ago.

Tilton would say only that the future of the ownership plan and governance structure "will evolve through this process."

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Whiteford said it's too early to know how the filing will affect the stock ownership plan. But he said he has no reason to believe he won't be a board member when United emerges from protection.

Although Tilton pledged to seek labor cost cuts through amicable negotiations, the company can ask the bankruptcy judge to impose concessions. The unions have retained their own lawyers.

While United was applying for the loan guarantee, union and non-union employees pledged to give up $5.2 billion in pay and benefits over 5 1/2 years. The airline initially sought $9 billion over six years. Tilton said the lower figure "will be a starting point" for negotiations now. "There's clearly a gap."

Tilton said UAL would also seek work rule changes, such as reducing the number of pilots on some international flights. Under its contract with its pilots, United exceeds the minimum requirements set by the Federal Aviation Administration.

"I'd rather have productivity improvements," Tilton said. "We're going to have conversations with our unions that we weren't able to have before."

Tilton said United officials weren't expecting to be denied the federal loan guarantee. He said they had hoped for conditional approval contingent on goals being met before money was advanced.

Wall Street analysts, wno had long predicted the Chapter 11 filing, viewed it as the most dramatic sign yet of a sea change in the airline industry. US Airways, a much smaller major airline, slipped into bankruptcy protection in August. Other big airlines, including American and Delta, have announced thousands of new job cuts.

"This is part of the restructuring process ongoing in the industry and will ultimately result in fewer network carriers and fewer hubs," said analyst Brian Harris of Salomon Smith Barney.

But for United's 83,000 workers, Monday's news was a lot more personal.

"I'm going to retire a lot less comfortably now, if I make it to

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retirement," said United mechanic Dennis Sanderson, who works at Washington Dulles airport.

As a result of earlier layoffs, Sanderson, who is about two years from retirement, is 16th from the bottom in seniority at Dulles. If there's another round of layoffs at Dulles, he said, "I'm gone."

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Contributing: Barbara DeLollis

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Social Issues: Labor Relations

Labor Sharpens Its Pension Sword; Unions are using their shareholder clout -- and pickets -- to lean on employers

By Aaron Bernstein and Amy Borrus in Washington, with Christopher Palmeri in Los Angeles

ON OCT. 28, SEVERAL dozen union members rallied at Kroger Co.'s headquarters in Cincinnati, holding signs protesting the company's threat to cut health-care benefits for its striking supermarket workers in Southern California. But these protesters were not strikers, or even colleagues from their union, the United Food & Commercial Workers (UFCW). The picketers were members of 14 Cincinnati area construction unions. Stranger still, they were there at the behest of the Cincinnati Worker-Owner Council, a group of construction labor officials who are also trustees of union pension funds.

What was going on? The construction unions were using their pension funds, which own 5 million shares of Kroger stock, to help fellow unionists draw a line in the sand against health-care rollbacks. Their argument: Kroger's benefit cuts hurt shareholders -- including construction worker pensioners -- by sapping employee morale and productivity. "As owners, we need to provide for long-term value.... If there's this endless taking it out of the pockets of the employees, we don't think it will help Kroger's," says Ed Durkin, director of corporate affairs at the United Brotherhood of Carpenters.

Ever 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. Spearheaded by the AFL-CIO Office of Investments, labor has become one of the country's strongest voices for corporate reform, demanding independent boards of directors, mutual-fund accountability, and curbs on runaway CEO pay. But now a number of unions are upping the ante, using their pension holdings to pressure companies on bread-and-butter labor issues as well. Combining old-fashioned tactics such as picketing with their clout in the boardroom, unions are attacking employers on everything from health-care benefits to job outsourcing (table).

While a few unions have tried such tactics before, there has been a new burst of activism recently as they have become more comfortable wielding shareholder clout.

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Labor's efforts **spell** trouble for management, which could face a new wave of demands by shareholders of all stripes if the arguments catch on. But labor isn't exactly united around the more militant approach, either. Some union officials worry it could undermine the credibility that the AFL-CIO has so carefully cultivated with institutional shareholders **by** pushing governance and other traditional stockholder issues. "If the Securities & Exchange Commission thinks labor is starting to use its shareholder vote inappropriately, I fear there will be more regulation of us," says one labor staffer.

Still, officials at the AFL-CIO, the Carpenters, and other unions argue that their intent is precisely to redefine just what the interests of stockholders can be. Paying good benefits and respecting labor rights doesn't conflict with the idea *of* maximizing shareholder value but rather promotes it over the long term, argues William B. Patterson, the head of the AFL-CIO Office of Investment. Nor does this agenda threaten shareholders who disagree. "Other shareholders will vote no [on labor-sponsored proxy resolutions] if they think our demands are not in their interest," says Patterson.

ABRUPT DOWNGRADE

LABOR HAS A LONG WAY to go to win over most institutional shareholders, but it's making **some** inroads. Even as the Carpenters took to the streets, Patterson's office hosted an analysts' call to make the case about the California supermarket strike. The Oct. 30 call was co-sponsored **by** J.P. Morgan Chase & Co. and Smith Barney Citigroup and featured UFCW Executive Vice- President Sarah Palmer-Amos, She may not have changed many minds, but **labor's** resolve did help persuade Smith Barney retailing analyst Lisa F. Cartwright to downgrade her assessment of Safeway Inc., one of the marketers involved in the labor dispute. Cartwright co-sponsored the call because *"it's* important for investors to understand the whole picture, even if they disagree with the union," she says.

Other unions have had some luck using their shareholder clout to aid **in** organizing drives. The Service Employees International Union (SEIU) has signed up hundreds of office-building janitors around the country by **leaning** on the state and local pension funds of their members who work in public-sector jobs. Many of the funds invest *in* large office **buildings**, often buying a majority stake. About a dozen, including the California Public Employees' Retirement System (CalPERS) and the Ohio Public Employees Retirement System, have **adopted** an SEIU-sponsored "responsible contractor" policy. These require the real estate companies that manage the office buildings to hire janitorial companies with "fair" wages and benefits. In practice, that often means the contractors must be union or allow the SEIU to try to organize the building. Says Bruce Perelman, a board member of the $27 billion Los Angeles County Employees Retirement Assn., which in December adopted such a policy: **"Some** [building] managers feel you pay people as little as you can, but we think that's not always the best idea from an investor standpoint."

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Unions are walking a fine line when they use their retirement funds to pursue traditional labor goals as well as shareholder ones. The danger is that they can be accused of exceeding their duties as pension fund fiduciaries, says Vanderbilt University law professor Randall S. Thomas. But that's also labor's point: expanding the concept of fiduciary interest beyond simply maximizing short-run returns. As labor makes its case, more companies may face a new era of shareholder activism.

(available online)
Flexing Workers' Shareholder Muscle
Some union pension funds are now linking their shareholder power to bargaining and organizing issues -- which could alienate other stockholders. A few examples:
HEALTH-CARE CUTS
The AFL-CIO and construction workers' pension funds are telling Kroger and Safeway shareholders that management shouldn't slash health-care benefits -- an issue tnat has caused a month-long strike in California
RESPONSIBLE CONTRACTING
The Service Employees International Union has persuaded a dozen public pension funds to invest in office buildings only if the property manager uses janitorial contractors that permit unionization and offer workers decent wages and benefits
PRIVATIZATION
The American Federation of State, County & Municipal Employees has coaxed large pension funds holding its members' money to not invest in companies that privatize public jobs -- transferring work to independent businesses
Data: BusinessWeek

TABULAR OR GRAPHIC MATERIAL SET FORTH IN THIS DOCUMENT IS NOT DISPLAYABLE

Photograph: CINCINNATI At Kroger's offices PHOTOGRAPH BY MICHAEL WILLIAMS

---- INDEX REFERENCES ----

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HEADLINE: Shareholder Access **Proposals Conflict with Federal Proxy** Rules **and State Law**

AUTHOR: By Andrew R. Brownstein and Igor Kirman

HIGHLIGHT Shareholder proposals seeking open access to **proxy** materials have resurfaced with a vengeance, but the authors discuss why, despite their surface appeal, there continue to be sound legal and policy grounds for opposing such **proposals.** This article discusses the recent AFSCME **shareholder** access **proposal** and others, and explains why they may be excluded from **proxy** statements based on SEC no-action letters, **SEC proxy rules,** and New York and Delaware corporate law.

BODY

Amid the myriad of **shareholder proposals** for the 2003 **proxy** season relating to corporate governance is a well-organized campaign that, if successful, might result in a significant change in the governance of American corporations. The pension plan for the American Federation of State, County and Municipal Employees **("AFSCME")** has targeted several prominent companies for a **proposal** to require inclusion in company **proxy** materials of director candidates nominated by holders of 3% of the company's outstanding shares. [n1] In addition, AFSCME has announced that it is lobbying 150 public employee pension funds to adopt voting policies in favor of such **"shareholder** access" initiatives. [n2]

Open access to company **proxy** materials for **shareholder** director nominations is not a novel idea. Over the past 60 years, Congress, the Securities and Exchange Commission ("SEC"), commentators and **shareholder** activists have made **proposals** to grant access to company **proxy** materials for **shareholder** director nominations. [n3] Generally, the frequency of such **proposals** has risen during periods when the corporation and management have been under attack, such as in the aftermath of the corporate scandals of the 1970s and the period of hostile takeover battles of the 1980s. Thus, it comes as no surprise that in the current environment following an unprecedented large number and scale of corporate scandals and widespread public distrust of corporate boards and management, **proposals** for **shareholder** access to **proxy** materials would resurface with renewed vigor.

Despite the seeming timeliness of such **proposals** and their surface appeal to popular concepts such as **shareholder** democracy and board accountability, there continue to be good reasons to oppose such **proposals** on sound legal and policy grounds. In this article, we consider the recent **shareholder** access **proposals** that have been made by **AFSCME** and others under the **federal shareholder proposal rule, Rule** 14a-8, and conclude that such **proposals** may be excluded from company **proxy** statements for several reasons. We show that **shareholder** access **proposals** are excludable from company **proxy** statements under a long line of SEC no-action letters and are inconsistent with numerous SEC **proxy rules,** which are structured on the basis that persons who wish to solicit votes in favor of an alternative slate of directors must do so using a separate **proxy** statement.

Furthermore, at least under the laws of the states of **New** York and Delaware, we believe that **shareholder** access **proposals** are invalid as a matter of state **taw** because they seek impermissibly to interfere with the power of the board of directors, which alone is entitled to make decisions on the use of company assets such **as** the company **proxy** statement in managing the affairs and business of the company. Moreover, in the case of **proposals** such as those submitted by AFSCME that seek *to* grant the access right only to **shareholders** who meet certain large stock ownership requirements,

such **proposals** are also likely to be invalid as a matter of Delaware and New York **state law** because they treat shares of the same class disparately.

The Shareholder Access Proposal

Although it has appeared in various forms over the years, the basic form of the **shareholder** access **proposal** is a **shareholder proposal** submitted under **Rule 14a-8** seeking to require the inclusion by a company in its **proxy** statement and **proxy** card of any person nominated by a **shareholder** for election to the company's board of directors. Often, such **proposals** also require that the company include a supporting statement or biographical information about such **shareholder** candidates.

Some **proposals** have sought to permit all **shareholders** to have the access right while others have sought to limit such right to **shareholders** or groups of **shareholders** beneficially owning a certain percentage (most commonly 3%) of the company's outstanding voting stock. Finally, such **proposals** have been submitted both in precatory form as recommendations for the company's board of directors to consider and, as the case with three of the six **proposals** submitted by **AFSCME** for the **2003 proxy** season, as proposed bylaws to be adopted by **shareholder** vote.

The **shareholder** access bylaw **proposal** recently submitted by **AFSCME ("AFSCME Proposal"),** for example, seeks to amend a company's bylaws to require the inclusion by the company in its **proxy** materials of disclosure information about, as well as a 500-word supporting statement in favor of, any person nominated for election to the company's board of directors **by** any **shareholder** or group of **shareholders** beneficially owning *3%* or more of the company's outstanding common stock (limited to one nominee per such **shareholder** or group) and to require that such nominee appear on the company's **proxy** card. There would be no prohibition on soliciting **shareholders** to form **a** 3% group.

Nor would there be any limit on the number of candidates that could be nominated by different groups of 3% **shareholders,** but each such group could nominate only one candidate. The **AFSCME Proposal** requires the **shareholder** submitting the nomination to indemnify the company against liabilities arising out of violations of law relating to such **shareholder's** solicitation and to comply with all applicable laws to the extent the **shareholder** uses soliciting materials other than the company's **proxy** materials. The board of directors would **be** directed to adopt a procedure for timely resolving disputes over whether the information supplied for inclusion in the company **proxy** statement complies with SEC **rules.**

Federal Law

SEC No-Action Positions

The staff of the Division of Corporation Finance of the **SEC** (the "Staff ") has for a long period of time permitted companies to exclude **shareholder** access **proposals from their proxy** statements (including both mandatory bylaws and precatory **proposals)** on the basis of **Rule** 14a-8(i)(8), which permits exclusion of **proposals** that relate to an election of directors. The Staff has noted that such **proposals,** "rather than establishing procedures for nomination or qualification generally, would estabtish a procedure that may result in contested elections to the board, which is **a** matter more appropriately addressed under **Rule** 14a-11." [n4] Since boards of directors, consistent with their fiduciary duties, typically nominate a sufficient number of candidates for all available board seats, the **shareholder** access **proposal** would necessarily establish a procedure that would result in a contested election by forcing the company to include in its **proxy** materials and on its **proxy** card candidates opposed to the company's nominees.

Thus, for example, in a letter dated April 9, 2002, the Staff issued a no-action position permitting Goldfield Corporation to exclude from its **proxy** materials a **shareholder proposal** requesting that Goldfield develop bylaws to "qualify nominees who have demonstrated a meaningful level of stockholder support and to provide them with free and equal ballot access." [n5] Similarly, in a letter dated March **22,** 2002, the Staff **took** a no-action position permitting Storage Technology Corporation to exclude from its **proxy** materials a **shareholder proposal** recommending that the company amend its bylaws to require the inclusion in its **proxy** materials of the name of each candidate for the board nominated by **shareholders.** [n6] In each case, the Staff found the **proposal** excludable under **Rule** 14a-8(i)(8) and stated that the **proposal,** "rather than establishing procedures for nomination or qualification generally, would establish a procedure that may result in contested elections of directors." [n7]

A number of **shareholder** access **proposals** that the Staff has permitted to be excluded sought, in the same manner **as** the AFSCME **Proposal,** to grant the **shareholder** access rights only to those **shareholders** beneficially owning a minimum specified amount of the company's stock. In a letter dated February 6, 1990, for example, the Staff permitted

Unocal Corporation to exclude a **proposal** to amend the company's bylaws to allow "any **shareholder** who owns, controls, or represents by **proxy** at least 125,000 shares of stock" to name one or more nominees for director, whose names would be included in the **proxy** statement and whose biographical information would be included in the notice of annual meeting to **shareholders** "in the same manner as any, and all other nominees presented for election." [n8] Similarly, in a letter dated March **23,** 2000, the Staff permitted Kmart Corporation to exclude a **proposal** requiring the company to grant any 2% **shareholder** a "right of access" to the **proxy** statement for the purpose of presenting a non-management candidate for election to the board of directors. [n9]

History and Structure of the Proxy Rules

The Staff's longstanding view that a company's **proxy** materials should not be the battleground for contested elections finds support both in the history of **Rule** 14a-8(i)(8) itself as well as in the structure of the **federal proxy rules.** Over a period of many years, Congress and the SEC have engaged in a process of adopting and revising the **proxy rules** periodically, with emphasis on the additional protections **shareholders** require when contested elections or other **proxy** battles are involved. These **rules,** individually and when taken as a whole, constitute a carefully constructed legal regime designed to regulate **proxy** contests on the assumption that **proxy** contests are to be waged by contestants using separate **proxy** materials that are then subject to additional regulation for the protection of **shareholders.**

History of the Director Election Exclusion

The view that election contests are outside the purview of the **rules** providing **shareholder** access to company **proxy** materials has been a basic feature of the SEC's **proxy rules** for over 60 years. During that time, the SEC has periodically considered the issue of **shareholder** access to the company's **proxy** statement and each time has determined not to create a **federal** right of access to a company's **proxy** statement with respect to the election of directors. **As** early as 1942, the **SEC** proposed giving **shareholders** access to company **proxy** statements to nominate director candidates. [n10] The **SEC** abandoned the idea in the face of unfavorable public comment and strong Congressional criticism [n11] and by 1947, the SEC had codified director elections as a basis for exclusion under **Rule** 14a-8. [n12]

In reaction to **proposals** from corporate democracy activists of that era, in the 1970s the SEC again considered the question of whether **shareholders** should have "access to management's **proxy** soliciting materials for the purpose of nominating persons of their choice to serve on the board of directors." [n13] Noting the **conflict** between facilitating **shareholder** communications and the danger that enactment of **Shareholder** access **proposals** would encourage the harassment of management, waste corporate assets and render issuers' **proxy** statements unintelligible, the Staff proposed further study of nominating committees as a tool of **shareholder** access in lieu of granting **shareholders** access to company **proxy** materials.

Congress has also periodically considered the issue of **shareholder** access to the company's **proxy** statement. [n14] The most recent such initiative was proposed in May, **2002** by Senator Carl Levin and sought to permit **shareholders** beneficially owning 3% or more of a class of outstanding securities of an issuer to include certain **proposals,** including the nomination of a director, in the company's **proxy** materials. [n15] Notably, a **shareholder** accesss right was not included in the recent, comprehensive corporate governance legislation passed as the Sarbanes-Oxley Act of 2002. [n16]

As described above, the **proposal** to grant **shareholders a** right of access to company **proxy** statements for purposes of nominating directors has been thoroughly considered by both the SEC and Congress from time to time through numerous legislative and regulatory initiatives, Congressional hearings, consideration of comments made in public forums, review of comment letters and Staff studies. In each case, neither the SEC nor Congress has created a **federal** right of access to a company's **proxy** statement for purposes of nominating directors. The Staffs interpretation of **Rule** 14a-8(i)(8), as applied to the **shareholder** access **proposal,** is consistent with this history and any effort to change that interpretation would represent a significant change in policy and law. Such a change would necessarily and appropriately be the subject of legislation or a rulemaking process — with the attendant opportunity for full airing and consideration by all interested parties of all the ramifications of such a substantive change in corporate governance. [n17]

Structure of the Other **Proxy Rules**

The Staffs position against the use of **a** company's **proxy** materials as the battleground for contested elections is also supported by the existence and structure of the other **proxy rules.** The SEC acknowledged this when, in proposing amendments to **Rule** 14a-8 in **1976,** it made clear that **Rule** 14a-8 is not available as a means for conducting contested elections, stating that "the principal purpose of **[Rule** 14a-8(i)(8)] is to make clear, with respect to corporate elections,

that **Rule** 14a-8 is not the proper means for conducting campaigns or effecting reforms in elections of that nature, since other **proxy rules,** including **Rule** 14a-11, are applicable thereto." [n18] **An** entire edifice of interrelated **proxy rules** has in fact been structured on the basis that persons who wish to solicit **shareholder** votes in favor of alternative director candidates, whether a full slate or a "short slate," must present their nominees in a separate **proxy** statement from the one distributed by the company.

Rule 14a-12(c), for example, imposes additional information and procedural requirements with respect to disclosures made in the context of contested solicitations. **Shareholder** access **proposals,** including the **AFSCME Proposal,** have been silent with respect to the applicability of this **rule** and it is not clear how the **rule** would be applied in the scheme contemplated by a **shareholder** access **proposal.** To permit the 500-word supporting statement contemplated by the **AFSCME Proposal** to be "buried" in the company's **proxy** statement and thus avoid compliance with the **Rule** 14a-12(c) requirements would be to subvert the specific protections that the SEC has deemed **shareholders** require during such contested elections and might **lead** to a violation of **Rule** 14a-12(c).

Similarly, **shareholder** access **proposals** also have not contemplated the workings of **Rule** 14a-6, which requires that certain preliminary **proxy** materials be submitted to the SEC at least 10 calendar days prior to the distribution of definitive copies of those materials to **shareholders.** In an election contest, the **SEC** would review the **proxy** statements of both the company and the insurgents, and each would respond and negotiate with the SEC regarding the specific concerns that the SEC may have with that **proxy** statement prior to mailing to **shareholders.** Moreover, each side would have the opportunity to send letters to the SEC pointing out what it regards to be false or misleading statements in the other side's solicitation material.

It is unclear how this process would work if both the nominating **shareholder's** supporting statements and the company's opposition statements were required to be included in the same document under the control of the company. Whereas under **Rule** 14a-8, both the company and the **shareholder** proponent are afforded an opportunity to direct the SEC to false or misleading statements in the other party's statements relating to a **shareholder proposal** under **Rule** 14a-**8,** [n19] no comparable procedure exists under **Rule** 14a-6.

Rule 14a-4, which sets forth the SEC's requirements as to the form of the **proxy** itself, also supports the notion that election contests and other **proxy** fights are properly waged through separate **proxy** materials and not through the company's **proxy. Rule** 14a-4(a) requires that the form of **proxy** "shall indicate in boldface type whether or not the **proxy** is solicited on behalf of the registrant's board of directors or, if provided other than by a majority of the board of directors, shall indicate in boldface type on whose behalf the solicitation is made." **Shareholder** access **proposals** such as the **AFSCME Proposal** seem to envision a "common ballot" requiring the company's board of directors to solicit **proxies** for all nominees, including those who are in opposition to the company's nominees. Such a requirement would contravene the clear purpose of **Rule** 14a-4(a) and would disguise rather than identify the party soliciting on behalf of the alternative slate.

In addition, **Rule** 14a-4(b) states that a form of **proxy** "may provide a means for the security holder to grant authority to vote for the nominees set forth, as a group, provided that there is a similar means for the security holder to withhold authority to vote for such group of nominees." Companies routinely use this **rule** to permit their **shareholders** an option that may facilitate their voting. If a **shareholder** access **proposal** were implemented, however, and **shareholder** nominees were required to **be** included on the company's **proxy** card, the company might be precluded from seeking authority for its nominees in this manner.

In 1992, the SEC amended **Rule** 14a-4 to permit insurgents ***to*** nominate a "short slate" (i.e., less than all of the board seats subject to election). [n20] Prior to the amendment, the "bona fide nominee" **rule,** which requires persons named in a **proxy** statement to consent to **run** on a slate, prevented insurgents from filling out their slates with management nominees. After the adoption of the amendment, an insurgent is now permitted to submit a short slate of candidates and fill the remaining position with management nominees so long as the insurgent follows certain procedures, including seeking authority to vote in the aggregate for the number of director positions **up** for election and using a **proxy** card that specifies which management nominees it will not **support.** [n21] The **shareholder** access **proposal,** if enacted, would permit an insurgent to run a "short slate" without complying with the requirements of **Rule** 14a-4(d)(4).

Another **proxy rule** that Is in **conflict with the Shareholder** access **proposal is Rule** 14a-7, which provides that an insurgent seeking to mail **proxy** materials to **shareholders** may request the company to either provide a list of **shareholders** or, at the company's choice, to mail the insurgent's **proxy** materials but at the insurgent's expense. If a

shareholder access **proposal** were implemented, the company would lose its rights under **Rule** 14a-7 with respect to the information contained in its **proxy** statement - both the right to choose whether to mail the insurgent's materials or to provide the **shareholder** list as well as the right not to bear the expense of the mailing. At the same time, insurgents would be permitted to avoid the requirements of a limitation that is clearly imposed on them by the **proxy rules.** Ironically, in the case of **proposals** such as the **AFSCME Proposal** that **seek** to grant access only to certain large **shareholders,** smaller **shareholders** (presumably those least able to pay such expenses) would still be required to prepare and pay for their separate solicitation materials.

Finally, Schedule **14A** itself requires different disclosure depending on whether the solicitation is a contested election. For example, Items 4 and 5 of Schedule **14A** require more stringent disclosure when an election is contested. Most **shareholder** access **proposals** have not included a requirement that nominating **shareholders** comply with these additional requirements. Even those **proposals** that include an attempt to do so, such as the AFSCME **Proposal's** requirement that a nominating **shareholder** provide the information required **by** Item 5(b) of Schedule 14A, do not go far enough and subject the company to risk. [n22] (Item 5(b) requires participants in a solicitation to provide various disclosures regarding how many—and the nature of—the company's securities that a participant owns.) Such **proposals** are unable to offer any assurances that the information to be provided by **shareholders** would not **be** false or misleading under the standards of **Rule** 14a-9 or would not otherwise violate the securities laws. Therefore, since the company will be required to rely on third parties for required **proxy** information, it may find itself required to make the unpalatable choice between violating the SEC's disclosure requirements and risking a violation of its bylaws.

The **conflict** between the **shareholder** access **proposal and the federal proxy rules** is clear. **A** large number of **proxy rules** have been structured on the basis that persons who wish to solicit **shareholder** votes in favor of an alternative slate of directors must present their nominees in a separate **proxy** statement from the one distributed by the company. These **rules** are not anti-democratic, nor do they preclude **shareholders** from nominating, and soiiciting **proxies** for, director candidates of their choosing. Rather. they simply require added disclosure for election contests, clear identification of soliciting parties and pre-filing of **proxy** materials in contested elections, all in the interest of avoiding confusion and furthering the **shareholder** protection and disclosure objectives of the securities laws.

State Law

We believe the **shareholder** access **proposal** is excludable underRule 14a-8 [n23] because the **shareholder** access **proposal conflicts** with two fundamental **state law** principles: that the board of directors maintains authority to manage the business and affairs of the company and that shares of the same class should not be treated disparately.

Under **state law,** the board of directors. rather than **shareholders,** manages the business and affairs of the company, subject to the directors' fiduciary duties, which protect all of the **shareholders** as to the directors' exercise of their management obligation and responsibility. [n24] One of the most basic and fundamental tasks performed by a board of directors in managing a corporation is to direct the process of electing directors at the annual meeting. This **process** necessarily involves a multitude of steps, including calling the annual meeting, considering and nominating qualified candidates for the board of directors, sending a notice of the meeting, preparing and mailing **proxy** solicitation materials, and providing for designated representatives to vote **proxies** at the annual meeting itself, as well as spending corporate funds to perform all of these functions. in each case in accordance with the exercise of the board's fiduciary duties.

The board of directors is unique in its role of designating director candidates because its discretion is limited by its fiduciary duties *to* the company and its **shareholders. Shareholders** may nominate director candidates for self-serving reasons; the board of directors may not. In addition, unlike any nominating **shareholder,** the board of directors has duties under both state and **federal** law to ensure that the company's **proxy** statement does not contain false ***or*** misleading information, as well as to exercise appropriate care and responsibility in the nomination and solicitation process. State common law has long held that directors arc under a duty of candor, including to provide **shareholders** accurate information when soliciting **proxies** for election to the board. [n25]

Because directors, unlike **shareholders,** arc charged with fiduciary responsibility for the management of the corporation's business, they are also responsible for decisions about the use of corporate property. In fulfilling its duties to manage the director election process, the board of directors is entitled to use corporate funds, except to pursue a personal struggle for power, because such funds arc being used for a corporate purpose in the exercise of the board's fiduciary duties. [n26] Conversely, courts have held that an insurgent that wages a **proxy** fight against a company is not entitled to a reimbursement unless such insurgent is successful and both the company and **shareholders** approve such reimbursement.

[n27]

The case law on the fiduciary obligations of boards of directors to manage the business of the company (including the duty **of** candor in ensuring accurate disclosure in the company's **proxy** statements), together with the law on the use of corporate property in election contests, recognizes that only those who manage the business of the company, through the exercise of fiduciary responsibility, are entitled to use corporate property in so doing. Conversely, those who do not have any similar fiduciary responsibility, such as **shareholders,** are not entitled to the use of corporate funds or to access to corporate property or resources, such as corporate disclosure documents, unless a fiduciary determination is made **by** the board of directors. The **shareholder** access **proposal** would violate this principle because it would require the expenditure of corporate funds and give access to **shareholders** to the corporate disclosure machinery without a decision of a fiduciary.

Although the general absence of **shareholder** rights to use the corporation's **proxy** statement has been modified by the right specifically granted by **Rule** 14a-8, which also specifically permits exclusion of **proposals** relating **to** the election of directors, **Rule** 14a-8 does not reach as far as an actual nomination of director candidates, which would not be a **Rule** 14a-8 **proposal.**

Similarly, it is a fundamental **state law** principle, at least in Delaware and New **York,** that shares of the same class of stock shall not be treated disparately. In **New York** this is established by statute and confirmed by case law. [n28] In Delaware, largely the same principle is established at common law, [n29] and in the limited circumstances where Delaware courts have permitted **shareholders** to be treated unequally, they have done so only after finding that a board of directors made a fiduciary determination that such unequal treatment was reasonable in light of a legitimate benefit to be achieved thereby or a threat to be thwarted. [n30] The effect of the **shareholder** access **proposal** is to confer a valuable right upon larger **shareholders** that is denied to small **shareholders** without the board of directors deliberating in the exercise of its fiduciary duty on the question whether any benefit to the company justifies this unequal treatment. Discrimination in such a manner does not pass muster as a **state law** matter.

Conclusion

Although the rhetoric often used to support **shareholder** access **proposals** would suggest that such **proposals** seek to grant **Shareholders** the right to nominate or elect directors, such **proposals** in fact do not provide either a right to nominate directors or to elect them. Those rights are already provided by **state law** and the charters and bylaws of most companies. Instead, the **shareholder** access **proposal** is an attempt to transform the company **proxy** statement into a battleground for contested elections. As we have shown, the **federal proxy rules** are structured on the assumption that competing director slates will be presented to **shareholders** in separate **proxy** documents rather than in the company **proxy** statement. This position not only has long support in staff no-action letters and SEC and Congressional review of this issue, but also makes sense in light of the enhanced protections that are deemed necessary when **shareholders** are asked to vote in contested elections for directors.

In addition, at least in Delaware and New **York,** the **shareholder** access **proposal** is at odds with **state law.** In seeking to require the company to permit large **shareholders** to have access to corporate property without the prior judgment of a fiduciary, the **shareholder** access **proposal** stands in **conflict** with the fundamental corporate law principle that directors, not **shareholders,** manage the business and affairs of the corporation and make decisions with respect to the use of corporate property. Moreover, those **shareholder** access **proposals** that seek to limit access to only certain large **shareholders** are also in **conflict with the state Jaw** principle that shares of the same class of stock **are** to be treated equally.

FOOTNOTES:

[n1]Footnote 1. AFSCME has sent mandatory bylaw **proposals** to Citigroup, Inc., Sears, Roebuck & Co. and Exxon Mobil Corporation and precatory **proposals** to AOL Time Warner, Eastman Kodak Company and the **Bank** of New York, Inc.

[n2]Footnote **2.** On November **26,2002,** AFSCME issued **a** press release announcing that it has submitted **shareholder** access **proposals to** six companies and that it has written a letter to 150 public employee pension funds urging support for initiatives that would give **shareholders** access to corporate **proxy** statements. See "**AFSCME** Calls for Increased Activism, Details **Proxy** Access Campaign to Public Pension Funds" (Nov. 26, 2002), **http://www.afscme.org/press/index.html.**

[n3]Footnote 3. See Jayne W. Barnard, **Shareholder** Access to the **Proxy** Revisited, 40 Cat. U. L. Rev. 37 (1990); Note, A **Proposal** for the Designation of **Shareholder** Nominees for Director in the Corporate **Proxy** Statement, *74 Colum. L. Rev. 1139, 11.54n. 79 (1974);* Melvin Eisenberg, Access to the **Proxy** Machinery, *83 Harv. L. Rev. 1489 (1970).* Unlike AFSCME, however, some previous proponents recognized that **shareholder** access could only be adopted as part of a **rule** change that would preserve the protections of the current **proxy** regulation and provide further protection against abusive takeover and election techniques. See, e.g., Martin Lipton & Steven **A.** Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, *58 U. Chi. L. Rev. 187,* 230–33 *(1991);* William T. Allen, Jack 3. Jacobs & **Leo** E. Strine, The Great Takeover Debate: **A** Meditation on Bridging the Conceptual Divide, *69 U. Chi. L. Rev. 1067, I097 (2002).*

[n4]Footnote **4.** See, e.g., Storage Technology Corp., **SEC** No–Action Letter (Mar. 22, 2002); Kmart *Corp.,* SEC No–Action Letter (Mar. 23, 2000); Ford Motor Co., SEC No–Action Letter (Jan. **24,** 2000); Unocal Corp., **SEC** No–Action Letter (Feb. 6, 1990). The predecessor **Rule** 14a–11, which for many years governed contested elections of directors, or "**proxy** contests," was replaced in 1999 by **Rule** 14a–12 and section (c) thereof, which were expanded to cover the subject matter of **Rule** 14a–11.

[n5]Footnote **5.** Goldfield Corporation, SEC No–Action Letter **(April** 9,2002).

[n6]Footnote 6. Storage Technology Corporation, **SEC** No–Action Letter (March **22,** 2002).

[n7]Footnote **7.** See also General Motors, SEC No–Action Letter (March 21, 2000) (permitting exclusion of **proposal** requiring company to publish the names of all nominees, revise its **proxy** statement **to** include all nominees and publish the number of shares voted for each nominee); United Road Services, SEC No–Action Letter (March 10,2000) (permitting exclusion of **proposal** that would amend bylaws to require that each duly–nominated candidate for director be listed in the company's **proxy** statement and on its **proxy** card and that the company's **proxy** materials contain the same type and amount of information about each dulynominated candidate for **director);** BellSouth Corp., SEC No–Action Letter (February 4, 1998) (permitting exclusion of **proposal** recommending a bylaw providing that **shareholder** nominees to the board would be included in the company's **proxy** statement and **proxy** card, even if the board recommended a vote against such person); Unocal Corporation, SEC No–Action Letter (February, 8, 1991) (permitting exclusion of **proposal** recommending a bylaw to require the company to include in its **proxy** materials the names of any **shareholder's** nominees for director and information about the nominees "in the same manner as any, and all other nominees presented for election").

[n8]Footnote 8. Unocal Corporation, SEC No–Action Letter (Feb. **6,** 1990).

[n9]Footnote 9. Kmart Corporation, **SEC** No–Action Letter (March **23,** 2000). See also Toys "R" Us, Inc., SEC No–Action Letter **(April** 3, 2000); Oxford Health Plans, Inc., SEC No–Action Letter (February **23,2000);** CVS Corporation, SEC No–Action Letter (February 1, 2000); AT&T Corporation, SEC No–Action Letter (January **24,** 2000); The Coca–Cola Company, SEC No–Action Letter (January 24, 2000); Ford Motor Company, **SEC** No–Action Letter (January 24, 2000); Newmont Mining Corporation, SEC No–Action Letter (January 18, 2000); Black & Decker Corporation, SEC No–Action Letter (January 18, 2000); Storage Technology Corporation, SEC No–Action Letter (March 11, 1998); Amoco Corporation, SEC No–Action Letter (February 14, 1990).

[n10]Footnote 10. See Release No. 34–3347 (Dec. 18, 1942).

[n11]Footnote 11. See Securities and Exchange Commission **Proxy Rules:** Hearings on **H.R.** 1493, H.R. 1821 and H.R. 2019 before the House Comm. on Interstate and Foreign Commerce, 78th Cong., 2d. Sess. 34–43 (1943). During the congressional hearings in 1943, SEC Chairman Ganson Purcell testified that the **shareholder** access **proposal** was not adopted because it would be burdensome and unworkable. Id. at 161. Specifically, he noted a memorandum submitted to the SEC, which listed the following objections: (1) The **rule** had nothing to do with the principle of disclosure and would also go beyond SEC authority by converting a **proxy** into a ballot; (2) persons unqualified under **state law** might be nominated; (3) the **rule** might create an unworkable situation in determining who would be nominees if many persons were nominated; (4) the number of opposition candidates might be greater than the number of vacancies; and *(5)* the **rule** would engender confusion among **shareholders** and would lead to the invalidation of **proxies** because of improper marking. Id. at 157.

[n12]Footnote 12. See Release No. 34–4037 (Dec. 17, 1947).

[n13]Footnote 13. See Release No. 34- 13482, Part II, B. (Apr. 28, 1977).

[n14]Footnote **14.** See, e.g., S. 2567, 96th Cong., 2d Sess. § 8(a) (1980) (bill providing that **shareholders** owning more than 0.5% of shares outstanding would have the right to nominate a director nominee in the company **proxy); S.** 1323, 100th Cong., 1st Sess. (1987) (bill providing **shareholders** owning more than 10% or more of a company's stock with access to corporate **proxy** machinery to nominate candidates for the board of directors); H.R. 2172, 100th Cong., 1st Sess. (1987) (bill entitling any **shareholder** with the greater of either 3% of the voting power or $500,000 worth of shares in a public company access to the corporate **proxy** machinery to nominate candidates for the board of directors); **S.** 1198, 102nd Cong., 1st Sess. (1991) (bill that would grant **proxy** access rights to **shareholders** representing the greater of 3% of a company's voting power **or** $1,000,000 in market value).

[n15]Footnote 15. S. 2640, 107th Cong., 2d. Sess (2002). This bill has been read twice and referred to the Committee on Banking, Housing and Urban Affairs.

[n16]Footnote 16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. (2002).

[n17]Footnote 17. On August 1, 2002, the Committee of Concerned **Shareholders** and James McRitchie petitioned the **SEC** to modify provisions of **Rule** 14a-8(i) to permit **shareholders** to use **shareholder proposals** under **Rule** 14a-8 for the purpose of electing directors, Request for Rulemaking to Amend **Rule** 14a-8(i) To Allow **Shareholder Proposals** To Elect Directors, File No. 4-461 **(Aug.** 1, 2002).

[n18]Footnote 18. Release No. 34-12598 (July **7,** 1976).

[n19]Footnote 19. See **Rule** 14a-8(i)(3) and **Rule** 14a-8(m).

[n20]Footnote **20.** See Release No. 34-31326 (Oct. 16, 1992).

[n21]Footnote 21. See **Rule** 14a-4(d)(4).

[n22]Footnote 22. While the AFSCME **Proposal,** in requiring the nominating **shareholder** to provide Item 5(b) information, implicitly acknowledges that **Rule** 14a-12(c) would **apply** to **shareholder** nominations of directors, because that is the only instance in which Item 5(b) information is required, it does not require the nominating **shareholder** to submit the information required by Item 4(b) of Schedule 14A, which is also required for election contests to which **Rule** 14a-12(c) applies, and which generally relates to the cost of the solicitation in election contests.

[n23]Footnote 23. See **Rule** 14a-8(i)(2) (permitting exclusion of **proposals** that would, if implemented, cause the company *to* violate any state, **federal** or foreign law to which it is subject); see also **Rule** 14a-8(i)(1) (permitting exclusion of **proposals** that are not proper subjects under the laws of the jurisdiction of the company's incorporation).

[n24]Footnote 24. See Del. Gen. Corp. Law § 141(a); N.Y. **Bus.** Corp. Law § 701; *Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Vogel v. Lewis, 268 N.Y.S.2d 237, 240 (N.Y. App. Div. 1966),* aff'd *224 N.E.2d 738 (N.Y. 1967).*

[n25]Footnote 25. See *Wyatt v. Armstrong, 59 N.Y.S.2d 502, 504-06 (N.Y. Sup. Ct. 1945); Stroud v. Grace, 606 A.2d 75, 84-87 (Del. 1992).*

[n26]Footnote 26. See *Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168 (N.Y. 1955); Kors v. Carey, 158 A.2d 136, 141 (Del. Ch. 1960).*

[n27]Footnote 27. See *Grodetsky v. McRory Corporation,* 267 *N.Y.S.2d 356, 359 (N.Y. 1966); Steinberg v. Adams, 90 F. Supp. 604 (S.D.N.Y. 1950)* (construing Delaware law).

[n28]Footnote 28. See N.Y. Bus. Corp. Law § 501(c); see also *Avon Prods. v. Chartwell Assocs. L.P., 738 F. Supp. 686 (S.D.N.Y. 1990),* affd, *907 E2d 322 (2d Cir. 1990)* (per curiam); *Bank of N.Y. Co., Inc. v. Irving Bank* **Corp., 536** *N.Y.S.2d 923, 924-25 (N.Y. Sup. Ct. 1988),* aff'd without comment, *533 N.Y.S.2d 412 (N.Y. App. Div. 1988).*

[n29]Footnote 29. See, e.g., *Telvest, inc. v. Olson. No. 5798, 1979 Del. Ch. LEXIS 347,* **at** * 17-18 (Del. Ch. Mar. 8, 1979).

[n30]Footnote 30. See, e.g., *Applebaum v. Avaya, Inc., 805 A.2d. 209, 214,* affd *2002 WL 31647809* (Del. Supr.); *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).*

AUTHOR-NOTES: Andrew R. Brownstein and Igor Kirman are with the firm of Wachtell, Lipton, Rosen & Katz. They are representing Sears, Roebuck & Co. in connection with a **shareholder** access **proposal** submitted by **AFSCME.**

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Archived Articles

Hanover Settlement Seen as "Breakthrough" for Equal Access
By Will Boye, Senior Editor
2003.23.05

The settlement of a shareholder lawsuit by an oil services firm in Houston may advance the "equal access" debate that is now before the Securities and Exchange Commission, according to corporate governance advocates. As part of the settlement with **Hanover Compressor,** shareholders with more than 1 percent of the company's common stock will be allowed to nominate two independent directors to the company's board.

"It's a breakthrough," said Rich Ferlauto, director of pension investment policy at the **American Federation of State, County and Municipal Employees (AFSCME).** "We believe that this really sets the stage for shareholders to demand that other companies do the same."

"If this settlement helps to set a precedent...I think anything helps in our effort to get access [to the proxy]," said Brad Pacheco, spokesman for the **California Public Employees' Retirement System** (CalPERS).

The **SEC** recently announced a review of proxy rules, a move that was precipitated by a shareholder resolution submitted to **Citigroup** Inc. by **AFSCME;** the proposal would have required the inclusion of one board member nominated by shareholders owning at least 3 percent of the company's stock. The SEC allowed Citigroup *to* exclude the proposal from its proxy materials but then announced that the Division of Corporation Finance would review the rules and suggest changes to "improve corporate democracy."

The Hanover settlement, which will provide investors with more than $80 million in cash, stock, and debt instruments, will also allow each individual or entity holding more than 1 percent of the company's stock to submtt names of candidates for Hanover's board. Hanover's nominating and governance committee will then select two of those individuals for election to the board. After the shareholder-nominated directors have served a one-year term, the board will only be obligated to nominate one shareholder-nominated director, according to the settlement term sheet.

The class-action against Hanover alleged that the company and other defendants engaged in insider trading, improperly reported revenues, and manipulated stock value through off-the-book transactions. Darren Robbins, a partner at **Milberg Weiss Bershad Hynes & Lerach** who represented the plaintiffs, said that the negotiation of the corporate governance portion of the settlement was "very, very lengthy," and that the provision allowing for shareholder-nominated directors was more than a sticking point in the talks.

"That would be an understatement," he said. Robbins declined to get into specifics but said that the company voiced "concerns about manipulation *of* the process" by outside

parties.

Hanover also agreed to rotate its independent auditor every five years, another first in corporate governance reforms (the Sarbanes-Oxiey Act requires only that companies rotate the lead partner). Hanover officers and directors will also have to retain 33 percent of any shares acquired through option exercises for at least 12 months.

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Archived Articles

Apria Makes Room far Shareholder Nominees
By Will Boye, Senior Editor
2003.13.06

Apria Healthcare Group, one of the largest home health care firms in the U.S., will open up its proxy materials to shareholders beginning next year. The company will include in its proxy statement up to two nominees submitted by any stockholder or group of stockholders owning at least 5 percent of the company's stock for at least two years. The new policy was adopted by Apria's board and was mailed to shareholders **as** an exhibit to the company's proxy statement.

The announcement comes as the **SEC** is preparing to review its proxy rules and consider the issue of shareholder access to the proxy (see related story). **It** also follows a class-action settlement by **Hanover Compressor** Corp. that allows stockholders with more than 1 percent of that company's stock to nominate two independent directors to the company's board *(Friday Report,* May 23). Apria is believed to be the first company to voluntarily ***adopt*** such a reform.

"It has become painfully obvious over the past few years that corporate America must improve board room dynamics," said Apria Chairman Ralph Whitworth in a statement. "This has to start with a robust and inclusive process for determining board composition. Apria's new policy will allow our shareholders to participate in that process without the cumbersome and expensive undertaking **of** filing and distributing a separate proxy statement."

If more than two nominations are received for the same board seat, the nominating stockholder owning the most shares will receive priority. The policy also states that any shareholder nominee who **does** not receive at least 25 percent of the votes cast in the director election cannot be nominated again for four years.

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INSTITUTIONAL SHAREHOLDER SERVICES' FRIDAY REPORT (October 24,2003)

Proxy Access Proposal Reveals Cracks in Governance Juggernaut

By Michael P. Bruno, Staff Writer

Two weeks after the SEC proposed new securities rules allowing unprecedented shareholder access to the proxy ballot, fault lines are emerging in the debate of what has become the latest hot-button issue of the corporate governance reform movement.

On Oct. 8, the five commissioners unanimously proposed a set of shareholder access rules, a controversial measure that they predicted would leave corporate interests and investor activists equally unhappy. The rule, which would create a two-year access window set off by two possible "triggering events," would go into effect on Jan. 1, 2004, if adopted, meaning that shareholder nominees could appear on company proxy materials as early as the 2005 proxy season.

Since then, two commissioners and several other high-profile governance experts have expressed caution over the specific SEC proposals, though most said the goal of greater shareholder participation was still worth pursuing.

"I agree with this proposal in theory, but to paraphrase no lesser an authority than Homer Simpson, 'Communism works . . . in theory,'" Commissioner Cynthia A. Glassman said at the National Association of Corporate Directors' 2003 Annual Corporate Governance Conference. "While I agree that the rule could have a positive effect on some poorly governed companies, I am concerned that the rule's reach will not be so limited. To use a military analogy, we may be dropping a cluster bomb when a surgical strike is more appropriate. I am also very concerned about the potential competitive effects the proposal could have, especially for companies that compete in global markets?

Before the conference, Commissioner Paul S. Atkins told the Friday Report that because the ramifications of the proposal could be so severe, he will be paying close attention to official comments submitted to the SEC.

"I think this is a step forward, but there are aspects of it that we have to be very careful about and people are talking about that, and that's what I was trying to reflect. Depending on where all these percentages are set, it can have a profound effect on corporate relations with shareholders," Atkins said after testifying on Capitol Hill for his re-confirmation last week. "The chairman is really interested in going very broadly for comment and even have a ... conference or roundtable or townhall meeting, something Iike that, I think we're all supportive of him doing that sort of thing."

"I haven't really made up my mind," Professor Charles M. Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware, told the Friday Report. "The goal of the thing is to bring institutional holders on the boards. I think that's a great idea. The question that is going to be coming up in the next couple of weeks as we go through this is the way to do it. Maybe a partial reimbursement of a slate by a company, maybe that's an approach. Is it direct access, I don't know."

Ira M. Millstein, senior partner at Weil, Gotshal & Manges LLP, followed the theme of inevitability in a luncheon speech at the NACD conference. "One way or another, you're going to get access. It may be not too much in the beginning, but it's a beginning," he said.

"Everyone is quite **aware** of the fact that structural adjustments alone are not going to do the trick," he continued. The current board election system, which resembles "Chinese elections" in that "there's only one slate and everybody knows that slate is there to be ratified, not to be voted on," hasn't produced the best directors in the world. "If it had we might have avoided what we just went through," Millstein said.

But shareholder activist Herbert Denton, president of Providence Capital Inc., said during **a** separate panel appearance at the conference that just the mere threat of greater shareholder power would be enough to rein in corporate behavior.

"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 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," Denton said. "There are going to be a ton of things put forward by shareholders that never see the light of day but are negotiated behind closed doors. Whether it's good or not..."

Roger W. Raber, NACD president and CEO, told the Friday Report that the association will release a statement next week commenting on the SEC access proposals. He declined to discuss the NACD's opinion until then, but said:

"We've said from day-one if you have a governance nominating committee made up of outside, independent directors, you have criteria for selection, you disclose it, you include recommendations from shareholders, then it's going to work. And if doesn't, you're going to have shareholder intervention and I think that is very appropriate. Our focus is if you've got those independent directors, have the criteria and disclose it and invite shareholder nominations, than it should" work.

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News

'Holy grail': Proxy ballot access missing from corporate governance list

Barry B. Burr

Proxy ballot access for shareholder nomination of directors -what some institutional investors consider the holy grail of corporate qovernance - was removed from proxy statements this season.

The proposal doesn't have universal support among corporate governance activists; even those who support it believe it would be used rarely.

But the proposal is getting consideration from the Securities and Exchange Commission. The SEC this month directed its division of corporate finance to recommend changes to proxy rules on the election of directors "to improve corporate democracy," including the nomination process.

The directive referred to a resolution submitted to Citigroup Inc. by the $600 million American Federation of State, County and Municipal Employees' Pension Plan, Washington. The SEC upheld Citigroup's request to keep the resolution off the proxy statement. It would have allowed shareholders with at least 3% of the stock to nominate director candidates.

The SEC ordered the division to present its recommendations by July 15.

Unions very active

Union pension funds have been among the most active institutional investors this year, said Charles M. Elson, law professor at the University of Delaware and director of its Center for Corporate Governance.

"Unions have a lot of interesting shareholder resolutions," said

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Kenneth A. Bertsch, vice president and director-corporate governance, Moody's Investors Service, New York.

"We really stepped up the pace," filing 24 resolutions this year vs. six last year, said Richard C. Ferlauto, director-pension and benefit investment policy, AFSCME.

Union-staff and Taft-Hartley pension funds in all filed some 400 resolutions this year, up from about 280 last year, he added.

Corporate scandals, the catalyst of shareholder anger last year, haven't receded from importance, others agreed,

"I think they're in the back of people's minds, reflected in the lack of confidence in the equity market," said Elizabeth Fender, director-corporate governance, TIAA-CREF, New York.

"There are a lot of scandals still going on," Mr. Elson said. "Shareholder votes have demonstrated a clear suspicion of management. Governance resolutions are doing well, rubbing off from the scandals," although proposals aren't necessarily getting a majority of votes.

Up for vote

Major issues coming to a vote in this proxy season include:

- generous executive severance, so-called golden parachutes;
- expensing of stock options;
- performance-based options; and
- reincorporation of U.S. companies to the United States from Bermuda and other offshore tax havens.

Some 862 shareholder proposals had been filed so far this year, according to the most recent count by the Investor Responsibility Research Center, Washington, and the Interfaith Center on Corporate Responsibility. Many never make it to a vote; they are withdrawn after

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negotiations or challenges.

Corporate governance resolutions numbered 625 of the total, compared with 529 in all of 2002.

Executive pay issues are the overwhelming focus of this year's corporate governance resolutions, accounting for **44%**. Last year, resolutions related to traditional anti-takeover and board issues accounted 57% of all proposals submitted, according to the two groups.

At TIAA-CREF, executive compensation is the centerpiece of its corporate governance approach, said Ms. Fender. "Executive compensation is a key issue to evaluate how directors are exercising their fiduciary duty in overseeing management. This is one area where directors have to stand up to management, giving shareholders insight into the effectiveness of the board," she said.

The SEC in mid-April upheld TIAA-CREF's efforts to sponsor resolutions at SBC Communications Inc. and Siebel Systems Inc., calling for reduced use of executive stock options, including megagrants, that have no performance hurdles, said Peter C. Clapman Sr., senior vice president and chief counsel of corporate governance at TIAA-CREF. He said TLAA-CREF would like to see greater reliance on stock, which has a downside risk and aligns interests of management **more** with shareholders, he said.

No position

TIAA-CREF has no position on the issue of giving shareholders access *to* the proxy ballot to include their nominations for directors. "It's a **newer** issue," Ms. Fender said, noting TIAA-CREF hopes to issue new corporate governance guidelines this summer.

The AFSCME is a leading advocate of such access. "I think ballot access would **be** used fairly rarely and only when the board has abdicated its responsibility" in nominating directors aligned with shareholder interest, **said** Mr. Ferlauto.

Mr. Elson **opposes** the effort. "If the nominating committee is truly independent and takes into consideration the interest especially of large shareholders, access to the proxy ballot is **unnecessary."**

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He noted that proposed New **York** Stock Exchange rules awaiting SEC approval call for all directors on key committees, including nominating committees, to be independent. He believes the newly formed committees **should** be given a chance to function in the interest of **shareholders**, to see if ballot access is necessary.

Opening proxy ballots to shareholder nominations "could create a **free-for-all,"** Mr. Elson said."The problem **is** there is nothing now between an all-out war of a proxy fight and passivity" in **approving** directors, added Moody's Mr. Bertsch.

The reincorporation issue, another leading union stand, has the backing of **many** large public pension funds but not all institutional investors, as witnessed by its defeat at scandal-tainted Tyco International Ltd. The vote in favor was 26.4%.

"We look at it on a case-by-case basis," said **Ms.** Fender. TIAA-CREF, which doesn't disclose its votes, weighs the potential tax saving of offshore incorporation and the loss of any shareholder rights.

But Mr. Elson believes shareholder protection outweighs any tax advantages. "I don't believe Bermuda provides adequate protection for shareholders," he said.

The AFSCME and the California F'ublic Employees' Retirement System, Sacramento, in April jointly withdrew a reincorporation resolution at McDermott International Inc. The company agreed to work with the two pension funds "to bring a fair resolution to the issue of whether McDermott should redomesticate from Panama to the United States," according to a statement by the three parties.

McDermott, which operates from New Orleans, agreed to place a management resolution on reincorporation in its next proxy statement. The resolution will recommend reincorporation in the event the tax, *costs* and other considerations are believed by McDermott's directors to be in the best interests of shareholders. If **the** resolution does not gain support of McDermott's **board** of directors and its management, the ballot will contain a 500-word statement of support from the union pension fund and CalPERS.

Stock options

Another hot button is stock options. Mr. Ferlauto noted that expensing

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stock options "is gaining momentum without votes." Some 200 companies, amounting to about 30% of the market's capitalization according to Mr. Bertsch, have decided to expense options. The Financial Accounting Standards Board should decide on the issue by year-end. Many companies are waiting for the FASB decision, Mr. Bertsch said. For that reason, many shareholders are not supporting such a change in resolutions this year.

Union funds have won some significant votes on executive severance agreements. While reincorporation lost at Tyco, an AFL-CIO pension fund resolution on golden parachutes got 57.7% of the Tyco shareholder vote.

Similar resolutions, sponsored by the AFL-CIO fund and the Amalgamated Bank and Communication Workers of America, got majority votes at Alcoa Inc., United Technologies Corp., Union Pacific Corp. and Hewlett Packard Co., according to the AFSCME.

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Photo Caption: Richard C. Ferlauto said corporate scandals are behind the surge in shareholder resolutions. * Charles Elson says shareholders are showing their suspicion of corporate management in light of recent corporate scandals.

---- INDEX REFERENCES ----

COMPANY (TICKER): Citigroup Inc. (C)

KEY WORDS: ECONOMY, BUSINESS AND FINANCE COMPANY INFORMATION PROXY FILINGS

NEWS SUBJECT: English language content; Dow Jones Total Market Index; Corporate Governance; Management Issues; Corporate/Industrial News; Proxy Filings (ENGL WEI CCPGVN C41 CCAT PRX)

NEWS CATEGORY: CURRENT

INDUSTRY: Diversified Financial Services; Dow Jones Industrial Average components; Dow Jones Global Titans Index components; S&P 500 Index component; Dow Jones Sector Titans Index - Financial (FIS XDJI XGTI XSP5 XSTF)

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Investor Relations Business
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Monday, October 27, 2003

Conn. Treasurer Touts the Power of Social Investing to Reform

Matthew Greco

The push by socially responsible investors for corporate reform and to help create more responsible businesses has made real and substantial progress, according to Connecticut state Treasurer Denise Nappier who spoke at the recent annual forum of the New York-based Interfaith Center on Corporate Responsibility. Indeed, an upcoming United Nations conference on climate change that Nappier is helping to organize will include dozens of state Treasurers, representing hundreds of billions of dollars in potential socially responsible investment assets.

Speaking on the topic of "Pushing the Envelope of Corporate Change," Nappier told the audience of 300 institutional investors that issues of sustainable business practices have reached new heights as part of the corporate governance agenda.

ICCR is a coalition of 27 faith-based institutional investors, whose members include denominations, dioceses, orders, pension funds, healthcare foundations and publishing companies and whose combined assets exceed $10 billion.

Members use their positions in the market as leverage to change unjust or harmful policies through shareholder resolutions and corporate dialogue.

Change for the Better

Much progress has been made on a host of issues, said Nappier, including environmental protection, the fair and humane treatment of workers, creating independent and responsible directors and boards, and excessive executive pay.

Indeed, the sharp drop in public confidence in corporations and executives has created an "unprecedented window of opportunity," for reform, Nappier said.

"We must keep it open and let the fresh air of reform come in. There's never been a better time for investor power-and never more need for stricter oversight," she said.

Nappier pointed to the recent resignation of New York Stock Exchange President Richard Grasso over a scandal regarding excessive pay as both a sign of investors' power and the need for continued regulatory oversight.

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Concerted Effort

At the same time, other regulatory agencies are moving in the same direction-whether it's Congress, the Securities and Exchange Commission, state Attorney Generals or state Treasurers. "We're all moved to act," she said.

But to get the job done, different investor groups need to collaborate with each other. That includes not only the religious funds as represented by ICCR, but public pension funds, labor funds, environmental funds and other socially responsible investment funds, Nappier said.

Coalitions can bring the expertise and leadership that no one group possesses. Given the current opportunity, "what we make of it is up to us," she said.

New-Fund Power

One of those opportunities includes unprecedented shareholder access to independent directors and to promote director accountability.

That access will help counter "arrogant" board actions, such as ignoring majority shareholder votes on certain shareholder resolutions.

The pressure can help ensure that regulators keep up the pressure and don't let up on corporate reform because it's not only "a few bad apples. We know that's not true," Nappier said.

The SEC is considering new proxy rules to give investors better rights, and socially responsible investors must keep on the SEC to make sure the new rules go far enough (See IRB, 10/13/03).

Other issues include continued pressure on corporations regarding workplace diversity and democracy.

Sustainable-business issues relating to global warming and environmental sustainability are also extremely important, she said. Companies like ExxonMobil Corp, must realize that investors are not going to go away, she said, speaking about the upcoming U.N. conference.

"We have every right to know what's being done to protect the environment," she said, exhorting the assembled group of religious investors to stick together to accomplish social change.

The crowd applauded Nappier's comments, which corresponded to ICCR's corporate mission. In its just-released annual report, the organization notes: "As a

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community of believers, we hold our faith dear and our call to justice sacred. We pledge our assets to the work of justice on behalf of the marginalized and oppressed. We are committed to a just ordering of society and invite the global community to join us in this effort."

Dissenting Voice

But not everyone was optimistic. Michael Musuraca, assistant director in the department of research and negotiations for the American Federation of State, County and Municipal Employees-representing the largest public sector union in New York-spoke in response to Nappier's comments.

Musuraca agreed that the socially responsible investment movement is at a crossroads-not because things are going so well, but because there's so much danger.

Musuraca said the fight for corporate reform is also a political fight that must involve all citizens. The reform of corporate America will have to change the culture, which won't happen, "unless you energize the people who are seriously hurt by it," he said.

Musuraca also said he expects the struggle to be long and hard and that corporations won't reform anything unless pressured to do so.

He pointed to underfunding of pension funds, corporations seeking to avoid paying taxes and fighting better environmental standards as evidence.

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Calpers Rides Again

The scourge of corporate slackers is back, with an ambitious leader and a controversial new agenda

BY MARC GUNTHER

Calpers trustee Phil Angelides demands social responsibility as well as high investment returns.

TO VISIT THE UNOFFICIAL world headquarters of shareholder activism, you have to fly to Sacramento and locate the government office building that is home to the 1,600 employees of the California Public Employees Retirement System, or Calpers, the nation's biggest pension fund. The Finance Minister of the Philippines made the trip to Calpers after the fund decided to divest its holdings in his country. So did top executives of JDS Uniphase, which Calpers accused of destroying shareholder value. When AIDS activists from Los Angeles wanted to pressure GlaxoSmithKline to lower the prices of drugs in Africa, they sought help from Calpers — and got it. "Calpers is the 800-pound gorilla," says Tom Myers, general counsel at the AIDS Healthcare Foundation.

With assets of $154 billion and a willingness to throw its weight around, Calpers is one of the world's most influential investors. Its ally in shareholder advocacy, the California State

Teachers Retirement System, or Calstrs, has another $103 billion in assets. That concentrates a quarter of a trillion dollars of investing power in a state not known as business-friendly. How that power will be used by the trustees who run Calpers and Calstrs—all Democrats, many with close ties to unions—is an important question.

Traditionally, big pension funds led by Calpers have focused on board independence, executive pay, and other corporate governance issues. In its heyday in the early 1990s, Calpers joined with other big investors to help topple the CEOs of GM, American Express, and IBM because their companies were underperforming. "Calpers has been a consistent force for shareholders, and the most important one," says Robert A.G. Monks, a pioneering shareholder advocate.

Calpers is still raising hell over governance issues today. Once a year it publishes its Focus List of underperforming companies with governance problems. The fund hires outside managers to run actively managed "governance funds" that take big stakes in poorly managed firms and then try to turn them around. It files shareholder proposals. Most important, its governance staff of nine people works behind the scenes with corporate executives and boards. JDS Uniphase, for example, agreed under pressure to limit its use of options, stop repricing them, and link compensation more closely to long-term financial performance. Later this year Calpers will publish its first list of overpaid executives and ask compensation committees to explain, in detail, how they measure CEO effectiveness. "We want to cut down the universe of people who are well paid to those who are really performing," says Ted White, who runs Calpers's governance programs.

Recently, though, Calpers and Calstrs have gone beyond governance into social engineering. Needless to say, this is controversial. Over the objections of its professional staff, Calpers trustees voted to divest tobacco stocks. (The stocks subsequently outperformed the market.) Calpers has lobbied U.S. firms that reincorporated overseas to "come home to America" even if that means paying more taxes. The trustees have also steered investments to inner-city businesses and are taking a close look at "green investing."

PHIL ANGELIDES' TO-DO LIST

- ❍ Lobby SEC for corporate democracy so shareholders can nominate and elect directors.
- ❍ Spotlight overpaid CEOs.
- ❍ Explore "green investing" at Calpers and Calstrs.
- ❍ Expand "double bottom line" investments in California's emerging markets that deliver financial return and economic opportunity.
- ❍ Beat Arnold in 2006.

Leading the funds down this new path is Phil Angelides, the state treasurer of California, who sits on the boards of both Calpers and Calstrs. Angelides is a 50-year-old Democrat who made a fortune as a real estate developer before he was elected treasurer in 1998. Brainy and engaging, he shrewdly sat out the California recall election and is now positioned to challenge Arnold Schwarzenegger, the new governor of California, whose job he covets. Think of him as a Left Coast version of Eliot Spitzer, ready to save capitalism from its worst excesses, and in so doing propel himself to higher office. "This is a time when questions need to be asked about what is the right responsibility, the right compass, for America's corporate and financial sector," Angelides declares. "We can't lose sight of what we've just come through: the largest sustained losses in the market since the Great Depression. The biggest wave of market manipulation since the 1920s. The most visible acts of corporate irresponsibility. You know how they have, in floods, a 100-year flood? This is the 100-year flood of corporate irresponsibility. This was about millions of Americans losing trillions of dollars."

Calpers itself has lost nearly $20 billion since 2000. "On WorldCom alone, we lost $850 million," Angelides laments. Longer term, the fund has done better. During the ten-year period ended June 30, 2002, Calpers gained an average of 8.2% a year, slightly trailing the 8.3% average annual gain of big public pension funds. Calpers is currently fully funded, which means that it pays retirement and health benefits out of its earnings without requiring government subsidies. California taxpayers, not state employees, would have to make up any future shortfalls.

The new social agenda at Calpers is a tricky business because if it does crimp returns, no one wants to have to dip into taxpayer dollars to pay pensions. Trustees are obliged by law to run the funds for the sole interest of beneficiaries. Some fund trustees worry that Angelides and his liberal allies, led by Sean Harrigan, a union leader who is president of the Calpers board, are overreaching. "We've got to keep our eye on the ball," says Bob Carlson, a retired lawyer who has served on the board for

Recently, Calpers and Calstrs have gone
BEYOND GOVERNANCE AND INTO SOCIAL ENGINEERING.
Needless to say, this is controversial.

32 years and voted against divesting tobacco. "The only social concern I have is safe and adequate benefits for retirees and future retirees."

California state controller Steve Westly, who sits on the Calpers and Calstrs boards, also says social policy should be made by legislatures, not pension funds. "Vote with your heart," Westly says. "Invest with your head."

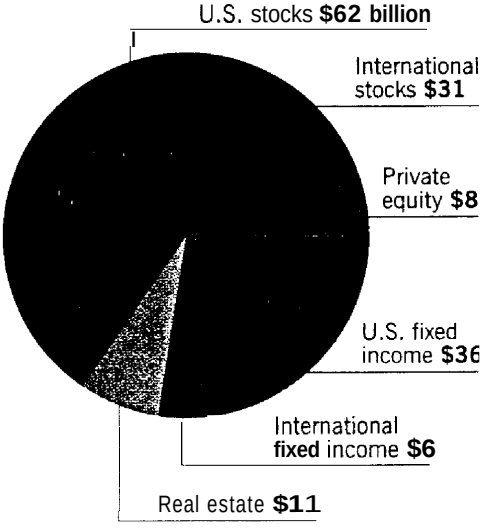
WHEN I MET PHIL ANGELIDES, the first thing we did was take a 15-minute drive to a suburb of Sacramento called Laguna West. Angelides is a Sacramento native who went to Harvard, then returned home to work in politics and real estate. He developed Laguna West. It wasn't his most profitable project, but it's his favorite because the development was guided by New Urbanism. Laguna West has a town green, pocket **parks,** sidewalks, artificial waterways, and front porches. His company planted 13,000 trees there; Apple built a factory nearby. Home values have appreciated nicely.

We've come here because Angelides has several points to make. (He always seems to have several points to make. He is one of those fast-talking people whose mind outpaces his mouth.) Point No. 1: Doing good and doing well go together in business. His reputation for fair dealing, he said, helped him survive the California real estate bust that bankrupted other developers. Point No. 2: Think long term. Laguna West struggled at first, and people doubted its success. "The real judgment is, What will this community look like in 30 years?'' he said. Point No. 3: Making money is fine, but the rewards should go to those who take **risks and** create value, not to an elite managerial class. "I'm a big believer in free enterprise. There's no other engine like it," he said. "Risk and reward. Pay for performance. What we don't want to see is the development of an economic plutocracy that feeds resentment in our society."

That is what **got** Angelides so ticked off about Dick Grasso. The former chairman of the New York Stock Exchange earned $139.5 million while running a regulatory agency during an era of scandal. He also collected **a** $5 million bonus for getting the exchange reopened after Sept. 11. At a news conference broadcast live on CNBC, Angelides called for Grasso to resign. "I'm not aware of one firefighter, one police officer, the mayor of New York, or anybody else having gotten a $5 million bonus for doing the right thing for America," Angelides declared. "This defies all rationality and fairness." The next day Grasso quit.

The Calpers Stockpile

TOTAL ASSETS **$154 billion**



FORTUNE CHART

Despite his wealth and Ivy League pedigree. Angelides styles himself a populist. His grandparents were Greek immigrants. His father. an engineer who worked for the state of California, urged him to make money and give back. "In an immigrant family." Angelides says, "the notion that you could be involved in the leadership of your community was held up as a special privilege." He's been a prolific fundraiser for Democrats, especially Greek Americans. (Michael Dukakis and Paul Sarbanes are friends.) The Greeks gave us democracy, and Angelides wants to deliver nothing less to corporate America.

That's why he and other institutional investors are lobbying the SEC to give shareholders easier access to the process of nominating and electing directors. "Shareholders are owners of companies. Owners," Angelides says. "There ought to be a voting-rights act that allows owners some reasonable say. Not two years after problems manifest themselves. It's like telling a homeowner you can install an alarm after your home's been burgled."

ALL THIS TALK *OF* REFORM doesn't at all please the leaders of corporate America. (For the record, the Business Roundtable, an organization of CEOs, opposes the SEC's proposal to open up the proxy-voting process. It warns that giving too much power to shareholders could "stifle business innovation, decrease productivity, and stall economic growth," among other horrors.) But it actually makes sense for pension funds like Calpers and Calstrs to work on a grand—not to say grandiose—stage. These organizations invest **differently from** money managers who depend on active stock picking to drive returns. Calpers holds stocks in more than 1,600 **U.S.** companies, most through index funds. The funds are virtually permanent holders of a broad cross section of corporate America. "If they can't sell, they have got to care," explains James Hawley, a business professor at St. Mary's College of California and author, with Andrew Williams, **of** *The Rise* of *Fiduciary* ***Capitalism.*** The idea is that since their portfolios are so diversified, shareholder activism and its ripple effects ultimately pay off for Calpers and Calstrs.

The social agenda at Calpers and Calstrs is driven by this holistic view of their holdings. Angelides argues that social good generates economic returns for his funds because a healthier society means healthier companies. Calpers's inner-city investments, for instance, might generate not only direct returns (and they do, says Angelides) but also indirect benefits because they curb inequality, reduce the costs of poverty, and create new customers for

"There's no other engine like free enterprise," says Angelides. "What we don't want is an **ECONOMIC PLUTOCRACY** that feeds resentment in our society."

other companies owned by the fund. Angelides calls this a "double bottom line" — financial returns and social good. If Calpers, through either its investments or shareholder activism, can support companies that contribute to the health of the economy — say, by educating their workforce or preventing pollution — and penalize those that are antisocial, the fund will ultimately benefit. "I don't think many companies can be successful in an unsuccessful economy," Angelides says. Nor can companies thrive, he says, in an economy plagued by environmental woes, health-care costs, or "great divisions between rich and poor that erupt into social tension."

This is an unorthodox approach to pension-fund investment, to say the least. Think about what it means for an issue like global warming. Calpers and Calstrs arguably have good reason to pressure automakers and utility companies to reduce their emissions of greenhouse gases because of the threat that global warming poses to the tourism and agriculture companies that are also part of their portfolios. (In November, Angelides, Harrigan, and Jack Ehnes of Calstrs participated in a "climate change summit" with other pension fund managers and environmental activists at the United Nations. "It's a threat that we need to be cognizant of," said Harrigan.)

Sean Harrigan is Calpers's board president and Angelides' main ally.

The risks of pursuing this untested path, which Calpers and Calstrs are just now exploring, are obvious. Inner-city investments sound fine, but they could be turned into payback for campaign contributors. (Calpers has been tainted by pay-to-play scandals in the past.) And who is to decide which company's practices are social or antisocial, good or bad for the overall economy?

"Once you get off the traditional financial criteria, you're on a slippery slope," says Hawley, the St. Mary's professor. "It can easily get politicized." When I visited Calpers, Christianna Wood, the deputy chief investment officer, said she'd just gotten a letter asking the fund to sell its holdings in Take Two, a videogame company that allegedly makes a game that degrades women. "We can't go around divesting on every ad hoc issue," she said. "We would end up owning nothing." Calpers's staff tends to be more cautious than the trustees when it comes to defining the fund's mandate. "We lose effectiveness when we get away from arguments that carry weight with the financial community," says governance expert Ted White.

Nevertheless, Calpers did write to GlaxoSmithKline about the high prices of its AIDS drugs. Several weeks later—and this could be a coincidence—the company dropped its prices. Myers, the lawyer for the AIDS foundation, says Calpers should go after "rogue companies" like Glaxo because "companies that engage in irresponsible conduct don't perform well." (GSK says it has repeatedly dropped the prices for its AIDS drugs to make them more widely available, particularly in the developing world.) Of course, cutting drug prices could also cut profits and returns.

Angelides' activism makes some people around Calpers nervous. "I pray that Phil does not use the fund's capital to build up his own political capital," says a former staff member, who asked not to be identified. Others are impressed. "He's very smart. and he's doing his homework," says Richard Koppes, a former Calpers general counsel who now works on governance for the law firm Jones Day.

Whether Angelides' new brand of activism will pay off is an open question. The relationship, if any, between social responsibility and economic performance is complex and hard to measure. "You may say it's pretty fuzzy," Bob Monks says, "but life's pretty fuzzy." We'll just have to await the returns — from the stock market, not the ballot box — to see how this experiment plays out. F

FEEDBACK mgunther@fortunemail.com

Angelides' activism **MAKES SOME PEOPLE NERVOUS.** "I pray Phil doesn't use the fund's capital to build his own political capital," says a former Calpers staffer.

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BODY

CEOs and CFOs at $1 billion-plus companies are racing to comply with personal certification and other **Sarbanes-Oxley** requirements—with little regard to implementation costs.

At a recent global gathering of executives, the chairman and CEO of a corporation ranked among the world's 100 largest public companies confided that he **had** just signed off on the company's financials with great trepidation ***and*** less than full comprehension of every accounting policy he was approving.

Though few corporate executives may **be** as candid about their first experience with the new regulations, CEOs and CFOs in companies large and small are racing to better understand their financials in order to comply with **Sarbanes-Oxley** and a myriad of other new SEC and corporate governance requirements. To attest to the completeness and accuracy of corporate financial statements, non-financial disclosures, exhibits and footnotes, companies are beefing up internal processes, policies **and** analyses... with little regard to implementation costs.

The new regulatory environment takes the function of financial reporting to the next level of accountability. Everyone involved — boards of directors and audit committees, **external** and internal auditors, senior **and** multiple layers of management, financial staff. outside and in-house counsel — has a heightened awareness of the risks involved in filing their financial statements. This translates to more policies, more procedures, more risk assessment, more analysis, more scrutiny.., **and** more expense.

Yet few companies are calculating the costs. In **a** recent informal poll of $1 billion-plus companies based in Chicago and New York, The Johnsson Group found that companies — ranging from pharmaceuticals to financial services — are finding the filings painful to complete and the regulations costly to meet. Many corporations have spent considerable time analyzing **and** adjusting their traditional close process, reporting and review schedules. Most of the companies said that more layers of management and their board's audit committees were reviewing the implications of accounting policies in an unprecedented way. Focused almost exclusively on the need to comply, none had examined the cost of implementing the new regulations.

In this new regulatory environment, companies will, have to add financial staff and pay significantly higher auditing fees — projected at 20 percent to 200 percent over pre-Enron/Andersen fees. In some cases, independent auditors' are being retained to audit the company's auditors. New risk ratings assigned companies by their auditors will require the lower-rated companies to pay higher audit fees, and new risk management consulting services will also add to the price tag. Accelerated reporting deadlines, to be phased in over three years, compress the time in which to perform an audit, which will now require more people and further elevate costs. The new, more prudent practices of assigning two partners to **an** audit — one to oversee **and** one to observe — and rotating both partners every five years will also increase audit firms' fees.

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Corporate governance costs are also on the rise. For example:

Director and Officer (D&O) insurance premiums are soaring — some as much as 500 percent to 1,000 percent over 2001 levels.

Board committee meetings are being scheduled more frequently and for longer duration. adding meeting fees to annual retainers for directors.

New Disclosure Committees are being formed to bolster the board's ability to scrutinize financial statements and increase investor confidence.

New board-level consultants are being engaged, from compensation experts to those who can provide financial training to non-financial directors.

Costs of Compliance

To help clients with 2003 budgeting estimates, The Johnsson Group set out to get a handle on what a "typical" company might face in terms of onetime costs to meet initial deadlines, and ongoing costs for subsequent reporting periods. Costs were estimated for a Fortune 500 corporation with global operations and $3 billion in annual revenue. Cost estimates include: an in-house internal audit department, in-house legal counsel and significant disclosure requirements. Rough estimates, based on long corporate experience and an intimate knowledge of the financial reporting function, range from $4 million up to $9 million in tangible onetime costs and another $3 million to $8 million in recurring annual costs (see table). Naturally, actual costs will vary widely by company.

Equally significant are the intangible or opportunity costs involved for company directors and top management. With a larger share of time and resources directed at reporting financial activity, the company's leadership will have that much less time and resources available for forward thinking. Also, new products, new markets and new mergers or acquisitions may be realized more slowly as a result of the new regulatory environment.

Although much attention has been focused on the impact on large public companies, many privately held and smaller public companies are affected as well. Indeed, SEC Section 12 requires private companies with more than 500 security holders to file reports with the SEC and comply with Sarbanes-Oxley. Additionally, the SEC is requiring companies with a common equity public float of at least $75 million as of the end of 2002 to file 10-Qs and 10-Ks. For smaller companies, compliance costs can be disproportionately burdensome due to their size—an unexpected challenge in an already difficult economic environment.

Yet, despite the expense, some companies understand that this sharpened focus on financial reporting can have a positive net effect. "We voluntarily began certifying our financial statements six months early," explains Elisabeth DeMarse, CEO of BankTate.com, an Internet consumer-banking marketplace. "As a smaller public company, our willingness to comply with Sarbanes-Oxley prior to our regulatory deadlines gives us a leg up in building credibility with our investors." she adds.

It's clear that in the aftermath of Enron, there is a heightened interest in solving operational problem areas that are either slowing the reporting process or management review of filings. Improvement projects on the back burner are rapidly moving to the front. As a result, expect to see faster external audits, increased expenditures in the finance operation to meet the new requirements and, eventually, improved internal controls and operations.

For example, costly software designed to consolidate financials or enable precise forecast processes might have seemed unnecessary in the past, but the need to close the books more quickly and forecast more precisely—under unprecedented scrutiny—is causing companies to recalculate costs versus benefits of such initiatives.

Focus on Key Skills

In addition to cost analysis, companies are beginning to focus on the types of personnel skill sets necessary to meet the ongoing requirements. Communications skills, combined with the ability to synthesize the numbers and present meaningful explanations, become increasingly important as many more questions arise from audit committees, management and auditors about various accounting procedures and results. Designating overt accountability is a major corporate culture shift that will produce an organization more deeply involved with tasks that have historically been the private domain of the auditors and senior management.

With this heightened focus, public companies will move closer to the end game, which is to restore confidence in

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the quality of numbers **and** information provided to the public, employees, bankers, regulators and investors. Restored investor confidence will go hand-in-hand with more precision and transparency of the core financial processes **and** renewed credibility for corporations, which will come at a price the companies have no choice but to pay.

SEC Reporting and Disclosure Changes Summary of Estimated Impact

(Incremental Costs)

The added expenses **as** a result of increased regulatory requirements:

(Assumes a "typical" Fortune 500 company with **$3** billion in sales, global operations, **an** in-house internal audit function, in-house legal counsel **and** signiticant disclosure requirements .)

One Time/Initial

Independent audit scope changes and fee increases	$1,000,000 - $5,000,000
Internal **audit** expansion	$250,000 - $500,000
External legal fees increases	$800,000 - $1,500,000
Legal resources expansion	$150,000 - *$250,000*
Outside consulting services	$400,000 - *$600,000*
Corporate governance change (BOD, D&O premiums)	*$200,000 - $250,000*
Finance/accounting/reporting expansion	$250,000 - $500,000
Required process improvements	$200,000 - $400,000
System enhancements	$250,000 - $500,000
Total incremental costs	$4,000,000 - $9,000,000

Ongoing/Annual

Independent audit scope changes and fee increases	$1,000,000 - 55,000,000
Internal audit expansion	$200,000 - *$300,000*
External legal fees increases	$500,000 - $1,000,000
Legal resources expansion	$100,000 - $200,000
Outside consulting services	*$250,000* - $300,000
Corporate governance change (BOD, D&O premiums)	$200,000 - $400,000

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Finance/accounting/reporting expansion	$250,000 - $300,000
Required process improvements	$100,000 - $200,000
System enhancements	$200,000 - $300,000
Total incremental costs	*$3,000,000 - $8,000,000*

Source: The Johnson Group Inc.

RELATED ARTICLE: Recommendations For Streamlining the Reporting Process:

* Improve precision of transaction processing.

* Bliminate system interfaces wherever possible.

* Accelerate the reporting and close process to give top management and the audit committee ample time to review and ask questions. (External auditors are resisting pressure to cut into their audit time, crting more extensive auditing requirements, which further compresses rime for the internal processes)

* Closely review key balance sheet accounts (both existing balances and accrual procedures/policies) as many "standard practices" such as consistency and materiality are no Ionger the cornerstone of the audit.

* Since the Management Discussion & Analysis (MD&A) section of the annual report will be subjected to more intense scrutiny (to appropriately draw investor attention to significant issues), get business unit heads in the practice of drafting MD&A for their areas.

* Quantify the costs associated with these changes in order to plan for them and prioritize the expenditures

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SECURITIES REGULATION

BY ROBERTA S. KARMEL

Shareholder Nominations: Increased Access to Proxy Card?

IT IS IRONIC that state comptrollers and treasurers have been in the fare-front of an initiative to shift regulation of internal corporate affairs from slate law to federal law. In response to the pending rule proposal of the Securities and Exchange Commission (SEC) on shareholder nomination of directors,[1] a group of state pension fund managers from New York, California and elsewhere — as self-declared 'representatives of shareholders" — advocated broad shareholder access to the company's proxy card on the ground that "[c]ompetition for board seats and the accountability that contested elections impose will raise standards for those who serve as directors."[2] By contrast, the Business Roundtable has attacked the SEC proposals as presenting "the possibility of special interest groups hijacking the director election process."[3] The politically charged atmosphere in which the SEC's proposals have been floated may obscure the complicated and difficult federalism issues raised by the pending regulation.

Broad Shareholder Access

The SEC's proposed rule would create a mechanism whereby director nominees of long-term security holders, or groups of long-term security holders, with significant holdings, could be included in company proxy materials where there are indications that the proxy process has been ineffective or that security holders are dissatisfied with that process. The proposal would be applicable to all companies subject to the proxy rules and once applicable, shareholder access would apply for two years. Two circumstances would trigger shareholder access: the receipt of more than 35 percent kithhold" votes of any director; or a shareholder proposal to activate the shareholder access process proposed by a shareholder or group who have held at least one percent of outstanding shares for one year and received a majority of shareholder votes cast.

The names of shareholder nominees proposed through this mechanism may be submitted by a shareholder or group who has beneficially owned at least five percent of shares outstanding for at least two years and who express its intent to hold the shares through the annual meeting. Any shareholder or group nominating a candidate must be eligible to report beneficial ownership on Securities Exchange Act of 1934 (Exchange Act) Schedule 13G and have filed such a schedule. The candidacy or election of board nominees must not violate controlling state law, federal law or the rules of any applicable national securities exchange or association. Further, the nominee must satisfy the objective independence criteria of the listing standard applicable to the issuer and have no specified relationships with the nominating shareholder or group or agreements with the issuer regarding the nomination. The maximum number of nominees that may be proposed is as follows: one nominee if the board has eight or fewer directors; two nominees if the board has between nine and 19 directors; three nominees if the board has 20 or more directors. If a company receives nominees in excess of the applicable numbers, those nominees from a shareholder or group with the largest share ownership would be selected as nominees.

The SEC's shareholder access proposals were preceded by the publication of a staff report on shareholder access to proxies[4] and new disclosure requirements with regard to board nominating committees.[5] The staff report discussed the possibility that such mechanisms could raise questions under applicable state law with regard to the triggering of 'poison pill" takeover defenses and other matters, but suggested ways to encourage shareholder nominees essentially along the lines that have now been proposed by the commission. Although the new disclosure requirements do not raise federalism issues to the extent that they are raised by the SEC's shareholder nomination proposals, they nevertheless may intrude on companies' governance processes governed by state law.

Standing Nominating Committees

For some time, companies haue been required to disclose in their proxy statements whether they have a standing nominating committee and, if so, to describe Its members, functions and processes, including whether thk committee considers shareholder recommendations for board nominees; Under the SEC's new disclosure rules, beginning Jan. 1, 2004, companies will be required to provide further information about a board's processes for director selection, its consideration of candidates recommended by shareholders and the procedure by which shareholders may submit candidates for consideration to the board. If a company does not have a nominating committee it will have to state why it does not. If a company does have a nominating committee it will have to make the charter of the nominating committee available on its Web site or as an attachment to Its proxy statement at least once every three years. Information regarding the independence of nominating committee members must be set forth. Among other new required disclosures are statements as to whether the nominating committee has a policy regarding shareholder nominees and, if the nominating committee has received a nomination from a shareholder or a group of shareholders who beneficially own more than five percent of the company's voting common shares, a statement as to whether the nominating committee chose to nominate such a candidate. Further, issuers will have to describe any minimum director qualifications sought by its nominating committee, the process by which its nominating committee identifies and evaluates nominees and the source for the recommendation of any nominees, such as a security holder, a nonmanagement director, an executive officer or a third-party search firm.

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Although a variety of questions could be raised about the SEC's proposal tb encourage shareholder access to management's proxy, two Issues are the most important: does the SEC have the statutory authority to pass such a regulation; and is it a good idea as a polfcy matter.

At least one sitting SEC commission has expressed serious doubt about the SEC's authority to promulgate a rule mandating shareholder access to management's proxy. Although the law is not entirely clear, such doubts are certainly justified.

Section 14(a) of the 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.[4] Notwithstanding its potential breadth, §14(a) has been Interpreted primarily as a disclosure rather than a regulatory provision.

The Sarbanes-Oxley Act

Nothing in the Exchange Act provided for direct regulation of the internal corporate governance of securities iksuers traded on the public securities markets until the enactment of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). However, nothing in Sarbanes-Oxley addresses or enlarges the SEC's authority with regard to the proxy rules. 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." But this provision was not Included in the statute because it was viewed as "unhecessary, since It [was] no! believed that the bill [was] open to misconstruction in [that] respect"[5] The Supreme Court has held that the antifraud provisions of the Exchange Act require deception, manipulation or nondisclosure, 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."[6]

In *Business Roundtable v. SEC*[7] the Supreme Court invalidated a rule that SEC had promulgated to regulate deviations from a one share, one vote regime for corporate shares of lfsted 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.[8] 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.

> *Should pension funds have been so heavily invested in equities at the top of the market and were investments being managed in a sound actuarial manner?*

Rather, it requests commenters to do so. The SEC's approach seems rather burdensome and sidesteps the obvious problem of the uneven application of the rules in states with different laws. This Is because, among other things, a company would not be required to Include a director nomlnee If that would violate state law.

Much could be said about corporate abuses over the past few years and the detrimental effect of the bursting of the 1990s stock market bubble on Investors, and particularly pension fund beneficiaries, and such rhetoric forms much of the basis for the SEC's new proxy rules. Older Americans who contemplated a cushy retirement are angry. Pension funds are embarrassed. But should such funds have been so heavily invested in equities at the top of the market and were pension fund Investments being managed in an actuarial sound way?

Shareholders as Owners

The state treasurers and comptrollers who have urged the SEC forward In the direction of shareholder proxy access declared that shareholders are owners of corporations and should have the right to nominate candidates for directors on the company proxy card. In an institutional stock market, where pension funds are not investing thetr 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 lofig-term investors but some of whom are short-term traders and many of whom chose indexation as an investment strategy, it is really a legal fiction (however useful) to say that shareholders are owners of a company. More mischievous Is the notion that corporate suffrage should mimic political suffrage so *that there* should be contested elections for directors. There is nothing now to prevent shareholders or a shareholder group from putting up a director or a slate of directors in opposition to a management slate. Shareholder access to management's proxy card would be a free ride. 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 powerful but small political group who may be overly influenced by governmental rather than business models.

(1) Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003).

(2) Letter from Alan G. Hevesi et al. to Chairman William Donaldson, Oct. 1, 2003. See also Alison Carpenter, AFSCME, CalPERS Seek Investor Access to Nomination Process, 35 SEC. REC. & L. REP. (BNA), Sept. 29, 2003, at 1599.

(3) Statement by the Business Roundtable on the SEC's Proposed Shareholder Access Amendments, Press Release, Oct. 8, 2003, available at http://www.brt.org.

(4) Staff Report: *Review of the Proxy Process Regarding the Nomination and Election of Directors*, Division of Corporation Finance [2003] FED. SEC. L. REP. (CCH) ¶86,938 (July 15, 2003).

(5) Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Exchange Act Release No. 48,301, 68 Fed. Reg. 48,724 (Aug. 14, 2002) (Proposed Rule), Securities Act Release No. 8340 (Final Rule).

(6) S. Rep. No. 1455, 73d Cong., 2d Sess. 1934, at 74, 77. See also *SEC v. Transamerica Corp.*, 163 F2d 511, 518 (3d Cir. 1947), cert. denied, 332 US 847 (1948).

(7) S. 9323, 73d Cong., 2d Sess. (1934), at §13(d).

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

(9) *Santa Fe Industries, Inc. v. Green*, 430 US 462, 479 (1977).

(10) 905 F2d 406 (D.C. Cir. 1990).

(11) Id. at 410.

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Feature

*1 LIGHTHOUSE OR HIDDEN REEF? NAVIGATING THE FIDUCIARY DUTY OF DELAWARE CORPORATIONS' DIRECTORS IN THE WAKE OF MALONE

Mark Klock [FNa1]

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*2 Introduction

In Malone v. Brincat, [FN1] the Supreme Court of Delaware held that corporate directors breach their fiduciary duty to shareholders when they knowingly disseminate materially false statements regarding corporate financial performance in the absence of any request for shareholder action. [FN2] Early commentary quickly interpreted this holding as a substantial and unwarranted expansion of directors' fiduciary duties under Delaware law. [FN3] This interpretation is based on a careless reading of Malone and other Delaware cases, and a general misunderstanding of the fiduciary duty concept in the corporate director context. [FN4] While Malone does involve a set of facts never previously confronted by Delaware's high court, [FN5] it does not expand the scope of a director's duties under Delaware law and is entirely consistent with both prior law and the underlying policies subsumed by the concept of corporate directors' fiduciary duties. [FN6]

*3 An accurate analysis of the Supreme Court of Delaware's most recent application of the fiduciary duties of corporate directors to a new fact pattern is important for several reasons. First, Delaware is the undisputed champion in the race for corporate charters, and many investors are likely to own stock in Delaware corporations and therefore have the potential to be directly affected by this decision. [FN7] Second, the analysis of the court, which is expanded upon in this paper, should be persuasive to other jurisdictions. [FN8] Third, the general fiduciary duty of corporate directors has newly increased importance in light of the recent statutory developments erecting procedural barriers for plaintiffs pursuing remedies against corporate directors under the federal securities laws. [FN9] Finally, the Court's opinion also highlights the importance of Delaware corporate law in obtaining remedies against accountants in light of the federal courts' restrictions on aiding and abetting liability. [FN10] Indeed, the interaction between federal securities laws and Delaware's corporate governance laws is now more important than ever. [FN11]

*4 Compared to federal laws governing securities transactions, Delaware law has relatively fewer procedural hurdles for plaintiffs and is relatively more favorable towards imposing secondary liability on defendants. [FN12] Interestingly, while Delaware law only requires disclosure to be made in limited circumstances, [FN13] it also requires all disclosures to be honestly made. [FN14] On the other hand, federal law requires periodic disclosure, but makes recovery for dishonest or misleading disclosures difficult to pursue by private individuals. [FN15] However, the violation of certain current federal disclosure laws clearly creates causes of action under state law, [FN16] notwithstanding Congressional efforts to preempt some of these claims. [FN17] Given the likelihood that the state court forum will be less hostile to plaintiffs, we can continue to expect at least some actions brought in state court which previously would have been brought in federal court. [FN18]

While Malone and the commentary thereon are the focal point of this article?the article is broader than the case and examines the concept and role of fiduciary duty with an emphasis on the genera1 concept of fiduciary duty rather than specific component duties, such as the duty of care and the duty of loyalty. The role of directors in the modem corporation in relation to shareholder rights is examined, as well as the following related issues: dual regulation of directors' conduct in a federal system; derivative versus direct causes of action; and aiding and abetting breaches of fiduciary duty. The key to the analysis is the view that when directors knowingly disseminate materially false information to the public they have: 1) interfered with shareholder voting rights and corporate governance; and 2) put their own interests in maintaining their positions ahead of the corporate interests.

This article begins with an overview of the concept of fiduciary duty. Then, the facts and the holding of Malone are presented, and the case and prior commentary on Malone are analyzed in the context of fiduciary duty. Finally, the relevance of *5 Malone is discussed in light of developments in the litigation of federal securities claims, including secondary liability.

I. The Fiduciary Duty of Corporate Directors

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A. Corporate Governance and Voting Rights

While there are abundant materials on the modeling of corporations, [FN19] a brief overview helps put the fiduciary duty of corporate directors in context. The standard model of a corporation as taught in the economics, finance, and law curriculum is that a corporation is the embodiment of a nexus of contracts. [FN20] A salient feature of these contractual arrangements is the separation of ownership and control. [FN21] In this model, shareholders are said to own the firm while managers control it. [FN22] This separation of ownership and control comes with both advantages and disadvantages. [FN23] Among the advantages is the facility with which capital can be raised. [FN24] Investors are able to contribute capital and earn returns on their investments without having to worry about the operations of the business. [FN25] Managers, who have specialized expertise in operating businesses but insufficient personal capital, can earn greater returns for the shareholders than the shareholders could earn for themselves. [FN26] The disadvantage is that the incentives of those controlling the firm are not perfectly aligned with the interests of those who own the firm.[FN27]

*6 This model of the corporation is sometimes useful, but like any model, it is a simplification of a considerably more complex reality. [FN28] In reality, an investor purchasing a share of stock receives a bundle of rights. [FN29] Some of these rights are fairly specific, such as the right to receive a pro rata share of the residual assets in the event of liquidation, [FN30] while some *are* quite vague, such as the right to receive a pro rata share of any dividends the corporate directors might (or might not) decide to pay. [FN31] Because corporate law varies from state to state, the bundle of rights also varies to the extent that these rights are determined by such law and that corporations incorporate in different states. [FN32] In addition, some of these government-determined rights are codified (and codes change over time), while others are the creatures of common law. [FN33]

Other rights are set by the corporate charter and can be corporation- specific, like a customized contract. [FN34] This complexity necessitates some simplification in discussing the rights of shareholders and the duties of corporate directors. [FN35] Occasionally, the simplification is extended too far, wherein a simplification which is useful in one context is taken out of that context. [FN36] Nevertheless, as a first approximation, there are some rights which would generally be considered common to all shareholders of publicly traded corporations (or at least those holding shares with voting rights). Among these rights would be the following: the right to vote in periodicly scheduled elections for or against directors or abstain; the right to remove *7 directors at other times (possibly subject to limitations); [FN37] and the right to choose to continue holding the stock or sell the stock (voting with one's feet). [FN38] According to Judge Easterbrook and Professor Fischel, voting rights are a mechanism to fill in the details which cannot be contracted for in an organization as complex as a large public corporation: "The right to vote is the right to make all decisions not otherwise provided by contract--whether the contract is express or supplied by legal rule." [FN39]

Implicit in each of these voting rights is the right to make an informed choice. Shareholders are not required to make their choice on an informed basis, [FN40] but surely they must have the right to make the choice on an informed basis; otherwise, the right to choose is no right at all. [FN41]

That is not to say that the shareholders have the right to unlimited information, [FN42] only that they have the right to make their choice based on the information available to them without interference by the directors. [FN43] *An* arresting law officer cannot knowingly mislead a suspect with the assertion that he does not have the right to remain silent until an attorney is present because it would interfere with the suspect's right to freely choose to exercise his rights to avoid self-incrimination and to retain counsel. [FN44] Deliberately misleading shareholders with material false information is analogously interfering with their rights.

The information on which the shareholders are entitled to base their choice varies. Some of the information is mandated by government statutes, [FN45] some of it is mandated by judicial decisions, [FN46] and some of it shareholders may have to choose to ask for themselves. [FN47] If they do not ask for this information, then that might be an *8 uninformed decision, or it might be an informed choice--not to seek more information given the information which is already known. [FN48]

Giving investors a choice is something society should encourage. [FN49] Investors need some level of information to decide how to manage their investment, but clearly not all investors want to be consumed by minor details about corporate operations. [FN50] If investors had to spend enormous amounts of time studying corporate details, they would be discouraged from investing in stocks, and corporations would have difficulty raising capital. [FN51] Alternatively, if investors had no access to information, many would also be reluctant to invest and capital formation would be impaired. [FN52] Individual investors are best able to determine for themselves how much effort to put into studying the business, and

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therefore should have some choice about the amount of information to digest. [FN53]

Some would use this line of argument to suggest that there should be no mandatory disclosure requirements, and that all disclosure rules should be determined in the marketplace. [FN54] This argument states that mandatory disclosure is *9 wasteful because it requires corporations to spend resources producing material investors do not value highly. [FN55] Others would argue, as a matter of public policy, certain minimal levels of disclosure should be set, so that this minimal information is always in the marketplace whether or not investors have requested it. [FN56] After all, the information in the market is important to potential future investors, not just current shareholders.

The argument presented in this Article is that whichever camp one might be in, everyone should agree on two common elements. First, regardless of the level of mandatory disclosure, investors should be free to choose how much of it they consume. [FN57] Second, regardless of the level of mandatory disclosure, investors should be free to choose to seek further information, either directly from the corporation or indirectly from a security analyst. [FN58] It is difficult to imagine anyone taking exception with these fundamental rights to choose.

Once again, though, implicit in all of these rights of choice is another right. It is the right to rely on the information given by the corporate directors as reasonably accurate, or at the very least, the right to have directors treat them honestly in any information they give, either directly to the shareholders or indirectly through release into the public markets. [FN59] Clearly, if shareholders do not have this right--that is, they cannot rely on the honesty of directors in the release of information--then the three legal rights which were put in the model (the right to vote for directors, remove directors, or vote with one's feet) are not rights at all. [FN60] Shareholders cannot be said to have the legal right to remove directors if the directors can legally infringe on this right by knowingly misleading the shareholders to believe that their investment is *10 doing well. [FN61] Additionally, public policy arguments support this view. [FN62] Shareholders cannot efficiently make important decisions regarding corporate governance if they cannot accept information provided by the directors, whatever the manner of disclosure, as honest. [FN63]

Thus, the first important conclusion of this Article has been reached without yet touching on the origin of the fiduciary duty of corporate directors: in a simple model of corporations, shareholders should have the legal right, congruent with the public interest, to accept information publicly released by corporate directors as being honestly released. [FN64]

Returning to the standard model of the corporation, directors can be theorized as either in direct control of the firm, or as the intermediaries between the managers who control the firm and the shareholder owners. [FN65] Either way, directors have duties to the shareholders. [FN66] The market can sometimes be a disciplining mechanism for enforcing these 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. [FN67]

Nevertheless, economists have long recognized that these market mechanisms are imperfect. [FN68] The seminal paper in 1976 by Professors Michael Jensen and William Meckling explains much of the behavior of corporations in terms of divergent interests between owners and controllers and the transaction costs *11 associated with aligning these interests. [FN69] In an economic model, there is no way for investors to force directors to act in the maximum best interest of shareholders unless the investors monitor the fine details of management's activity. [FN70] But monitoring, auditing, and contracting prohibitions are costly activities. [FN71] It will be economically profitable for investors to expend some resources on these activities to save some costs resulting from managerial opportunism, but it will not be profitable to eliminate managerial opportunism completely. [FN72]

B. The General Concept of Fiduciary Duty

Fortunately, these ideas were recognized in the law long before they appeared formally in the economics literature. [FN73] The law, recognizing that shareholders and corporations are not fully capable of protecting themselves from the corporate directors who are supposed to act in the interests of the corporation and its shareholders, imposed fiduciary duties on directors. [FN74]

[T]he legal situation in which a director finds himself is the product of judicial precaution, motivated by the necessity of safeguarding the interests of the corporation, of its stockholders, and of those who deal with it fiom overreaching by the members of its managing body for their own advantage. The reason for holding corporate directors to a high degree of accountability is a result of their dominant position, growing out of the complete control accorded to the board in the management of corporate affairs .... The courts have consistently upheld the board's independence. But it is a proper corollary

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of the grant of extensive powers that their misuse be prevented and their abuse punished. Accordingly, equity subjects the directors of a corporation to the same liability for negligence or misconduct as it does trustees. [FN75]

***12** While this general principle has become firmly embedded in modern corporate law, [FN76] there have been questions about the precise scope of the duty, [FN77] to whom the duty is owed, [FN78] and the effectiveness of the duty in promoting diligence **and** deterring fraud. [FN79] Some commentators believe that fiduciary duty does little to promote diligence on the **part of** directors but is effective in deterring fraud. [FN80] Indeed, courts seem much more likely to impose liability when the breach of fiduciary duty involves self-dealing or self-protection. [FN81]

Thus it **is** not **surprising** that much of the material asserts that the fiduciary duty ***of*** directors is one which is difficult to define in bright lines and needs to be addressed in the context of specific facts. [FN82] Clearly, the underlying idea is that directors are empowered by shareholders to direct the management of the corporation for the benefit of the shareholders. [FN83] This **very** general notion can be vague and provide little guidance in some circumstances. For example, when must directors affirmatively disclose information to the public? [FN84] This difficulty sometimes makes it tempting to skip **an** initial **inquiry** into how the general concept of fiduciary duty applies in a given factual setting and jump directly to some **prior** outcome in **a** similar factual context. [FN85] However, the general concept of fiduciary duty--exercising control of the firm **on** behalf of the shareholders and corporation--can provide general guidance, and one should begin the analysis there. **As** an example, the directors selling the corporate assets to themselves well below market price or turning ***13** a blind eye towards massive managerial theft would clearly violate the general concept of fiduciary duty in the context **of** corporate directors. [FN86]

C. Models of the General Concept of Fiduciary Duty

Material on the fiduciary duty of corporate directors often divides the duty into specific component duties, such **as** the duty of care and the duty of loyalty. [FN87] The duty of care is essentially the directors' duty to not act negligently, exercise **some** degree of diligence in gathering information used to make business decisions, and exercise the reasonable care which an ordinarily prudent person would exercise in the management of her own business. [FN88] The duty of loyalty involves the directors' obligation not to put self-interests ahead of corporate interests by engaging in a transaction which benefits **the** director unfairly at the expense of the corporation or taking a corporate opportunity. [FN89]

This model of fiduciary duty is probably based on a desire to make a distinction between breaches involving self-dealing (where courts are quick to impose liability) and breaches involving mere negligence (where courts are reluctant to judge **on** the basis of hindsight, absent gross dereiiction of duty). [FN90] Breaches **of** fiduciary duty do not always fall neatly into one category or the other. For example, if a director lies about his qualifications, it could be classified as either a breach of the duty of care or a breach of the duty of loyalty. [FN91]

These two duties are often even further subdivided into duties such as the duty of honesty, duty of candor, duty **of** disclosure, etc. [FN92] Such duties are really just outcomes resulting from the application of directors' general fiduciary duty to ***14** particular fact patterns. [FN93] **In other** words, the component duties are just models used to help explore the concept of fiduciary duty **as** it applies to specific circumstances. [FN94] Like any model, they are simplifications which in some contexts can help further an understanding **of** the world, but can also easily be misapplied out **of** context. Admittedly, these models have crept into the case law **and** can be considered to be **part** of the law, [FN95] but I argue that in any inquiry as to whether a specific set of facts constitutes **a** breach of fiduciary duty, one should first consider the basic ideas inherent in **the** concept of fiduciary duty generally in order to lessen the chances of applying some model of fiduciary duty out of context and consequently reaching an unreasonable result.

General fiduciary duty can be thought of as simply **a method** for **filling** in terms which cannot be contracted due to imperfect foresight. [FN96] Shareholders get the protection of fiduciary principles, and directors agree to be bound **by** them. [FN97] This provides a less costly method than monitoring and bonding every action of the firm. [FN98]

II. Malone v. Brincat–Expansion of Duty or Adherence to the Concept?

A. Facts

Malone was an appeal **from a** Court of Chancery decision to dismiss a complaint with prejudice for failure to state **a** claim. [FN99] The Supreme Court of Delaware affirmed **the** dismissal but reversed the decision to dismiss with prejudice, finding that **the** facts alleged in the pleading could **be** articulated so as to state a valid claim under Delaware **law.** [FN100] Therefore,

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the record is not well-developed, and the case is based solely on the pleadings. [FN101] Nevertheless, ascertaining whether certain circumstances will survive a motion to dismiss for failure to state a claim and enable a plaintiff to get to the discovery stage is of obvious importance to the bar. [FN102]

*15 The plaintiffs alleged that the directors of Mercury Finance Company, a Delaware corporation, knowingly disseminated false information regarding the financial performance and financial health of the firm throughout a four-year period at the end of which the company had "lost all or virtually all its value (about $2 billion) ...." [FN103] Specifically, the directors allegedly reported earnings of $120.7 million or $.70 a share when actual earnings were $56.7 million or $.33 a share in 1996; $98.9 million or $.57 a share when actual figures were $76.9 million or $.44 a share in 1995; $86.5 million or $.49 a share when actual figures were $83 million or $.47 a share in 1994; and $64.9 million when actual earnings were $64.2 million in 1993. [FN104] Total shareholder equity disclosed by the directors on December 31, 1996 was $353 million when plaintiffs alleged it was no more than $263 million. [FN105]

The complaint also alleged that the false and misleading information was disseminated through mandatory periodic filings with the Securities and Exchange Commission, and that the directors were aided and abetted by KPMG Peat Marwick, LLP, which was apparently the corporation's certifying accountant. [FN106] The Court of Chancery held that since the directors had no duty of disclosure under Delaware law in the absence of a request for shareholder action, their disclosure of inaccurate information was unconnected with any Delaware corporate governance issue. [FN107] Without a primary violation, the aiding and abetting claim was also dismissed. [FN108] The Court of Chancery partially justified its decision with a reluctance to duplicate or usurp federal law governing the release of inaccurate information into securities markets. [FN109]

The Supreme Court of Delaware affirmed the dismissal of the complaint as drafted because it did not carefully state: whether it was brought under a derivative or direct theory; whether procedural requirements for a derivative action had been complied with; the remedy sought; or the causation between the alleged wrongdoing *16 and damages. [FN110] However, the Court reversed the prejudicial effect of the dismissal, holding that the facts, if redrafted, could support either a derivative or direct cause of action, as well as the aiding and abetting claim. [FN111] The most significant part of the holding was the Court's statement that deliberately misinforming shareholders violates the directors' fiduciary duty. [FN112]

B. Analysis of the Fiduciary Principles Underlying Malone

Initial reports on Malone were quick to characterize the case as requiring a duty of candor, [FN113] and hinted that this was a broadening of the "Delaware carve-outs" contained in the Private Securities Litigation Uniform Standards Act of 1998. [FN114] In the only published full discussion of the case, the author of a comment characterizes the Malone opinion as creating a newly expanded disclosure duty for corporate directors. [FN115] This conclusion is based on a careless reading of both prior Delaware law and of Malone. [FN116] The comment serves as a useful foil for raising many of the issues Underlying Malone.

One problem with analyzing the broad and general fiduciary duty which corporate directors owe to the corporation and its shareholders, as consisting of the sum of a finite set of specific duties as discussed earlier, is that little snippets of holdings and dicta are often taken out of context. [FN117] This has happened in the case of *17 Malone. [FN118] For example, both the Court of Chancery and the commentator on Malone misinterpreted the following passage from Stroud v. Grace: "[The duty of candor] represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." [FN119]

An incorrect interpretation of the passage is that a request for shareholder action is a necessary condition for finding a breach of fiduciary duty related to disclosure or lack of disclosure. This misinterpretation appears to be caused by focusing on the "duty of disclosure" language. [FN120] What Stroud represents, however, is no more than a proposition that directors are under no obligation resulting from their fiduciary duties to communicate with shareholders unless shareholder action is being sought. Indeed, Stroud may represent even less, which is quite a different rule of law. [FN121]

Malone is often mischaracterized as a duty of disclosure case. In fact, it represents nothing more than the contention that material deception of shareholders about corporate financial performance in a material way is a breach of the directors' general, broad fiduciary duty to the corporation and to the Shareholders. [FN122] Once Malone was characterized as a duty of disclosure, it became easier, though not inevitable, to classify it as an expansion of directors' liability. [FN123] The Supreme Court of Delaware's prior major ruling on the fiduciary duty of disclosure was Stroud. [FN124] That ruling held that directors

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have a fiduciary duty to disclose all material information when the directors seek shareholder action, and that under the facts presented in Stroud, there was no duty to disclose more than the statutory minimum. [FN125] This holding is interpreted repeatedly to mean that since directors owe no duty to disclose anything in the absence of a request for shareholder action, fiduciary duty does not govern directors' communications to shareholders when no shareholder action is *18 sought. [FN126] This deduction is clearly erroneous. Fiduciary duty governs all director conduct at all times. [FN127] At any time directors communicate with shareholders, whether they do so voluntarily or because they are legally required to do so (perhaps by federal securities laws), they must communicate honestly. If one began an analysis considering the general fiduciary principle--acting on behalf of the corporation and its shareholders--it would be difficult to imagine reaching a conclusion that when no disclosure is required, intentional false disclosure about financial condition is permissible.

There is a useful analogy in the law of torts. [FN128] Just because one owes no duty to save a drowning man absent a special relationship, it does not mean one can push someone in the water and watch them drown without liability. [FN129] While directors might not be obliged to give information absent special circumstances, neither can they push the shareholders into a pool of false information and watch without liability.

This line of argument suggests that directors have a duty not to deceive shareholders because such deception constitutes an interference with shareholder rights. [FN130] First of all, shareholder rights--specifically the right to vote on directors, the right to remove directors, and the right to vote with their feet--are not meaningful rights if the directors can deliberately deceive the shareholders about the corporate business. [FN131] The particular information which is likely to be most important to investors is financial performance. [FN132] Introducing misleading financial statements into the marketplace interferes with these shareholder rights and corporate *19 governance. [FN133] Furthermore, the interference is self-serving as it increases the directors' ability to maintain their position without shareholder consent. Shareholders who do not act to vote against directors, remove directors, or sell out can be deemed to have given implied consent to the management of corporate affairs. But such consent cannot be inferred in an environment where directors injected materially false information into the marketplace.

This leads into an alternative explanation as to why shareholders have the right not to be deceived by the directors. Delaware corporate directors are expected to use their authority to the benefit of the shareholders and the corporation. [FN134] The directors serve at the pleasure of the shareholders. [FN135] They are authorized to use their judgment for the benefit of the shareholders. However, they are not authorized to replace shareholder judgment with their own, which is always the purpose underlying deceit. Deceit is an interference with the shareholders' right to use their own judgment in holding the stock and exercising their associated rights with ownership.

It cannot reasonably be argued that deceiving the shareholders is an action taken for their own benefit, especially in the situation presented by Malone, where the business was deteriorating and investors were led to believe it was doing much better. [FN136] It should be obvious that an ordinarily prudent man with an investment which is doing poorly would wish to be apprised of that fact before the capital is entirely depleted. This argument is supported by the commonality existing in covenants which give creditors the information and ability to act to save what remains of their investment before the collateral dissipates entirely. [FN137] If the business performs poorly, some investors will choose not to recognize their losses and let their remaining capital tide, betting on the business. Other investors will chose to cut their losses. If the loss is hidden from investors, not merely by a failure to disclose but by knowingly misleading information introduced into the marketplace, there has clearly been a breach of the fundamental first principles of the fiduciary duty generally, even though there might not be any prior outcome (such as a duty to disclose) resulting from a similar factual setting. [FN138]

***20 C. Analysis of the Malone Opinion Under Fiduciary Concepts**

A good place to begin is with a careful examination of what the Court actually said in Malone. The Court very carefully characterizes the case as a violation of the general fiduciary duty of directors--not as a duty of care or duty of disclosure case. [FN139] In the first four instances in which the opinion contains the term "fiduciary duty," the Court is merely stating that the complaint alleges a breach of the fiduciary duty of disclosure. [FN140] The fifth instance of the term "fiduciary duty" is the first one in which the Court puts its own words into the alleged facts. [FN141] Here the Court states, "Having alleged these violations of fiduciary duty, which (if true) are egregious ...." [FN142] The Court did not cast the allegations in terms of a specific component of fiduciary duty, but as a general duty. [FN143]

The next instance of the term is with respect to disclosure duty, but the Court is referring to Defendants' motion to dismiss in which they argue that they have no such duty. [FN144] The Court never disagrees with the Defendants' assertion that they

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owed no duty to disclose under Delaware law, but it does assert that the allegations could support a claim for a breach of fiduciary duty. [FN145] The seventh appearance of "fiduciary duty" in the opinion notes that there is a fiduciary duty to disclose material information when seeking shareholder action. [FN146] The language clearly indicates that a failure to do so is a sufficient condition for finding a breach of a fiduciary duty, but it is not a necessary condition. [FN147] That is, there are clearly other circumstances and conduct which will result in a breach of directors' fiduciary duty. [FN148] The Court carefully distinguishes this from a breach resulting from an affirmative duty to disclose by clearly and concisely writing both its characterization of the facts and its holding:

The present appeal requires this Court to decide whether a director's [[general] fiduciary duty arising out of misdisclosure is implicated in the absence of a request for shareholder action. We hold that directors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances. [FN149]

*21 The Court then launches into a discussion of the underlying premise for the imposition of fiduciary duties and their general scope. [FN150] The opinion demonstrates sound reasoning in not quoting prior holdings out of context, particularly since no plaintiffs had previously brought a similar set of facts before the Court. [FN151] Instead, the Court relies on the underlying premise for imposing fiduciary duty, which is not inconsistent with any prior binding case law. [FN152] The justices correctly note that the fiduciary obligations of directors stem from the separation of ownership and control. Since the owners are not in a position to protect themselves, they are afforded protection under the law imposing fiduciary duties on those in control. [FN153] The Court further notes that these duties oblige the directors to manage the business for the benefit of both the shareholders and the corporation. [FN154] Clearly, this does not mean that directors are liable for taking business risks without informing shareholders, but does suggest that they are liable for fiaud, waste, failure to manage, etc. [FN155]

In justifying the holding, the Court writes, "The director's fiduciary duty to both the corporation and its shareholders has been characterized by this Court as a triad: due care, good faith, and loyalty. That tripartite fiduciary duty does not operate intermittently ...." [FN156] Two important points are contained within this passage. First, the duties of due care, good faith, and loyalty are merely characterizations (or a model) of fiduciary duty, not the actual item. [FN157] Second, fiduciary duty is constant, not something which only applies when directors seek shareholder action or engage in transactions. [FN158] Perhaps in order to minimize the chances that a casual reader would interpret Malone as creating a new duty of disclosure, the Court highlighted its holding with the following bright-line marker:

The duty of disclosure is, and always has been, a specific application of the general fiduciary duty owed by directors .... The issue in this case is not whether Mercury's directors breached their duty of disclosure. It is whether they breached their more general fiduciary duty of loyalty and good faith by knowingly disseminating to the stockholders false information about the financial condition of the *22 company. The directors' fiduciary duties include the duty to deal with their stockholders honestly. [FN159]

If one insists on analyzing Malone in the context of a specific duty, it clearly can be cast within the duty of care framework. Violating federal securities laws with scienter (which the allegations suggest) is certainly not exercising the requisite care. Here, the federal securities laws do not preempt state law, but complement it. The federal requirements to disclose financial statements coupled with the state corporate law requirement not to deceive work together to: afford investor rights; protect the integrity of the market; and promote capital formation. [FN160] There are only two conceivable benefits that a contrary outcome in Malone might have. One would be to reduce resources spent on litigation. Obviously, litigation is a draconian method for achieving such an objective. The other potential benefit would be to make it easier to convince people to take on the responsibility of serving as directors--but it is not at all clear that the increase in the applicant pool would contain desirable applicants. Remember, Malone is not a fact pattern in which well-meaning directors are suddenly finding themselves subject to possible liability for lack of adequate oversight, subject to twenty-twenty hindsight. [FN161] The complaint alleges that the directors acted with scienter *to* mislead investors about the fact that $2 billion in corporate capital was rapidly dissipating. [FN162]

It may seem remarkable that the Court of Chancery dismissed the complaint in Malone. [FN163] This result underscores the primary point of this article--unreasonable results can be obtained when skipping the initial step in an analysis of fiduciary duty. Rather than first considering fiduciary duty generally, the Chancery Court framed the case in terms of whether the duty of disclosure was violated. [FN164] The answer was then easy to justify, since in another fact pattern, quite unrelated to Malone, the Supreme Court of Delaware had stated that there was no duty to disclose more than required by statute in those circumstances. [FN165] While this appears to be a different proposition than asserting that directors are free to mislead shareholders, as long as they are not soliciting shareholder action, undesirable results happen when the literal language of an

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opinion is applied in a different factual setting to a poorly framed question.

One could also argue that even if Malone is framed as a duty of disclosure case, that duty does apply because the directors were in reality soliciting shareholders *23 for their implied consent to continue as directors. What other motive could exist for intentionally filing false financial reports? Taking the argument further, this suggests that Malone can be interpreted as a duty of loyalty case as well. The directors were, in this case, putting their security in their positions as directors ahead of corporate and shareholder interests. Intentionally deceiving the shareholders about financial performance was a self-serving action to protect their positions at the expense of the corporate assets.

The tension between the need to protect shareholders from irresponsible or self-dealing directors and the need to protect corporate assets from strike suits is well-established. [FN166] Similarly, there is a long-held recognition of the necessity to shield directors working in good faith and taking risks for the potential benefit of the corporation from the harsh judgment of hindsight. [FN167] However, Malone does nothing to undermine the protection historically afforded corporate directors. [FN168] Plaintiffs do not allege the exercise of poor judgment or unreasonable decisions. [FN169] The complaint alleges fraud with scienter--that the directors intentionally deceived the shareholders about their most fundamental concern--financial performance. [FN170] While it is certainly possible that plaintiffs could abuse the litigation system and allege scienter without a reasonable basis, if such a complaint were not permitted to move forward, then shareholders would have no protection from such behavior under the laws of corporate governance. Even the Court referred to the deceptions as "egregious." [FN171]

Of course similar complaints might have remedies under federal securities laws in certain circumstances. [FN172] But not always. [FN173] The federal securities laws only afford relief where someone purchased or sold a security and suffered harm resulting from a material misstatement. [FN174] The plaintiffs in Malone had neither purchased in reliance of the misstatements, nor had they sold, [FN175] Indeed, it is likely that no market existed for the sale of the securities after the misstatements became public. In any event, it is not uncommon for a plaintiff to have the option to select a forum and a *24 theory for seeking relief, Unless state corporate law frustrates the intent of federal law, state law is not preempted. [FN176]

Regardless of whether one buys into the nexus of contracts view of the firm, or some more "progressive" approach, [FN177] any model of the firm requires integrity, which implies that the deals struck or the anticipated treatment of interest groups are honored. [FN178] Deceit is inconsistent with integrity, and it is perplexing that some would argue strongly against holding wrongdoing directors liable. One hopes that the position is simply due to a careless application of fiduciary law rather than a veiled argument to further shield wrongdoing directors.

III. What Does Malone Mean to Securities Litigation?

A. Background—Tensions and Complements Between Federal Securities Regulation and Corporate Governance

Malone has been criticized and characterized as a situation in which the Supreme Court of Delaware stepped into an area preempted by the federal government. [FN179] This article suggests, to the contrary, that Delaware law complements, rather than frustrates, federal regulation of the national securities markets. [FN180]

There are two significant new federal laws pertaining to securities litigation adopted in the past five years: the Private Securities Litigation Reform Act of 1995 [FN 181] and the Securities Litigation Uniform Standards Act of 1998. [FN182] The first of these was aimed at reducing perceived abuses of class actions based on violations of federal securities laws brought in federal court. [FN183] The law essentially raised procedural hurdles for plaintiffs in order to weed out strike suits. [FN184] The second act articulated *25 the objective of preempting the ability of plaintiffs to take the same claims to state courts where procedural hurdles could be lower. [FN185]

While sometimes controversial, the laws of corporate governance have been the domain of the states with little federal intervention. [FN186] Some commentators viewed state laws as too pro-management and anti-shareholder. [FN187] Noting that Delaware law is more pro-management than most and also has the most corporate charters, these same commentators jumped to the conclusion that Delaware was winning a "race to the bottom" in which states competed for corporations by offering laws which provided the greatest protection to corporate management. [FN188] While this theory still has some believers, [FN189] it has been rebutted by many other commentators. [FN190] Four main flaws in the theory have been reported. First, the argument that Delaware has extended a pro-management bias to the limit is not supported by the fact that some sections of the Delaware code are less pro- management than the Model Business Corporation Act (1984). [FN191]

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Second, the Delaware courts have not always been pro-management. [FN192] In particular, Smith v. Van Gorkom [FN193] held that some management deals could be evaluated in hindsight under the courts' concept of fairness when many believe that management should be shielded from such second-guessing under the business judgment rule. [FN194] Third, the reasoning under the race for the bottom theory is an example of post hoc ergo propter hoc thinking. [FN195] Translated, the phrase means, "after this therefore because of this." The criticism of the reasoning is essentially that an association does not necessarily imply causation. [FN196] In other words, Delaware's statutes might not be the dominant factor in corporate decisions to *26 incorporate in Delaware. There are many factors affecting the decision of where to incorporate including: tax factors, [FN197] predictability of the law (distinguished from bias in the law), [FN198] and, perhaps of overlooked significance, the experience and qualifications of the bench. [FN199] Finally, reasoning from the law and economics area also suggests that the race to the bottom theory does not provide a complete picture of the dynamics of incorporation decisions. [FN200]

The insight that the law and economics area brings to the analysis is that the race for the bottom theory is based on a partial equilibrium model. In other words, the view examines laws which managers would prefer and investors would not prefer if they could hold everything else constant. [FN201] Of course everything else cannot be held constant in the real world, and the results of dynamic, general equilibrium economic models are often very different from their static, partial equilibrium counterparts. [FN202] As an example, a shareholder considering investment in a corporation would clearly prefer to invest in a corporation where she would more easily be able to recover damages in the event of managerial misconduct, all else being equal. However, making it easier for her to recover in that scenario would also *make* it easier for others to bring strike suits, wasting corporate assets. [FN203] Therefore, in a full-blown general equilibrium economic model, investors would seek out corporations incorporated in jurisdictions which strike an appropriate balance between protecting investors' corporate assets from costly litigation and protecting investors' corporate assets from managers breaching their fiduciary duty. [FN204]

Many mainstream commentators have picked up on this law and economics perspective, noting that laws which are purportedly pro-management are not *27 necessarily anti-investor. [FN205] Indeed, Professor Lynne Stout has embraced a fundamental principal of economic efficiency that the best rules are those which minimize total costs. [FN206] She notes that any rule results in two kinds of costs--those which result from a Type I error and those which result from a Type II error. [FN207] She defines a Type I error as allowing a baseless investor claim to go forward and a Type II error as dismissal of a valid investor claim. [FN208] Any rule which reduces the costs of one type of error will necessarily increase the costs of the other type of error. [FN209] The best rules are those which minimize the combined costs. [FN210] If too many Type II errors are made, investors lose confidence in the integrity of the system and pull their capital out of the market, raising the cost of capital and hurting aggregate investment and economic welfare. [FN211] If too many Type I errors are made, corporate assets are wasted defending baseless suits, and the cost of capital is raised, hurting aggregate investment and economic welfare. [FN212]

Judge Frank Easterbrook and Professor Daniel Fischel argue that economic forces drive states to adopt efficient rules. [FN213] States which are "too" management *28 oriented or "too" shareholder oriented will observe a flight of capital, while those which have struck the economically efficient balance (that which minimizes total costs) will attract capital. [FN214] As evidence of this, they note the wide uniformity of corporate law left to the states without federal intervention. [FN215] Furthermore, innovations in rules that lower costs appear to be adopted by other jurisdictions, while bad ideas passed by state legislatures do not spread. [FN216] Examples of the latter include New Jersey changes in corporate law which pushed many corporations to Delaware. [FN217]

Some commentators refuse to adopt this perspective and continue to suggest a need for a uniform federal minimum standard of corporate law. [FN218] However, these calls have never gotten much attention from Congress. [FN219] Corporate law clearly remains in the domain of the states. [FN220]

The regulation of securities sold in the public market prompted a similar debate, but with different results. [FN221] The first state regulation of securities was adopted in 1911. [FN222] By 1933, all states but Nevada had passed such regulation. [FN223] All states have Blue Sky regulations today. [FN224] The federal government got into the business in the aftermath of the Great Depression in order to restore public confidence in the integrity of the nation's financial markets. [FN225] The Securities Act of 1933 sought to afford investors with full and fair disclosure in the public primary offering of securities, and the Securities and Exchange Act of 1934 sought to do the same in the aftermarket. [FN226] Ever since then, we have had dual regulation of securities markets by the federal and state governments. [FN227]

*29 As could be expected, some commentators have argued that the federal government should preempt the states from

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regulating securities because the system of dual regulation is unnecessary for the protection of investors and creates excessive costs for public companies. [FN228] Professor Roberta Romano has put forth an alternative view that the federal government should have a minimal role, and the regulation of securities should be left to the states. [FN229] Professor Romano's suggestion is that corporations should select a state code to govern the sale of their securities just as they select a state code to govern corporate and shareholder relations. [FN230] At first blush, the idea is quite radical given the views which have evolved in the securities bar, [FN231] However, Professor Romano makes an interesting case analogous *to* that built by Easterbrook and Fischel for the regulation of corporate governance. [FN232]

The similar theories, controversy, and commentary over the appropriate regulation of corporate internal affairs and the sale of securities has been underscored by the fact that certain fact patterns can lend themselves to similar claims under each theory. [FN233] For example, if the directors traded on inside information, a case could be brought under either 10(b) or under breach of the fiduciary duty of loyalty. The misappropriation theory which underlies many 10(b) cases is that the insiders took a corporate opportunity. [FN234] Alleged breaches of fiduciary duty under state law might be cast as allegations of federal securities laws, and vice versa. [FN235]

Some arguments can be made for the rationality of regulating corporate affairs at the state level while regulating securities at the federal level. [FN236] Corporate law is designed to help complete contractual terms which parties cannot fill in, and the states have proven well suited to provide this. [FN237] Securities laws are designed to *30 keep fraud out of the market for securities, and the federal government, with a longer jurisdictional reach, could be better positioned to achieve this goal. [FN238]

There are two important points to be made in this regard. First, the role of the federal securities laws is to protect the integrity of the marketplace by assuring the accuracy and freshness of information. [FN239] The federal securities laws were never intended to protect the integrity of corporate governance. However, in order for the separation of ownership and control to be viable, there must be integrity in the corporate governance system. [FN240] If state law does not protect shareholders from intentionally deceptive statements about corporate performance, who will put up the capital required for corporate investment and growth? There is clearly a need to provide protection from such practices under state law in order to foster economic growth.

Second, the federal securities laws do not entirely preempt state law. [FN241] Federal regulations provide a minimum level of compliance, but the Blue Sky laws supplement that minimum. [FN242] State and federal regulations are complementary in this regard. There is no reason why Delaware's law governing the fiduciary duties of corporate directors cannot be viewed as complementing the intent of the Securities and Exchange Act of 1934.[FN243]

Clearly, there have been many critics of both systems of regulation from all directions. Some feel corporate law is too restrictive of management, while others argue that it is too deferential. [FN244] Some feel securities law is too weak, while others consider it too costly. [FN245] Nevertheiess, the two systems complement each other in *31 furthering the formation of capital needed in a modem economy. Protecting the integrity of corporate governance and the integrity of the financial markets for corporate securities are intertwined and complementary objectives. [FN246] The fact of the matter is that we have had a system of peaceful coexistence in federal securities regulation and state Blue Sky and corporate governance regulation for sixty- seven years. The federal government sets minimum standards and the states compete for affirmative improvements in the regulatory system. [FN247]

B. The Securities Litigation Uniform Standards Act of '98

While commentators were busy debating who should be regulating corporations and investments, and whether those regulations created excessive *costs* or failed to protect market integrity, the notion that businesses and consumers both were losing to lawyer-vultures was gaining political popularity. [FN248] Politicians sought to publicly declare themselves willing to take on these plaintiff lawyers who run up costs for everyone including legitimate victims. [FN249] Litigation reform became a popular topic with general tort reform on the table. [FN250] One result of this wave was the Private Securities Litigation Reform Act of 1995. [FN251] This law was ostensibly intended to reduce perceived abuses in class actions brought in federal court under the securities laws. [FN252] The law was quite controversial; proponents felt it was about time that Congress protected legitimate business from professional plaintiffs attorneys attempting to coerce settlements out of baseless class action litigation, whereas opponents argued that an effective method of disciplining corporate management was being impaired. [FN253] A large volume of commentary has already been generated criticizing the legislation as attacking a nonexistent problem existing only in media *32 hype. [FN254] For instance, Dean Seligman built a compelling, but

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unsuccessful case against the legislation. [FN255]

The passage of the '95 Act did not end the controversy. [FN256] Rather, the controversy intensified with the development of the '98 Uniform Standards Act. [FN257] Allegations were made that the effect of the '95 Act was to drive "weak" securities class-action claims to state courts to be litigated under state rules of procedure circumventing the intent of Congress. [FN258] The claim was based on an assertion that filings in state courts rose following passage of the Act. [FN259] The claim itself is dubious and has been very controversial. [FN260] Two major studies by Price Waterhouse and National Economic Research Associates found that there was no statistically discernible difference in filings. [FN261] Furthermore, any difference in filings obviously need not be the result of the act. Filings can fluctuate over time. Indeed, the number of filings went up one year following the Act and down the subsequent year. [FN262] The economic studies could not distinguish any effect from the passage of the '95 Act from normal fluctuations in litigation resulting from random events and fluctuations in the economy. [FN263] Fluctuations in the economy having nothing to do with fraud will cause random fluctuations in securities prices and the number of claims which are brought forth.

Additionally, another theory was put forward to explain the alleged increase in filings. It was noted that the increase in filings essentially occurred in California where important cases were pending and also occurred against high-tech companies in Silicon Valley. [FN264] The volume of high- tech companies and their speculative nature (with high prices on no earnings, large numbers of failures, and vast wealth for a few) was a new development which made increases in allegations of securities fraud *33 inevitable. These wealthy interests lobbied Congress hard. [FN265] Legislation was put forward to preempt state laws which could make class action litigation of federal securities claims easier to proceed in state court. [FN266] Some characterized this as a call to stop another race to the bottom in which states competed to get the revenue for their plaintiffs bar by making it easiest to bring class action strike suits under securities laws. [FN267]

The bill was strongly criticized. [FN268] Many opposed the idea of interfering with state regulation that had coexisted with federal regulation since the beginning. [FN269] In a (justifiably) harsh criticism, Professor John Coffee blasted the bill for its thoughtlessness and unintended consequences in matters such as private contractual arrangements in debt markets. [FN270] Perhaps most damaging was the allegation that the bill was based on a Congressional finding which was unsupported by any statistically significant evidence [FN271] and that the bill was really just pushed by the political power of high-tech firms in Silicon Valley, their legislators, and their law professors. [FN272]

C. Does Malone Carve More for the "Delaware Carve-Out?"

There was some concern on the part of members of Congress that the '98 Act. as originally drafted, could interfere with state corporate laws governing fiduciary duties of directors. [FN273] As a result, a provision was added carving out exemptions to the Uniform Standards Act which became known as the "Delaware carve-out." [FN274] One important issue which Malone raises is whether the Supreme Court of Delaware circumvented Congressional intent under the Uniform Standards Act by acting opportunistically to enlarge the exemptions contained in the carve-out. This section addresses the question and suggests that Malone is both consistent with Congressional intent and will help to fill a void left by contraction of federal investor protection.

The carve-out consists of two specific exemptions to the general provisions of the '98 Act. [FN275] First, shareholder derivative actions are not preempted. [FN276] Therefore, if Malone broadens the scope of derivative liability, it judicially shrinks the area that *34 Congress preempted. This is not necessarily bad, as federal law is sometimes based on state common iaw, but it is a potential concern if Congress did not intend for this possibility. The other area which Congress expressly excluded from preemption is action arising from breaches of fiduciary duty to the shareholders, even though such actions might involve communications made with respect to the federal securities laws. [FN277] Thus, if Malone broadens the scope of fiduciary duty directors owe directly to their shareholders, it judicially shrinks the area which Congress preempted. Clearly, the Delaware Court felt that it did neither. [FN278]

First, some general comments on the issue of preemption are useful before examining Malone in this context. Preemption requires that the state law frustrate the objective of the federal law. [FN279] This necessarily requires a determination of Congressional intent. The harsh criticism directed at the '98 Act suggests that Congress acted without much thought and consideration, which makes an assessment of intent all the more difficult. [FN280] Clearly, Congress did not intend to preempt all strike suits, for it took no similar action in the area of product liability. [FN281] In fact, many in Congress voted inconsistently on these issues, raising the suggestion that this bill was merely a ploy to create an appearance for the public of toughness on plaintiffs attorneys while actually selecting the smallest and least powerful segment of the bar to offend.

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[FN282] These issues make it very difficult to assess intent, but the '98 Act expressly excluded shareholder derivative suits and suits involving breach of fiduciary duty. [FN283] As a result, it is difficult to assert that Congress did not intend to give a choice of forum and procedure to plaintiffs with claims which could be brought forth under either securities violations or corporate governance issues. Clearly, Congress did intend to provide that choice in creating the carve-out. The real issue is whether Malone expands fiduciary duty to an area not foreseen by Congress.

The (incorrect) view that Malone expands directors' fiduciary duties could be based on three different premises. First, there is the premise that Malone creates a new duty of disclosure or duty of candor. [FN284] This is a mischaracterization of the case which the Court carefully tried to prevent in its opinion. [FN285] Malone involves a breach of directors' general fiduciary duty, which includes the obligation to treat *35 shareholders honestly. [FN286] At a minimum, that means that directors cannot knowingly disseminate materially false information about corporate financial performance to the shareholders. [FN287]

The second flawed premise is that any communication made under the mandatory disclosure provisions of the federal securities laws is outside the domain of state law regarding fiduciary obligations. [FN288] This premise is without foundation. It is widely recognized that federal securities laws overlap with fiduciary duties under state laws, and the same facts may give rise to two sets of claims. [FN289] Congress did not intend to preempt those claims. [FN290] An absurd result arises from a contrary rule. Injured shareholders would have a private cause of action under corporate governance law against directors who knowingly disseminated false information, unless federal securities law required the disclosure, in which case the shareholders would not have the cause of action. The impetus for the disclosure logically should not determine the viability of a cause of action for intentional material false disclosure. In other words, if one were to follow the Chancery Court's reasoning that the fiduciary duty claim could not be sustained without usurping federal regulation, then one would obtain the bizarre result that federal law requiring disclosure would shield directors making false disclosures to shareholders who neither sold nor purchased.

The last possible premise from which one can argue Malone expands fiduciary duty too far is an argument that duty is expanded anytime liability is found resulting from a breach of fiduciary duty under a fact pattern that has not previously been put before the court. [FN291] This is a very static view of the law.

There are two important notes on the Malone case. First, it did not involve a case of forum shopping, for the plaintiffs had no claim for relief under the federal securities laws because there was no purchase or sale of a security in connection with the misinformation. [FN292] Second, the '98 Act did not apply to the case in any event because it was passed subsequent to the initiation of the action. [FN293] Nevertheless, the Court did recognize that its holding could have implications for future cases brought in the Delaware courts. [FN294] The Court concluded that even if the Act applied, it did not *36 preempt a derivative action, nor did it preempt a direct action since there was a breach of fiduciary duty under Delaware law. [FN295]

The procedural barriers which the '95 and '98 Acts installed to obstruct plaintiffs seeking relief under federal securities laws seriously eroded investor protection. [FN296] Where appropriate, fraudulent or other wrongful conduct injuring either the corporation or its shareholders might be better brought under a theory of breach of fiduciary duty. Malone, without expanding fiduciary duty, serves as a bright signal light for directors involved in wrongful conduct.

IV. Direct & Derivative Actions

A. The Economics of Collective Action

Economic incentives are important in the furtherance of public policy objectives. One desirable policy objective is to deter people from harming others. [FN297] The economic incentive which can help achieve this objective is to require those causing harm to compensate those they have harmed. [FN298] But when one person causes a large number of people to be injured, and those individual injuries are not large, there are collective action problems which impede efforts to enforce compensation. [FN299] The class action and shareholder derivative suits are devices for alleviating these problems associated with collective action. [FN300]

The underlying *purpose* of the federal securities laws is to deter fraud, and permitting cases to move forward that will deter fraud promotes that policy. [FN301] The government does not have the resources to police all fraud and is dependent on private attorney generals to bring actions to deter fraud. [FN302] This is true in the area of corporate governance as well as federal securities regulation. [FN303]

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*37 For defrauded investors, however, the costs of bringing an individual private action are often prohibitive; an investor's loss may not even exceed the expected costs of filing and pursuing a lawsuit. For this reason, courts have long noted that the ... class action may well be the appropriate means for expeditious litigation of the issues, because a large number of individuals may have been injured, although no one person may have been damaged to a degree which would have induced him to institute litigation solely on his own behalf. [FN304]

Thus, collective action helps to promote the underlying policy of federal securities laws. Without a mechanism to achieve such collective action, enforcement of these underlying policies would suffer. [FN305] This point has been taken to an even higher level by Professor James Cox. Professor Cox suggests that not only do shareholder suits deter bad conduct through the economic disincentive created by judgments, but they are capable of deterring bad conduct by conveying normative standards of socially acceptable behavior to others. [FN306]

Of course, collective action cannot take place without economic incentives. [FN307] One important element of the equation is effective legal representation: "Plaintiffs counsel is the engine that drives the derivative action. For the action to constitute an effective deterrent, counsel must be compensated on a basis at least commensurate with that applicable to class actions and other forms of contingent-fee litigation." [FN308] Congressional efforts to restrict class action litigation in state court and raise the barriers to such litigation in federal court impede both the ability of defrauded investors to recover and the deterrent effect associated with private actions. [FN309]

B. The Distinction Between Direct and Derivative Litigation

The derivative suit has been a controversial contrivance, by which shareholders can arguably force managers to act in the corporate interest, but which can also create some incentive problems whereby a small stakeholder can divert valuable corporate resources. [FN310] Some commentators argue that the underlying *38 justification for the derivative suit is to function as an alternative corporate governance mechanism which functions when directors fail to do their job. [FN311] Whether the mechanism is an effective one is debatable. Professor Romano concludes that "data support the conclusion that shareholder litigation is a weak if not ineffective, instrument of corporate governance." [FN312] The distinction between claims which are derivative and those which are direct can be a fine one: "Although the tests have been articulated many times, it is often difficult to distinguish between a derivative and an individual action .... The distinction depends upon the nature of the wrong alleged and the relief, if any, which could result if plaintiff were to prevail." [FN313]

in theory, a derivative action should be brought when the harm is to the corporation. [FN314] For example, if the directors persisted in a course of action that caused the corporation to pay significantly higher taxes than need be, the harm is to the corporation (although shareholders clearly suffer indirectly). If the harm is directly to individual shareholders, the action should be a direct one. [FN315] An example would be an interference with the rights of minority shareholders. Often though, the distinction will not be clear, as in the case of Malone, where the directors breached their fiduciary duty to the shareholders through the release of false financial information while apparently wasting the corporation's capital. [FN316]

As a practical matter, the decision as to whether to bring a derivative suit or a direct class action will sometimes be determined by procedural differences. There are differences in the recovery of attorneys' fees, insurance policy exclusions, reimbursement from corporate assets. etc. which can affect the incentives to settle. [FN317] If the plaintiff is looking for a quick resolution, the procedural differences could determine the form of action sought.

C. Analysis of Malone as Either Form of Action

Delaware law has recognized the appropriateness of a derivative suit for a corporate injury, such as depression of stock price, resulting from a breach of fiduciary duty. [FN318] In order to bring a direct rather than derivative action, Delaware law requires an interference with shareholders' contractual rights independent of corporate rights. [FN319] The allegations in Malone are consistent with such interference because the shareholders have the right *to* make important decisions free of *39 disinformation from the directors: whether to continue to hold the security, vote against the management, or remove the directors.

Prior commentary on Malone criticized the decision for permitting the shareholders to replead as a direct action. [FN320] This is consistent with that commentator's view that the facts of Malone do not support a breach of fiduciary duty claim, but it is inconsistent with Delaware law, which recognizes a direct action for breach of fiduciary duty. [FN321] The fact pattern in Malone, disclosure of false information enhancing financial performance, is a situation in which there is little substantive

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difference between the underlying theoretical differences between direct and derivative actions. The allegations suggest both an interference in shareholder rights and a corporate injury, making either form of action appropriate.

Of course, one can again raise the question of whether Congressional intent was circumvented in allowing a direct action. This should be addressed by examining that intent. Clearly, Congress intended to create procedural barriers to plaintiffs with claims under the federal securities laws. [FN322] Equally clear, Congress intended to prevent plaintiffs from circumventing those procedural barriers by bringing the same cases in state court. [FN323] However, Congress had no intent of preempting state laws of corporate governance. This is readily apparent from the Delaware carve-out exemptions. [FN324] Furthermore, Congress did not intend, where fact patterns arose which could result in either claims under federal law or state law, the federal law to preempt. [FN325] Congress was well aware that certain fact patterns give rise to both kinds of claims and expressly exempted derivative claims and breach of fiduciary duty claims from being subject to the '98 Act. [FN326] There is nothing to suggest that Congress sought to narrow the breadth of claims which could be brought in state courts under a breach of fiduciary duty theory. Given the argument that Malone did not expand fiduciary duties, it is in no way inconsistent with Congressional intent.

*40 V. Aiding and Abetting Liability

A. Recent Developments in Secondary Liability Under Federal Securities Laws

Since cases pertaining to securities fraud frequently involve insolvent defendants, [FN327] plaintiffs attorneys seeking to find remedies for aggrieved clients (and fees for themselves) have creatively sought ways to recover from parties who did not directly commit the fraud, but instead aided and abetted the perpetration of the fraud. These cases typically involve individuals who have provided the wrongdoer with assistance while knowing a wrong was being committed. [FN328] Secondary liability under this theory has been imposed on brokers, lawyers, and accountants. [FN329] Not surprisingly, the development of secondary liability has been applauded by commentators who see it as consistent with the original intent of the '33 and '34 Acts, [FN330] protecting the integrity of the market and defrauded investors. Others have argued against such liability. [FN331] Regardless of how one views aiding and abetting liability as a legal theory, there can be little doubt that "[a]iding and abetting liability encourages outside professionals to meet higher professional standards." [FN332]

The split in commentary results from two different views of the world, with little data to support either. On the one hand, holding someone secondarily liable for knowingly assisting in wrongdoing, while not actually pulling the trigger, is consistent with common sense justice and investor protection principles. [FN333] Furthermore, given that the integrity of the market is quite vulnerable to corporate certifying accountants, it seems as if it might be necessary to hold accountants secondarily liable as a method of promoting confidence in the public security markets. Many private actions for securities violations might not be brought without the ability to hold secondary participants liable. A reduction in the number of meritorious filings (or an increase in Stout's Type II errors) means a reduction in the number of private attorney generals. [FN334] This could lead to a loss in investor *41 confidence. [FN335] Finally, secondary liability often provides the only real remedy to victims because the primary violators *are* often insolvent. [FN336]

On the other hand, opponents of secondary liability often argue. that it is inconsistent with literal interpretations of statutory causes of action. [FN337] Furthermore, they argue that secondary liability is often just a means by which to extort a nuisance settlement from a deep pocket, which will simply result in higher fees paid by corporations to cover accountants nuisance settlement costs and a consequent lowering of investor profits. [FN338]

This last argument depends critically on empirical information regarding the extent to which suits against accounting firm defendants are nuisance suits rather than honorable attempts to recover from wrongdoers. If most actions are in the former category, there could be some legitimacy to the argument that imposing such secondary liability only increases costs and lowers average profits earned by shareholders. If on the other hand, imposing liability on accountants actually deters bad conduct, then the secondary liability scheme could lower costs associated with such conduct and improve shareholder profits. This is an empirical matter.

There is very little evidence on strike suits versus meritorious suits. A few studies have been done, but they are fraught with flaws. [FN339] Additionally, the researchers have interpreted the data differently. [FN340] Some conclude that the evidence suggests suits are not an effective corporate governance mechanism, [FN341] while others conclude that the data indicates derivative suits are not subject to abuse. [FN342] *42 Furthermore, only one study has focused on the role of secondary liability. [FN343] That study deals only with settlements, not filings, [FN344] and concludes that settlements involving

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accounting firms are tied to the merits of the case. [FN345] Any conclusions about the merits of secondary liability require more data on which to assess the relative trade-offs between, on the one hand, improving investor confidence and increasing remedies available to victims when accountants have assisted in a wrong versus, on the other hand, increasing the incidence and costs of strike suits against accounting firms. In the end, all investors pay for these costs. However, it has been noted in the literature that the one group best in a position to have information on this, the federal bench, was conspicuously absent from the Congressional testimony regarding the '98 Act. [FN346] Absent complaints from the bench about overcrowded dockets caused by nuisance suits, the burden should be on those making the economic arguments against secondary liability to prove it with data. Why fix the system if the bench does not see a problem with it?

Commentary aside, in recent years the U.S. Supreme Court has embarked on a crusade to contract secondary liability. [FN347] A series of cases chipped away at lower court case law until 1995 when the Court decided to accelerate the process with an explosive opinion in Central Bank of Denver. [FN348]
In a decision that delighted "deep pockets," shocked the plaintiffs' bar, and befuddled neutral observers, the Supreme Court held ... that aiding and abetting liability in private actions may not be imposed under section 10(b) of the Securities Exchange Act of 1934 ... or under rule lob-5. The Court's decision swept away decades of Iower court precedent that nearly universally recognized the propriety of such secondary liability under the statute and rule. [FN349]

*43 Another commentator wrote of the case, "The Supreme Court discarded a doctrine that had not only been accepted by all the circuits but had matured and become predictable, and there was no evidence the doctrine had created mischief in its wake." [FN350]

If Central Bank of Denver was a shock, the Court turned up the voltage at its next opportunity in Gustafson: "The decision [Gustafson] is so poorly reasoned and so contrary to the sixty years of thinking and practicing under the Securities Act that bias flashes on every page. Gustafson has been described as 'the most poorly-reasoned, blatantly results-driven securities opinion in recent memory.'" [FN351]

Meanwhile, a few applauded the Court's activism. [FN352] A primary argument advanced to support the underlying policy is that the abolishment of secondary liability is a bright-line rule, and bright-line rules are economically efficient. [FN353] Such reasoning is a good example of an oversimplified model resulting in a ridiculous generalization. If such extreme bright-line rules were always economically efficient, there would be no reason for the Board of Governors of the Federal Reserve System (a fairly respectable group of economists) to meet each month and decide policy. They could just increase interest rates fifty basis points every month until the economy became very efficient. Similarly, we might well be able to dispense with the Supreme Court if all laws drew bright lines, but it is unlikely that bright lines which are feasible are always optimal.

B. The Role of Corporate Law in Filling a Void: Malone

While the '95 and '98 Acts created procedural hurdles for securities plaintiffs which lessen the protection of the markets given by private attorney generals, [FN354] the elimination of secondary liability in federal securities cases creates an outright void in the protection of both defrauded shareholders and the integrity of the mandatory disclosure system, where those primarily liable are insolvent. [FN355] Therefore, the *44 Supreme Court of Delaware's recognition of an action against accountants for aiding and abetting a breach of fiduciary duty is significant. Other jurisdictions are split as to whether this claim is a viable cause of action. [FN356]

Nevertheless, secondary liability is clearly the law in Delaware. [FN357] This suggests that shareholders of Delaware corporations whose only remedy might be against an accounting firm, will look for ways to frame their complaint under Delaware corporate law. The Delaware bench has chosen to protect shareholders of Delaware firms and the integrity of corporate governance over the protection of accounting firms which assist in fraud.

Conclusions

The fiduciary duty of corporate directors is an elusive concept difficult to define in concrete terms and necessitating application to specific fact patterns. Given the large volume of cases and commentary on this duty in specific fact patterns, it is easy to conclude that the law requires an unreasonable result when blindly applying rules articulated in different fact patterns. However, such traps can be avoided by beginning the analysis with the general concept of fiduciary duty in the corporate director context. In Malone, the Supreme Court of Delaware properly concluded that for directors to knowingly release materially false financial statements, which are required to be filed under federal securities laws, constitutes a breach

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of the fiduciary duty corporate directors owe to the corporation and its shareholders under Delaware corporate law. This Article further justifies the result by viewing such conduct as both an interference with shareholder voting rights and a self-serving perpetuation of the directors' positions.

The Court further held that an action for such conduct can be brought as either a direct action (interference with shareholder rights) or derivative action (injury to the corporation by placing self-interest first), and that accountants who knowingly assisted the directors could be liable for aiding and abetting the breach of fiduciary duty. The Court further found that while the Uniform Standards Act of 1998 did not *45 apply to Malone because it was enacted after the case commenced, the legislation would not prevent such litigation in the future.

The practical significance of Malone in the area of investor-fiduciary relations is underscored by the fact that the Supreme Court of Delaware has already drawn on the case, holding a broker liable to an investor for failure to disclose material information in soliciting permission to move money into a sweep account and drawing an analogy between that relationship and the corporate director-stockholder relationship. [FN358]

The one difficulty with the Malone case which has not been discussed is the problem which will arise in trying to compute damages. However, the issue was not ripe for adjudication given that the case was merely an appeal of a *summary* judgment motion, and hence was not addressed by the Supreme Court of Delaware.

Given the procedural restrictions Congress has erected for private actions under the federal securities laws, and given the barriers the federal courts have erected in obtaining judgments against aiders and abettors, the interaction between federal securities laws and state laws pertaining to corporate governance has taken on increased importance. In creating the Delaware carve-out provisions of the Uniform Standards Act, Congress explicitly provided plaintiffs with an alternative forum with different procedural and substantive law to litigate federal securities violations when those violations also constitute a breach of fiduciary duty. The corporate law of Delaware, now more than anytime in the previous sixty-five years, will have a prominent role in protecting the integrity of the marketplace.

Much criticism has been directed at the '95 and '98 Acts as well as decisions of the federal courts contracting implied private rights of action. A detailed commentary on this trend is beyond the scope of this paper, which has focused on the importance of Malone in light of the current state of Delaware corporate law and federal securities laws. However, a brief remark is in order.

There is a role for the federal government to play in protecting the integrity of the market. Insider trading and other manipulative practices impair the efficiency of the market. discouraging investors from placing capital into the securities markets and raising capital costs for business which further impedes overall economic growth. [FN359] The federal government can play a useful role in protecting the integrity of the market. On the other hand, the SEC in recent years has become more paternalistic and overstepped its proper role of protecting the integrity of the market, while venturing into the arena of mandating a particular market structure and specific rules for trading, which it deems "fair." [FN360] Yet this has been done without substantive *46 evidence and appears to be more driven by politics than by construction of optimal rules for trading securities. [FN361] While the states. particularly Delaware, have proven to be well- suited at managing corporate law, they are not as capable of protecting the integrity of the modem financial marketplace as the federal government. Although Professor Romano's ideas about competitive securities regulation among states are intriguing, and worthy of serious consideration, the job cannot be handled by the states alone if for no other reason than that the marketplace has become global. [FN362] States are not in a position to negotiate treaties and enforce securities laws when fraud can enter the market from foreign soil. [FN363] But while the SEC has sought to take a more expansive, and possibly unwarranted role, the federal courts and Congress have sought to contract liability. This harsh and disconcerting contraction has been poorly reasoned and justified by extreme concern about abuses and costs associated with frivolous litigation without any empirical support or substantive evidence.

Whether good or bad, these developments in federal securities law are fact. It is only natural in light of this that state law governing fiduciary duties will be utilized to supplant at least some of the void. While Malone is only one data point from which no inferences can fairly be drawn, it is more consistent with the view that Delaware law has developed to maximize corporate value by detemng wrongdoing directors than with the view that Delaware has led a race to the bottom to attract corporations whose management wishes to entrench and insulate itself. If Delaware was racing to the bottom, its Supreme Court could have cast Malone as a duty of disclosure case and immunized the directors from liability. Alternatively, the legislature could have acted to legislatively ovemde the decision. This has not happened, which is consistent with the view

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that Delaware's interests lie in maximizing the value of Delaware *47 corporations by imposing liability on directors who treat shareholders less than honestly. [FN364]

[FNa1]. B.A., The Pennsylvania State University, 1978; Ph.D. in Economics. Boston College, 1983; J.D. (with honors), University of Maryland, 1988; Professor of Finance and Chair of the Department of Finance, The George Washington University. I would like to thank Marc Steinberg for advice in the early development of this paper. The views expressed herein are solely mine.

[FN1]. Malone v. Brincat, 722 A.2d 5 (Del. 1998).

[FN2]. See id. at 9.

[FN3]. See Nicole M. Kim, Comment, Malone v. Brincat: The Fiduciary Disclosure Duty of Corporate Directors Under Delaware Law. 74 WASH. L. REV. 1151, 1170 (1999). Cf., Misleading Info Claims Need Not Be Related to Request For Corp. Action, DEL. CORP. LITIG. REP., Jan. 4, 1999, at 4 (implying that liability without request for corporate action is a new development).

[FN4]. Compare Malone, 722 A.2d at 10 (clearly stating that the case is not about a duty of disclosure but is about a more general fiduciary duty owed at all times which is breached when directors knowingly disseminate false information about financial performance) with Kim, supra note 3, at 1151 (clearly casting Malone as a judicial expansion of a duty of disclosure).

[FN5]. See Kim, supra note 3, at 1167-68: cf. Mercury, Holders Debate Disclosure Duty Scope Before High Court, DEL. CORP. LITIG. REP., June 1, 1998, at 3 (referring to the action as "one of a kind").

[FN6]. See Malone, 722 A.2d at 10. The Court wrote:
The shareholder constituents of a Delaware corporation are entitled to rely upon their elected directors to discharge their fiduciary duties at all times. Whenever directors communicate publicly or directly with shareholders about the corporation's affairs. with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows a fortiori that when directors communicate publicly or directly with shareholders about corporate matters the sine qua non of directors' fiduciary duty to shareholders is honesty.
Id. (footnote omitted) (citing to Marhart, Inc. v. Calmat Co., Del. Ch., CA. No. 11820 (Apr. 22, 1992), slip op. at 6 (reported in 18 DEL. J. CORP. L. 330 (1993)).

[FN7]. See Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV L. REV. 1437, 1438 (1992); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 COLUM. L. REV. 1908, 1909 (1998); Roberta Romano, Law as a Product, 1 J. L. ECON & ORG. 225, 226 (1985); cf. Curtis Alva, Delaware and the Market for Corporate Charters: History and Agency, 15 DEL J. COW. L. 885, 889 (1990) ("[T]he General Corporation Law of Delaware [is] the most important corporation law in the United States."); Wells M. Engledow, Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties. 63 ALB. L. REV. 505, 507 n.5 (1999) ("Delaware ... is the panacea of corporate law.").

[FN8]. Cf. Malone, 722 A.2d at 9-12 (emphasizing a generalist approach to applications of fiduciary duty rather than a technical approach).

[FN9]. See generally Douglas M. Branson, Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions, 65 U. CIN. L. REV. 3, 3-41 (1996) (describing the procedural hurdles created by the Private Securities Litigation Reform Act of 1995); Richard W. Fainter, Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action, 84 CORNELL L. REV. 1, 1-13 and 32-35 (1998) (describing the difficulties that plaintiffs in securities cases face after the Private Securities Litigation Reform Act of 1995 and Securities Litigation Uniform Standards Act of 1998). This material is discussed in more detail in Section III, infra.

[FN10]. Malone permits plaintiffs to seek remedy against accountants for aiding and abetting a breach of fiduciary duty caused by a violation of federal securities laws. 722 A.2d at 15. However, aiding and abetting has recently ceased to exist as a viable action for most federal securities violations. See Branson, supra note 9, at 11; Marc I. Steinberg, The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation, 70 NOTRE DAME L. REV. 489, 489-90

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(1995); David J. Baum, Comment, The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5, 44 AM. U. L. REV. 1817, 1819-20 (1995).

[FN11]. Cf. Branson, supra note 9, at 11 (arguing that defrauded investors will now have to rely on an incomplete patchwork of state securities laws); J. ROBERT BROWN, THE REGULATION OF CORPORATE DISCLOSURE § 11.01 (3d ed.) (1999-2 Supp.) (development of Delaware's fiduciary duty law means investors no longer have to bring disclosure violations under federal law).

[FN12]. Compare Malone, 722 A.2d at 15 (holding that accountants can be liable for aiding and abetting a breach of fiduciary duty resulting from disclosure of false financial statements) with Central Bank of Denver v. First Interstate Bank, 511 U.S. 164, 177 (1994) (stating that aiding and abetting liability is not a valid claim under Section 10(b)).

[FN13]. See Stroud v. Grace, 606 A.2d 75, 85 (Del. 1992) ("Delaware law imposes upon a board of directors the fiduciary duty to disclose fully and fairly all material facts within its control that would have a significant effect upon a stockholder vote.").

[FN14]. See Malone, 722 A.2d at 10 (whenever directors communicate with shareholders, they must do so honestly).

[FN15]. See Painter, supra note 9, at 35 (the Private Securities Litigation Reform Act of 1995 made litigation substantially more difficult for plaintiffs); id. at 78 (the federal courts have made litigation substantially more difficult for plaintiffs); id. at 84 (the Securities Litigation Uniform Standards Act of 1998 has made litigation substantially more difficult for plaintiffs).

[FN16]. See Malone, 722 A.2d at 12-13.

[FN17]. See Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified as amended in scattered sections of 15 U.S.C.) (hereinafter '98 Act).

[FN18]. See Steinberg, supra note 10, at 515.

[FN19]. See, e.g., Gerald T. Garvey and Peter L. Swan, The Economics of Corporate Governance: Beyond the Marshallian Firm, 1 J. CORP. FIN. 139, 139 (1994).

[FN20]. See STEPHEN A. ROSS ET AL., CORPORATE FINANCE 15 (4th ed. 1996); Barry D. Baysinger and Henry N. Butler, The Role of Corporate Law in the Theory of the Firm. 28 J. L. ECON. 179, 179 (1985); R. H. Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937); Jonathan R. Macey, Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies From a Theory of the Firm Perspective, 84 CORNELL L. REV. 1266, 1266 (1999). But see Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes 70 TEX. L. REV. 579, 642 (1992) (criticizing the contractarian model of the corporation); Eric W. Orts, Shirking and Sharking: A Legal Theory of the Firm, 16 YALE L. & POL'Y REV. 265, 328 (1998) (criticizing models of the firm based solely on markets without ethical considerations).

[FN21]. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1 (1991).

[FN22]. See ROSS ET AL., supra note 20, at 16-17.

[FN23]. One of the leading corporate finance texts states. "The separation of ownership and management has clear advantages. ... But it also brings problems ...." RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 8 (6th ed. 2000).

[FN24]. EUGENE F. BRIGHAM ET AL., FINANCIAL MANAGEMENT 10 (9th ed. 1999) ("[I]t is much easier for corporations ... to raise money in the capital markets.").

[FN25]. Cf. EASTERBROOK & FISCHEL, supra note 21, at 15 ("Investors buy stock in the market and may know little more than its price.").

[FN26]. See EASTERBROOK & FISCHEL, supra note 21, at 8 ("The firm ... permits greater use of specialization").

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[FN27]. See Melvin Aron Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1471 (1989).

[FN28]. Law School Center for Law and Economic Studies working paper no. 150. <http://papers.ssm.com/paper.taflabstract-id=l633>0> (discussing shortcomings of various models of the corporation).

[FN29]. See Armen A. Alchian and Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777, 783 (1972) (characterizing stock as a bundle of rights).

[FN30]. See BODIE ET AL., INVESTMENTS 46 (4th ed. 1999) ("In a liquidation of the firm's assets the shareholders have a claim to what is left after all other claimants ... have been paid.").

[FN31]. *See,* e.g., Del. Code Ann. tit. 8, § 170(a) (1998) ("The directors ... may declare and pay dividends ....") (emphasis added).

[FN32]. See EASTERBROOK & FISCHEL, supra note 21, at 5 ("Managers ... must select the place of incorporation. The fifty states offer different menus ....").

[FN33]. See Unocal v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985) (Delaware corporate law develops in response to evolving needs): Morey W. McDaniel, Stockholders and Stakeholders, 21 STETSON REV. 121, 126 (1991) ("Much of corporate law is common law ....).

[FN34]. See Del. Code Ann. tit. 8, § 102(b) (1) (1998) (allowing the corporate contract to contain anything not contrary to law); cf. Macey, supra note 20, at 1281 ("[F]iduciary duties are fundamentally contractual in nature because shareholders and nonshareholder constituencies can customize them by agreement.").

[FN35]. See Lawrence A. Hamermesh, Calling off the Lynch Mob: The Corporate Director's Fiduciary Duty, 49 VAND L. REV. 1087, 1143 (1996) (acknowledging that the process of defining directors' fiduciary duties lacks scientific precision).

[FN36]. As an example of taking a simplification out of context, the lower court in Malone applied a ruling that nondisclosure in a particular situation did not constitute a breach of the fiduciary duty of disclosure to effectively conclude that false disclosure did not constitute a breach of any fiduciary duty. Malone, 722 A.2d at 8. Commentators have repeated the error. See supra notes 3, 4 and accompanying text.

[FN37]. See EASTERBROOK & FISCHEL, supra note 21, at 64.

[FN38]. See id. at 91 ("[Shareholders] receive few explicit promises. Instead they get the right to vote ....").

[FN39]. *See* id. at 66.

[FN40]. This might not be the case for a controlling shareholder who has a duty to minority shareholders, but I am attempting to simplify the discussion. See, e.g., ROBERT W. HAMILTON, THE LAW OF CORPORATIONS 379 (4th ed. 1996).

[FN41]. Cf. Miranda v. Arizona, 384 U.S. 436, 467 (1965) (privilege against self-incrimination is not effective unless the accused is fully informed of her rights).

[FN42]. Cf. Grimes v. Donald, 673 A.2d 1207, 1218 (Del. 1996) ("A stockholder ... has the right to use the "tools at hand" to obtain the relevant corporate records [in the context of a shareholder demand] ....").

[FN43]. *See* Schnell v. Chris-Craft Industries, 285 A.2d 430, 437 (Del. 1971) (management may not manipulate corporate machinery to perpetuate itself and interfere with shareholder voting rights); Stroud, 606 A.2d at 91 ("[Where] board action was intended to thwart fee exercise of the franchise ... such conduct violates Delaware law.").

[FN44]. Miranda, 384 U.S. at 476 (defendant cannot be tricked into a waiver).

[FN45]. See 17 C.F.R. § 240.14a-3 (1999) (information required to be furnished in proxy solicitations).

[FN46]. Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1997) (holding that defendants were required to disclose

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equally reliable maximum asset value estimates once they disclosed minimum asset value estimates).

[FN47]. See, e.g., Del. Code Ann. tit. 8, § **220** (1998) (stockholderrights to inspect corporate records).

[FN48]. Cf. **EASTERBROOK &** FISCHEL, supra note **21,** at **281** ('When investors spend time and resources inspecting, each one's effort will duplicate what another has done.").

[FN49]. **The** following passages are a succinct explanation as to why choice is good:
Contract law plays a vital role in our market economy. With its long- standing emphasis on freedom **of** contract, contract law promotes individual entrepreneurial activity and advances our society at large by encouraging and protecting consensual bargain-exchange transactions. Contract law encourages the assumption of economic **risks** inherent in any entrepreneurial endeavor **....**
Paul **L. Regan,** Great Expectations? **A** Contract Law Analysis for Preclusive Corporate Lock-Ups, **21** *CARDOZO* L. REV. **1,** 1 **(1999).**
[In markets with integrity], **goods** and services are exchanged, assets are moved to higher and better uses, **and** the welfare **of** society is enhanced. Freedom of contract, premised on the autonomous choices of presumptively rational participants, thus promotes and protects the gains realizable from private ordering, ***so*** that individual participants in **the** contracting process, and society at **large,** are benefitted.
Id. at **115.**

[FN50]. See EASTERBROOK & FISCHEL, supra note 21, at **281** ("Investors do not even want to inspect; they seek to be passive recipients of **an** income stream, not to be private investigators.").

[FN51]. **Cf. EASTERBROOK & FISCHEL,** supra note **21**, at **42** (limited liability reduces investor's need to spend resources on monitoring and increases value).

[FN52]. But see, BURTON G. **MALKEEL, A** RANDOM **WALK** DOWN **WALL** STREET **42** (6th ed. 1996) (describing **how** investors flocked to buy shares of "**A Company** for **carrying** on **an** undertaking of great advantage, but nobody to **know** what it is.").

[FN53]. Cf. Alchian & Demsetz, supra note 29, at **786** (if shareholders had to participate in every decision, many would shirk informing themselves on the issues).

[FN54]. Professors Fishman and Hagerty commented:
Critics **of** mandatory disclosure regulations argue that firms have the incentive to disclose the appropriate amount of information--hence mandatory disclosure is a wasteful use of corporate resources. The main result **of** this paper reinforces this argument in the sense that firms may actually have the incentive to disclose too much information, **and** mandatory disclosure of additional information only aggravates the problem.
Michael J. Fishman **and** Kathleen M. Hagerty, Disclosure Decisions by Firms **and** the Competition for Price Efficiency, **44** J. FIN. **633, 643 (1989).** See also Roberta Romano, Empowering Investors: **A** Market Approach to Securities Regulation, 107 YALE **L.J. 2359, 2373 (1998)** ("There is little tangible **proof of** the claim that corporate information is "underproduced" in the absence **of** mandatory disclosure, or that the benefits to investors from information that firms would not produce in the absence of mandatory disclosure actually outweigh their costs.").

[FN55]. See Fishman & Hagerty, supra note 54, at 643.

[FN56]. See Joel Seligman, The Merits **Do** Matter: **A** Comment on Professor Grundfest's "Disimplying Private Rights of Action Under the Federal Securities **Laws:** The Commission's Authority", **108** HARV. L. REV. **438, 455 (1994)** ("The mandatory disclosure system may also **have** contributed to higher levels of aggregate investment in United States securities.").

[FN57]. See **EASTERBROOK &** FISCHEL, supra **note** 21, at 299 (information is costly to digest).

[FN58]. Cf., e.g., Del. Code *Ann.* tit. **8,** § 220 (1998) (granting stockholders the right to inspect corporate records).

[FN59]. See Malone, **722** A.2d at 10 (there can **be no** fiduciary principles without honesty in communications to

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shareholders).

[FN60]. See Grimes, 673 A.2d at 1216 n.11 (citing SEC public records as a source available to shareholders to obtain necessary information).

[FN61]. Cf. Miranda, 384 U.S. at 476 (privilege against self- incrimination is *not* effective if waiver can be obtained by trick).

[FN62]. Allowing directors to knowingly inject materially false information into the market would have the effect of increasing the information asymmetry between corporate managers and the public. Information asymmetry is a well-documented impediment to the functioning of the market. See generally George Ackerlof, The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism, 84 Q. J. ECON. 488,488-500 (1970).

[FN63]. See Rales v. Blasband, 634 A.2d 927. 934 n.10 (Del. 1993) (specifically identifying SEC filings as a source of information available to shareholders for use in matters of corporate governance).

[FN64]. See Malonc, 722 A.2d at 9 (explaining the underlying premise for imposing fiduciary duties, and holding that knowingly disseminating false information which results in injury to beneficiaries of the duty is a breach).

[FN65]. See Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 EMORY L.J. 1155, 1155 (1990) (suggesting that one model is that the board of directors is the shareholders' monitor of managers).

[FN66]. See Jonathan R. Macey, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 STETSON L. REV. 23, 23 (1991) ("Under traditional state and corporate law doctrine, officers and directors of both public and closely held firms owe fiduciary duties to shareholders and to shareholders alone.").

[FN67]. See Eisenberg, supra note 27, at 1461 ("A corporation ... is organized by rules. ... Some of these rules are determined by market forces.").

[FN68]. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FM. ECON. *305, 305* (1976).

[FN69]. See id.

[FN70]. See id. at 308.

[FN71]. See id.

[FN72]. See EASTERBROOK & FISCHEL, supra note 21, at 41 ("[B]eyond a point extra monitoring is not worth the cost.").

[FN73]. See Charles M. Elson, The Duty of Care, Compensation, and Stock Ownership, *63* U. CIN. L. REV. 649,667 (1995) (fiduciary duty was created by the law to compel diligence by directors).

[FN74]. For a lengthy list of citations to purported authorities on the origination of the fiduciary duty of directors, see id. at *667* n.33. For a history of the development of fiduciary duty under Delaware case law see Hamermesh, supra note 35, at 1104-41.

[FN75]. HOWARD H. SPELLMAN, A TREATISE ON THE PRINCIPLES OF LAW GOVERNING CORPORATE DIRECTORS 15-16 (1931).

[FN76]. *See,* e.g., MODEL BUS. CORP. ACT § 8.30(a) (1984) (requiring a director to discharge his duties "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.").

[FN77]. *See* SEC v. Chenery Corp., 318 U.S. 80, *85 (1943).*

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[FN78]. See id. at 86.

[FN79]. See Elson, supra note 73, at 670-73 (effectiveness of the duty of care has been hotly debated).

[FN80]. *See* id. at 668 (duty of care has been ineffective in creating diligent directors).

[FN81]. See Joseph W. Bishop, Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1099 (1968) (breaches of duty based on negligence absent self-dealing are rare).

[FN82]. *See,* e.g., SOLOMON ET AL., CORPORATIONS LAW AND POLICY 672 (3d ed. 1994) ("The term fiduciary duty ... has no fixed meaning; its parameters are constantly evolving.") (internal quotation marks omitted). But see Malone, 722 A.2d at 10 ("This Court has endeavored to provide the directors with clear signal beacons and brightly lined channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders. This Court has also endeavored to mark the safe harbors clearly.").

[FN83]. See Macey, supra note 66, at 23.

[FN84]. See, e.g., Zirn v. VLI Corp., 681 A.2d 1050, 1056 (Del. 1996) (case holding that directors had a duty to disclose non-material information in order to make other non-material information which they disclosed at their option non-misleading).

[FN85]. See, e.g., Malone, 722 A.2d at 9 (reporting on the Court of Chancery's analysis),

[FN86]. See EASTERBROOK & FISCHEL. supra note 21, at 92 ("Fiduciary principles contain antitheft directives, constraints on conflict of interest, and other restrictions on the ability of managers to line their own pockets at the expense of investors.").

[FN87]. *See,* e.g., HAMILTON, supra note 40, at 378.

[FN88]. See id, at 381; D. Gordon Smith. A Proposal to Eliminate Director Standards from the Model Business Corporation Act, 67 U. CIN. L. REV. 1201, 1203-1204 (1999) {"The duty of care is often phrased in a way that would suggest an obligation on managers to act with the care of an ordinarily prudent person.").

[FN89]. See HAMILTON, supra note 40, at 398.

[FN90]. See EASTERBROOK & FISCHEL, supra note 21, at 103 ("Judges scrutinize alleged violations of the duty of loyalty more closely than alleged violations of the duty of care.").

[FN91]. Attempting to oversee a business when one is not qualified to do *so* is probably not prudent and a breach of the duty of care, but it is also putting one's own interests ahead of the corporation's and shareholders' interests and hence a breach of the duty of loyalty. Cf. the remarks of Judge Easterbrook and Professor Fischel:
[T]here is no sharp line between the duty of care and the duty of loyalty. What is the difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty)?
Id.

[FN92]. See Malone, 722 A.2d at 10-11

[FN93]. Cf. Malone, 722 A.2d at 10 ("Although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders.").

[FN94]. See id. (stating that the duty of loyalty is often raised in the context of spectacular one-shot appropriations).

[FN95]. See, e.g., Stroud, 606 A.2d at 85 (finding duty to disclose under certain situations to be part of the law).

[FN96]. See Macey, supra note 66, at 25 ("[F]iduciary duties should properly be seen as a method of gap-filling in

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incomplete contracts.").

[FN97]. See EASTERBROOK & FISCHEL, supra note 21 at 91.

[FN98]. See id. at 93 (the reason for fiduciary principles is to avoid the high cost of detailed contracting).

[FN99]. Malone, 722 A.2d at 7.

[FN100]. See id. at 15.

[FN101]. See id.

[FN102]. Cf. Sherrie R. Savett, The Merits Matter Most and Observations on a Changing Landscape Under the Private Securities Litigation Reform Act of 1995. 39 ARIZ. L. REV. 525, 525 (1997) ("Once the motion to dismiss hurdle is passed by the plaintiffs, the parties are constantly assessing the impact of the facts on a potential jury.").

[FN103]. See Malone, 722 A.2d at 8.

[FN104]. See id.

[FN105]. See id.

[FN106]. See id.

[FN107]. See id. ("The Court of Chancery held that directors have no fiduciary duty, of disclosure under Delaware law in the absence of a request for shareholder action.").

[FN108]. See id. at 14-15.

[FN109]. See id. at 8. The Court of Chancery wrote:
The federal securities laws ensure the timely release of accurate information into the marketplace. The federal power to regulate should not be duplicated or impliedly usurped by Delaware. When a shareholder is damaged merely as a result of the release of inaccurate information into the marketplace, unconnected with any Delaware corporate governance issue, that shareholder must seek a remedy under federal law.
Id.

[FN110]. See id. at 14.

[FN111]. See id. at 15.

[FN112]. See id. at 14. The Court wrote:
Delaware law also protects shareholders who receive false communications from directors even in the absence of a request for shareholder action. When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty. That violation may result in a derivative claim on behalf of the corporation or a cause of action for damages. There may also be a basis for equitable relief to remedy the violation.
Id: cf. Misleading Info Claims Need Not Be Related to Request For Corp. Action, supra note 3, (reporting on the holding in a headline).

[FN113]. See id. (classifying the case as a duty of candor).

[FN114]. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections of 15 U.S.C.). The Delaware carve-out has become the popular name for two exemptions contained in the act exempting state litigation based on shareholder derivative action and breach of fiduciary duty arising under state law. See Malone, 722 A.2d at 13.

[FN115]. See Kim, supra note 3, at 1152.

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[FN116]. Compare id. at 1170 ("In Malone ... the Supreme Court of Delaware significantly expanded the fiduciary disclosure duty of corporate directors ....") with Malone, **722** A.2d at 10 ("The issue **in** this case is not whether Mercury's directors breached their duty of disclosure ....") (emphasis added).

[FN117]. Compare Stroud, 606 A.2d at **75** (holding that there is **an** affirmative duty of disclosure when seeking a shareholder vote) with Kim, supra note 3, at 1152 (arguing that under Stroud, dissemination of material false information in the absence of a request for shareholder information does not breach any fiduciary duty).

[FN118]. See supra, note 116.

[FN119]. Stroud, **606** A.2d at 84.

[FN120]. See Kim, supra note 3, at 1152 (discussing disclosure duty).

[FN121]. See Stroud, **606** A.2d at 87 ("[I]n this case, the duty of disclosure does not go beyond [that required by statute] **....** Thus, under all ***of*** the circumstances here, the board had no duty to disclose anything beyond the [statutory requirements].") (emphasis added).

[FN122]. See Malone, 722 A.2d at 9.

[FN123]. The general rule in Delaware appears to **be** that directors do **nor** have **a** duty of disclosure **unless** they ***are*** seeking shareholder action. See **Stroud,** 606 A.2d at 84. This **has** an analogy in torts. Cf. Restatement (Second) of Torts § **314** cmt. c (1965) (explaining that one has no duty to save a drowning victim absent special circumstances). One would have a duty to save the drowning victim if one had thrown the victim **in** the water **in** the first place, and directors would analogously have a duty to disclose the **truth** if they originally disseminated material false information about corporate performance.

[FN124]. Stroud, 606 A.2d at **75.**

[FN125]. See id. at **84.**

[FN126]. See Kim, supra note 3, at 1152 (asserting that directors' misconduct did not implicate shareholder rights).

[FN127]. See Malone, 722 A.2d at 12.

[FN128]. **See** Melvin Aron Eisenbetg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 FORDHAM L. REV. 437,439 (1993). As Professor Eisenberg explains:
The duty of care of corporate directors and officers is a special **case** of the duty of care imposed throughout the **law** under the general heading of negligence .... Under the moral and policy propositions that underlie the law of negligence, **if** a person assumes **a** role whose performance involves the **risk** of injury to others, he is under a duty to perform that role carefully and is subject to blame if he fails to do ***so.***
Id.

[FN129]. See Restatement (Second) of **Torts** § 314 cmt. c (1965). This analogy was previously drawn in: Stanley Pietrusiak, Jr., Changing the Nature of Corporate Representation: Attorney Liability for Aiding and Abetting the Breach **of** Fiduciary Duty, **28** St. Mary's L.J. **213,** 238 n.84 (1996).

[FN130]. See Malone, 722 A.2d at 10 (directors have duty to deal with their shareholders honestly).

[FN131]. Cf. Painter, supra note 9, at 65 (deception **of** security holders is a breach of fiduciary duty **as** well as securities laws).

[FN132]. See Malone, 722 A.2d at 14 (deliberately misinforming shareholders about business of the corporation **is** a breach).

[FN133]. Cf. Painter, supra note 9, at 65 (deception of security holders is a breach of fiduciary duty **as** well as securities laws).

[FN134]. See Malone, 722 A.2d at 9.

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[FN135]. See Del Code *Ann.* tit. 8 § 141 (k) (1998) (directors may generally be removed with or without cause).

[FN136]. See Malone, 722 A.2d at 8.

[FN137]. See Clifford W. Smith and Gerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. FIN. ECON. 117, 152-53 (1979) (bond covenants are standardized, efficient, and operate to ensure that shareholders maximize firm value).

[FN138]. See Malone, 722 A.2d at 10 (honesty is the sine qua non of fiduciary duty).

[FN139]. See id.

[FN140]. See id. at 7-8.

[FN141]. See id. at 8.

[FN142]. Id. (emphasis added).

[FN143]. See id.

[FN144]. See id.

[FN145]. *See* id. at 9.

[FN146]. *See* id.

[FN147]. See id.

[FN148]. See id. at 10.

[FN149]. Id. at 9.

[FN150]. See id. ("An underlying premise for the imposition of fiduciary duties is a separation of legal control from beneficial ownership.").

[FN151]. See Kim, supra note 3, at 1167-68.

[FN152]. See Malone, 722 A.2d at 10 (fiduciaries who inform shareholders must do so honestly).

[FN153]. See id. at 9.

[FN154]. See id.

[FN155]. See SOLOMON ET AL., supra note 82, at 36 (directors may take chances without penalty for failure but must use reasonable degree of care) (excerpting from Bayer v. Beran, 49 N.Y.S.2d 2 (N.Y. Sup. Ct. 1944)).

[FN156]. Malone, 722 A.2d at 10 (emphasis added).

[FN157]. See id.

[FN158]. See id.

[FN159]. See id.

[FN160]. See id. at 13 ("The historic roles played by state and federal law in regulating corporate disclosures have been not only compatible but complementary.").

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[FN161]. See id. at **8.**

[FN162]. See **id.**

[FN163]. See id.

[FN164]. ***See*** id.

[FN165]. See Stroud, 606 A.2d at 87 (stockholder vote on amendments to charter of a privately held corporation).

[FN166]. See D. Brian Hufford, Deterring Fraud vs. Avoiding the "Strike Suit": Reaching **an** Appropriate Balance, 61 **BROOK.** L. REV. 593,601-03 (1995).

[FN167]. Gries **Sports** Enterprises, Inc. v. Cleveland Browns Football Co., Inc., 496 N.E.2d 959, **963** (Ohio 1986) ("The business judgment rule is a principle of corporate governance that has been **part of** the common law for at least one hundred **fifty** years.").

[FN168]. Cf. Malone, 722 A.2d at 8 (characterizing directors' alleged conduct as egregious).

[FN169]. See **id.**

[FN170]. See id.

[FN171]. See **id.**

[FN172]. **Cf.** id. at **12-13** ("[F]ederal law regulates disclosures by corporate directors in the general interstate market. **...** Delaware law also protects shareholders who receive false communications from directors ....").

[FN173]. See id. at 13.

[FN174]. See **id.**

[FN175]. See id.

[FN176]. See Burks v. Lasker, 441 U.S. 471,479 (1979).

[FN177]. Professor Lawrence E. Mitchell describes a corporation as a human organization and a cooperative enterprise requiring cooperation **among** its broad constituent groups to flourish. See Lawrence **E.** Mitchell. Cooperation and Constraint in the Modem Corporation: ***An* Inquiry** into the Causes of Corporate Immorality, **73** TEX. **L.** REV. 477,479 (1995).

[FN178]. I think it **is** fair to say that this is consistent with Professor Mitchell's call to develop rules that will encourage corporations to "behave **in** a responsible and ethical manner." See id. at 537.

[FN179]. See Kim, supra note 3, at 1175 (Court allowed state claim in area regulated by federal law).

[FN180]. See Malone, 722 A.2d at **13.**

[FN181]. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified at I5 **U.S.C.** § 77z-1, -2, 78j-1, 78u-4, -5 (Supp. 1996)).

[FN182]. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections **of** 15 **U.S.C.).**

[FN183]. See Joel Seligrnan, The Private Securities Reform Act of 1995, ***38* ARIZ.** L. REV. 717, 721 (1996) (excerpting H.R. Rep. No. 104-50, 104th Cong., 1st Sess.. pt. J. at 15 (1995)).

[FN184]. See Lynne **A.** Stout, Type I Error, Type II Error, and the Private Securities Litigation Reform Act, 38 ARIZ. L.

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REV. 711, 711 (1996) (in drafting the legislation, Congress was particularly concerned about strike suits).

[FN185]. See Painter, supra note 9, at 42.

[FN186]. See Romano, supra note 54, at 2361 ("The market approach ... takes as its paradigm the successful experience of the U.S. states in corporate law, in which the ... states ... compete for the business of corporate charters. There is a substantial literature on this particular manifestation of U.S. federalism indicating that shareholders have benefitted ....").

[FN187]. See William L. Carey, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 696 (1974) (suggesting Delaware has a shrinking concept of fiduciary responsibility, fairness, and shareholder rights).

[FN188]. See id. at 705.

[FN189]. *See* Bebchuk, supra note 7, at 1437 ("[S]tate competition is likely to fail with respect to certain important issues that state corporate law has traditionally governed.").

[FN190]. See ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 16-18 (1993) (empirical studies conclude reincorporating in Delaware benefits shareholders).

[FN191]. See Painter, supra note 9, at 16-17 (changes in Delaware's code have mostly been less pro-management than changes in the Model Business Corporation Act).

[FN192]. See, e.g., Smith v. Van Gorkom, 488 A.2d 858, 893 (1985) (subjecting management to the Court's ex post judgment on fairness).

[FN193]. Id.

[FN194]. See Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 BUS. LAW. 1437, 1455 (1985) (calling Van Gorkom, "one of the worst decisions in the history of corporate law").

[FN195]. See James Tobin, Money and Incotne: Post Hoc Ergo Propter Hoc? 84 Q.J. ECON. 301, 303 (1970).

[FN196]. See id. at 302 (timing evidence is seriously questioned).

[FN197]. See Robert F. Reilly, Interstate intangible Asset Transfer Programs, 62 CPA J. 34, 34 (1992) (describing tax benefits of incorporating in Delaware and transferring intangible assets to a Delaware corporation).

[FN198]. See ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 91 (1993) (the large number of corporate cases litigated in Delaware makes its law more settled).

[FN199]. *See* id. at 90 (Delaware has judicial expertise in corporate law)

[FN200]. See id. at 88 (race to the bottom hypothesis overlooks interaction of financial markets on managers' incentives).

[FN201]. Cf. Mark Klock, The SEC'S New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence, 51 FLA. L. REV. 753, 788-89 (1999) (criticizing the Security and Exchange Commission's use of partial equilibrium analysis to justify new regulations).

[FN202]. See Mark Klock, Mainstream Economics and the Case for Prohibiting Inside Trading, 10 GA. ST. U. L. REV. 297, 330-32 (1994) (describing the different results obtained with partial and general equilibrium models in the context of insider trading).

[FN203]. The types of rules which would benefit her (lesser procedural hurdles, lighter burden of proof, fewer presumptions favoring management, etc.) would also favor a plaintiff with a false claim seeking to extort a settlement or fool a jury.

[FN204]. This is the balance that maximizes shareholder wealth, Cf. ROMANO, supra note 190, at 2 n.1 and accompanying text (balancing marginal costs against marginal benefits maximizes welfare).

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[FN205]. See generally Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251, 251-292 (1977) (using economics to explain why the race for the bottom hypothesis is implausible on its face).

[FN206]. See Stout, supra note 184, at 714-15 (discussing the need to balance costs). But see Lynne A. Stout, The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation, 87 MICH. L. REV. 613,617 (1988) (arguing that economic efficiency merits reexamination).

[FN207]. See Stout, supra note 184, at 711.

[FN208]. The Type I and Type II nomenclature has been attributed in the legal literature to Professor Stout. See, e.g., Painter, supra note 9, at 68. However, it has been used for decades in the statistics literature. See ANDERSON ET AL., INTRODUCTION TO STATISTICS 220 (1981). To my way of thinking, Professor Stout flipped the definitions of the errors. In order to have an error in the legal system, there must be a plaintiffs claim. In order to have an error in statistical testing there must be a hypothesis. Statistics defines Type I error as rejecting a true hypothesis and Type II error as accepting a false hypothesis. The analogous definition for law would then be rejecting a valid plaintiffs claim in the first instance and accepting a false claim in the second instance. Professor Stout used the opposite definitions. See Stout, supra note 184, at 711. But all this depends on the general view one takes towards securities litigation, since the issue really boils down to whether one wishes to make the null hypothesis whether a valid claim exists, or whether one wishes to make the null hypothesis that liability does not exist. Since Stout's definitions are used in the legal literature, I will adopt them here as well to minimize total costs of confusion.

[FN209]. See, Elliot J. Weiss, The New Securities Fraud Pleading Requirement: Speed Bump or Road Block? 38 ARIZ. L. REV. 675,679 (1996) (any requirement that reduces strike suits will also make it more difficult to deter fraud).

[FN210]. Cf. id. ("The problem is ... how to construct ... a reasonable trade off between these competing [costs].").

[FN211]. *See* Stout, supra note 184, at 713 ("[F]raud is bad for securities markets because it erodes investor confidence." This is due to the fact that investors cannot distinguish between good and bad securities when fraud is present and bad ones drive the good ones out of the market.).

[FN212]. Cf. id. at 714 (describing Congress' concern over hundreds of millions of dollars spent on Type I errors),

[FN213]. See EASTERBROOK & FISCHEL, supra note 21, at 6.

[FN214]. Cf. id. (Managers are driven to maximize net profits which corresponds to minimizing costs).

[FN215]. See id. at 2 (corporate law in almost every state is enabling).

[FN216]. Cf. Romano, supra note 54, at 2365-66 (competitive regulation results in regulation which benefits market participants).

[FN217]. See id. at 2390.

[FN218]. See Bebchuk, supra note 7, at 1510 (federal minimum standards are warranted).

[FN219]. See Painter, supra note 9, at 15.

[FN220]. See Bebchuk, supra note 7, at 1438 ("The American legal system [[still] accords primary responsibility for regulating corporate affairs to the states.").

[FN221]. See generally Romano, supra note 54, at 2359-428 (arguing that the successful approach used in corporate law should be applied to securities law).

[FN222]. See Mark V. Holderman, "Not *So* Super" Markets, 62 U. CIN. L. REV. 429,429 n.1 (1994).

[FN223]. See 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 199 (3d ed. 1989).

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[FN224]. See ROMANO, supra note 190, at 108

[FN225]. See Painter, supra note 9, at 23 n.114.

[FN226]. See Alistair Alcock, The Rise and Fall of Private Actions under Rule 10b-5, 1998 J. BUS. L. 230, 230 (1998).

[FN227]. See Painter, supra note 9, at 31 ("... Congress's 1934 scheme for parallel federal and state regulation of the purchase and sale of securities generally remained intact prior to [1998]."); id. at 7 ("[S]tate private rights of action for securities fraud will continue to play a significant, albeit much reduced, role in U.S. securities regulation.").

[FN228]. See Rutherford B. Campbell, Jr., Blue Sky Laws and the Recent Congressional Preemption Failure, 22 J. CORP. L. 175, 178 (1997) ("Blue Sky laws impose significant costs on society which are unjustifiable under [cost- benefit analysis].").

[FN229]. See Romano, supra note 54, at 2361

[FN230]. See id. at 2403.

[FN231]. See id. at 2363.

[FN232]. See id. at 2363.

[FN233]. See Painter, supra note 9, at 65 (securities law and law of corporate fiduciary duties have an inherent connectedness).

[FN234]. See U.S. v. O'Hagan, 521 U.S. 642, 652 (1997) ("Under [the misappropriation] theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality defrauds the principal of the exclusive use of that information.").

[FN235]. See Painter, supra note 9, at 65 (many securities fraud cases involve breaches of corporate fiduciary duty).

[FN236]. See Painter, supra note 9, at 71-72.

[FN237]. Cf. Romano, supra note 54, at 2383-85 (data suggests investors have benefited from state competition to develop corporate law).

[FN238]. But cf, Romano, supra note 54, at 2362 (arguing that "the ever- expanding extratemtorial reach of U.S. securities regulation" has hurt U.S. investors by excluding them from offers).

[FN239]. See generally BROWN, supra note 11, at § 2.01

[FN240]. See Romano, supra note 54, at 2365 ("[B]oth the states and the federal government regulate securities transactions ....").

[FN241]. See id. ("[S]tates cannot tower the regulatory standards applicable *to firms* covered by the federal regime because its requirements are mandatory.").

[FN242]. See Joel Seligman, The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation, 93 MICH. L. REV. 649, 678 (1995) (Blue Sky laws augment federal securities laws).

[FN243]. See Malone, 722 A.2d at 13 (describing these bodies of law as symbiotic); cf. Stanley A. Kaplan, Fiduciary Responsibility in the Management of the Corporation, 31 BUS. LAW. 883, 884 n.3 (1976) ("In many instances, state Blue Sky Commissioners have demanded changes in corporate structures or in the character of the rights of security holders in order to improve fiduciary obligations of management, as a condition precedent to the issuance to a permit to sell securities within a particular state.") (supports complementary nature of corporate governance and state securities regulation).

[FN244]. Compare Carey, supra note 187, at 698 ("Management should not be omnipotent.") with Winter, supra note 205, at 258 (describing costs of restricting management).

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[FN245]. Compare Steinberg, supra note 10, at 490 (classifying Supreme Court's restrictions on scope of federal securities laws as callous and disconcerting) with Greg Jarrell, The Economic Effects of Federal Regulation of the Market for New Security Issues, 24 J. L. ECON. 613, 615 (1981) (data does not support the view that regulation leads to fairer pricing of securities).

[FN246]. See Painter, supra note 9, at 65 (securities law and law of corporate fiduciary duties have an inherent connectedness).

[FN247]. Cf. Painter, supra note 9, at 72 ("[C]ompetitive forces among states do shape the development of state securities laws.").

[FN248]. Cf. id. at 77 n.399 (describing various media reports on astronomical attorney fees relative to plaintiff recovery).

[FN249]. Cf. id. at 76-77 (documenting political vote splitting in Congress).

[FN250]. See id. at 76 (reporting on veto of Common Sense Product Liability Legal Reform Act of 1996).

[FN251]. See id. at 77 n.398 (President Clinton vetoed product liability reform).

[FN252]. See Stephen F. Black ET AL., The Private Securities Litigation Reform Act of 1995: A Preliminary Analysis, 24 SEC. REG. L.J. 117, 117 (1996); Susan S. Gonick and Joseph D. Daley, The Nonretroactivity of the Private Securities Litigation Reform Act of 1995, 25 SEC. REG. L.J. 60, 60 (1997).

[FN253]. See Branson, supra note 9, at 40-41 ("The gloom arises from the conviction that ... defense interests ... have joined together to destroy completely the federal courts as places of refuge and protection for defrauded investors."). See also id. at 24 (citing contributions of accounting lobby).

[FN254]. See, e.g., id. at 24 (any litigation explosion was clearly over or winding down).

[FN255]. See Seligman, supra note 56, at 438-57.

[FN256]. See Gonick & Daley, supra note 252, at 61.

[FN257]. See Richard H. Walker & J. Gordon Seymour, Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action, 40 ARIZ. L. REV. 1003, 1028 (1998) ("Scarcely had the ink dried on the Reform Act when the new congressional proposals ... to preempt state securities fraud lawsuits began to emerge.").

[FN258]. See Painter, supra note 9, at 4.

[FN259]. See id.

[FN260]. See id. at 9; cf. BROWN, supra note 11, at § 1.02[1] ("[T]he number of suits has not increased significantly in recent years. In general, approximately 125 companies a year are the subject of a securities fraud action. Given the total number of public companies--around 14,000--the number does not seem particularly excessive.") (questioning claims that there was any litigation explosion before the '98 Act).

[FN261]. See id.

[FN262]. See id. at 43.

[FN263]. See id. at 42-45.

[FN264]. See id. at 36 (most class actions for securities brought under state law in California, and high-tech companies from Silicon Valley make up disproportionate number of defendants).

[FN265]. See id. at 49 (documenting lobbying activity).

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[FN266]. See Walker and Seymour, supra note 257, at 1029.

[FN267]. See Painter, supra note **9,** at 41 (quoting Senator **Dodd).**

[FN268]. See John C. Coffee, Jr., State Securities Preemption: The Hidden Issues, N.Y.L.J. 5 (May 28, 1998).

[FN269]. See Painter, supra note 9, at 99 (Congress should not have preempted state causes **of** action).

[FN270]. See Coffee, supra note 268, at 5.

[FN271]. See Painter, supra note 9, at 99-100 (Congress did not **know** the answers to **any of** the underlying empirical issues).

[FN272]. See Painter, supra note 9 at 4-6.

[FN273]. See id. at 67 n.355.

[FN274]. See Malone, 722 A.2d at **13.**

[FN275]. See id.

[FN276]. See '98 Act at § 16d.

[FN277]. See id.

[FN278]. See Malone, 722 A.2d at 14.

[FN279]. See Burks, 441 **U.S.** at 479.

[FN280]. See Coffee, supra note 268, at 5.

[FN281]. **See** Painter, supra note 9. at 77 n.398 (Congress did not ovemde presidential veto of product liability reform).

[FN282]. See **id.** at 76-77.

[FN283]. See '98 Act at § 16d.

[FN284]. See Kim, supra note 3, at 1153 (calling disclosure **duty** "newly expanded"),

[FN285]. See Malone, **722** A.2d at 10 (case is not about disclosure duty).

[FN286]. See id. at 10-11 (shareholders entitled to **rely** on truthfulness **of** all information including public statements).

[FN287]. See Kim, supra note **3,** at 1175 (asserting that Malone is really a federal securities case).

[FN288]. ***See* id.**

[FN289]. See Painter, supra note 9, at 65.

[FN290]. See id. **at** 67 n.355 and accompanying **text.**

[FN291]. See Kim, **supra** note 3, **at** 1167-68 (noting that the **fact** pattern was unique).

[FN292]. See **Malone,** 722 A.2d at 13.

[FN293]. Indeed, it was not even in effect **at** the time of the decision. See **id.**

[FN294]. ***See* id.**

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[FN295]. *See* id.

[FN296]. See Painter, supra note 9, at 100 (Congress foreclosed well established sources of relief for defrauded investors).

[FN297]. See Eisenberg, supra note 128, at 439 ("Under the moral and policy propositions that underlie the law of negligence, if a person assumes a role whose performance involves the risk of injury to others, he is under a duty to perform that role carefully and is subject to blame if he fails to do so.")

[FN298]. See id.

[FN299]. See Jonathan R. Macey and Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. CHI. L. REV. 1, 8 (1991).

[FN300]. See id. at 9-11.

[FN301]. See Hufford, supra note 166, at 642. Of course this view does not imply that public policy should promote suits where no fraud is present which would discourage business activity.

[FN302]. See Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1988) (private actions both an effective enforcement weapon and a necessary supplement to government action).

[FN303]. See John C. Coffee, Jr. and Donald E. Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 COLUM. L. REV. 261, 261 (1981) (The shareholder derivative suit has "[l]ong [[been] considered the chief regulator of corporate management.") (footnote omitted).

[FN304]. See Walker & Seymour, supra note 257, at 1005 (internal quotations omitted).

[FN305]. Cf. Painter, supra note 9, at 11 (the private attorney general mechanism is at risk in the battle over securities regulation).

[FN306]. See James D. Cox, The Social Meaning of Shareholder Suits, 65 BROOK. L. REV. 1, 5 (1999).

[FN307]. Cf. Painter, supra note 9, at 3 ("[M]ost plaintiffs find litigation outside of a class action impractical and uneconomical ....").

[FN308]. Coffee & Schwartz, supra note 303, at 316.

[FN309]. See Painter, supra note 9, at 3 (because plaintiffs find litigation outside of class action to be uneconomical).

[FN310]. See EASTERBROOK & FISCHEL, supra note 21, at 101

[FN311]. See Romano, supra note 65, at 1155.

[FN312]. See ROMANO, supra note 198, at 179.

[FN313]. Grimes, 673 A.2d at 1213

[FN314]. See id.

[FN315]. See id.

[FN316]. See Malone, 722 A.2d at 8.

[FN317]. See ROMANO, supra note 198, at 171.

[FN318]. See Grimes, 673 A.2d at 1213.

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[FN319]. See id.

[FN320]. See Kim, supra note 3, at 1172-173 (direct action inappropriate).

[FN321]. See In re Tri-Star Pictures, Inc. Litig., 634 A.2d 319,326-33 (Del. 1993).

[FN322]. See Painter, supra note 9, at 33-34 ("Congress made clear its belief that opportunistic trial lawyers were undermining the securities litigation system and were the primary target of the legislation.").

[FN323]. Cf. Painter, supra note 9, at 41 (quoting Senator Dodd's rationale for preemption of state securities fraud litigation).

[FN324]. See '98 Act § 14d.

[FN325]. See id.

[FN326]. See id.

[FN327]. See Steinberg, supra note 10, at 517.

[FN328]. See id. at 498-99.

[FN329]. See Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 CAL. L. REV. 80, 82 (1980).

[FN330]. See, e.g., Kuehnle, Secondary Liability Under the Federal Security Laws--Aiding and Abetting, Controlling Person, and Agency: The Statutory Scheme, 14 J. CORP. L. 313, 376 (1989) (barring secondary liability would be contrary to the objectives of federal securities laws).

[FN331]. See Fischel, supra note 329, at 101 (1980) (secondary liability just creates costs for people engaged in normal business activities such as accounting, banking and law); O'Hara, Erosion of the Privity Requirement in Section 12(2) of the Securities Act of 1933: The Expanded Meaning of Seller. 31 UCLA L. REV. 921, 1002 (1984) (secondary liability inconsistent with plain language of the statute).

[FN332]. See Melissa Harrison, The Assault on the Liability of Outside Professionals: Are Lawyers and Accountants Off the Hook? 65 U. CM. L. REV. 473,524 (1997).

[FN333]. See Steinberg, supra note 10, at 490 (recovery from culpable aiders and abettors is just).

[FN334]. See Baum, supra note 10, at 1843.

[FN335]. See id.

[FN336]. See id. at 1839.

[FN337]. *See* O'Hara, supra note 331, at 1001

[FN338]. Cf. Walker and Seymour, supra note 257. at 1006 ("Commentators have contended that frivolous securities fraud class actions have been filed and that the costs issuers incur to defend such cases may be passed on to current shareholders of the issuer.").

[FN339]. Compare, e.g., Willard T. Carleton ET AL., Securities Class Action Lawsuits: A Descriptive Study, 38 ARIZ. L. REV. 491 (1996) (finding evidence of nuisance suits) with Edward Labaton, A View From the Trenches, 38 ARIZ. L. REV. 513, 513 (1996) (criticizing studies for defining settlements under $2 million as "nuisance" suits when cases are often settled for under $2 million due to insurance limits. insolvency, and other reasons; and further stating that frivolous suits in the class action area are small because attorneys do not take cases which will not earn them a living). See also Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 STAN. L. REV. 497, 597 (1991) (suggesting that securities class action settlements do not reflect the merits and that shareholder derivative suits suffer from

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the same criticism). But note that Professor Alexander's conclusions are based on a sample of only 9 companies (id. at 517, Table 4) and involve only initial public offerings of computer and computer related companies during six months of 1983 (id. at 507).

[FN340]. See generally Seligman, supra note 56, at 438-57.

[FN341]. See Roberta Romano, The Shareholder Suit: Litigation Without Foundation? 7 J. L. ECON. & ORG. 55, 84 (1991).

[FN342]. See Painter, supra note 9, at 42-44.

[FN343]. Stephen P. Marino and Renee D. Marino, An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters, 22 SEC. REG. L.J. 115 (1994).

[FN344]. See id. at 119.

[FN345]. See id. at 115.

[FN346]. See James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497,523 (1997).

[FN347]. According to one scholar:
The Burger and Rehnquist Courts began a process of retrenchment that was extraordinary. In forty federal securities law decisions, the Court decided thirty-two cases for defendants and, in almost every one, significantly narrowed the reach of federal securities laws. ... The activity in securities law at the United States Supreme Court level reflects one of the most pronounced jurisprudential shifts ever.
Branson, supra note 9, at 6-7.

[FN348]. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[FN349]. Steinberg, supra note 10, at 489 (notes omitted); see also Branson, supra note 9, at 11 ("[In Central Bank] The Supreme Court reversed twenty- five years of reliance on the common-law construct of aiding and abetting by lower federal courts to hold collateral participants to securities transactions secondarily liable.").

[FN350]. James D. Cox, Just Deserts for Accountants and Attorneys After Bank of Denver, 38 ARIZ. L. REV. 519, 545 (1996).

[FN351]. See, e.g., Branson, supra note 9, at 11-12 (quoting Stephen M. Bainbridge, Securities Act Section 12(2) After the Gustafson Debacle, 50 BUS. LAW. 1231, 1231-32 (1995)).

[FN352]. *See* Susan E. Springer, Case Note, Central Bank v. First Interstate Bank and the Demise of Section 10(b) Private Aiding and Abetting Liability: Opting for a Rule of Economic Efficiency, 4 GEO. MASON L. REV. 213,249 (1995).

[FN353]. See id. at 243-44.

[FN354]. See John W. Avery, Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995, 51 BUS. LAW. 335,377-78 (1996) ("To the extent the ['95] Act makes meritorious cases more difficult to pursue, it will not have served a worthwhile purpose. The strength of our markets depends on investor confidence that those markets operate honestly and fairly. Depending on the SEC to fill any void caused by a decrease in meritorious private litigation may be unrealistic in an era of governmental austerity.").

[FN355]. See Seligman, supra note 56, at 456:
Given the limited resources available for the enforcement of its mandatory disclosure system, private litigation has been frequently recognized as performing a useful augmentative deterrent, as well as compensatory, role. To date, the attack on the securities class action has generally been disconnected from the mandatory disclosure system it seeks to enforce. If the mandatory disclosure system is worth preserving, we must ensure that reductions in the effectiveness of the class action do not produce a corresponding weakening of the disclosure system. This weakness is potentially the most serious consequence of far-reaching new restrictions in the private enforcement of the federal securities laws.
(notes omitted).

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[FN356]. See Pietrusiak, supra note 129, at 241-43.

[FN357]. See Malone, 722 A.2d at 15.

[FN358]. See O'Malley v. Boris, 742 A.2d 845, 850 (Del. 1999).

[FN359]. See Klock, supra note 202, at 330-31.

[FN360]. See, e.g., Klock, supra note 201, at 789 ("[T]he SEC is making a judgment about the optimal structure of the market ....").

[FN361]. See Greg A. Jarrell, Change at the Exchange: The Causes and Effects of Deregulation, 27 J. L. ECON. 273, 307 (arguing that the SEC is driven more by political pressure than economic analysis).

[FN362]. See Marc I. Steinberg & Lee E. Michaels, Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality, and Reciprocity, 20 MICH. J. INT'L L. 207, 208 (capita1 markets have become global); cf. id. at 265 ("[E]fforts at international harmonization have been challenging and thus far largely unsuccessful.") (thus these difficulties would only be aggravated if we had fifty times as many regulatory systems). But see Romano, supra note 54, at 2418 (arguing her approach should apply to foreign securities as well). However, Professor Romano does admit to a potential problem in enforcement by private attorney generals. Id. at 2422.

[FN363]. See Mark A. Sargent, A Future for Blue Sky Law, 62 U. CIN. L. REV. 471, 492 (1994) ("Securities internationalization, therefore, poses a long-term threat to Blue Sky law's relevance. As truly international markets and regulatory systems develop, the regulatory aspect of Blue Sky law, on a very basic level, will seem more and more like a historical anomaly that has outlived its usefulness."); cf. Mark S. Klock, Comment: A Comparative Analysis of Recent Accords Which Facilitate Transnational SEC Investigations of Insider Trading, 11 MD. J. INT'L L. & TRADE 243, 265 (1987) (A multinational agreement between all countries ... does not appear feasible, so the problem would be exacerbated with fifty states); Russell E. Brooks, The Extratemtonal Reach of the Securities Exchange Act, 24 SEC. REG. L.J. 306- 315 (1996) (describing federal treatment of extraterritorial '34 Act violations);

[FN364]. Some might consider this last point to be kicking a dead horse given that several years ago Judge Winter declared that Professor Romano had demonstrated the race to the bottom theory to be wrong. ROMANO, supra note 190, at xi (Foreword). But cf., Kamar, supra note 7, at 1910 (arguing that state competition for corporations can still be unhealthy).

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INSTITUTIONAL SHAREHOLDER SERVICES

Postseason Report: Proxy Battles Rise Again, and So Do Stock Prices

By Rajeev Kumar, Deputy Director of ISS's U.S. Research

An emerging trend involving proxy fights should bring smiles to shareholders. Taken as a whole, the data suggest that proxy contests are leading to higher immediate stock prices, no matter who wins the fight but especially when dissidents gain victory. One expert predicts that shareholders can generally expect to see share prices rise when a proxy contest erupts.

"Today, given the numbers involved and the climate, it's a good sign," said Charles M. Elson, director of the **John L. Weinberg Center for Corporate Governance** at the University of Delaware. "Once there's a contest, the problems come to the surface. Either management will fix them or be replaced. Either way for shareholders, it's a win-win."

In another trend propelled by nearly two years of corporate scandals, the number of proxy fights also continues to **rise.** 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.

That's a far cry from the old days, when those who waged proxy contests could have passed as gluttons for punishment, burning money and waging campaigns with scant chance of success. Make no mistake; dissidents today still have an uphill battle, as this season's contest at **El Paso** dramatically demonstrated. Moreover, incumbents are adding to an already formidable arsenal by co-opting dissident agendas. That may cause dissidents to lose—but it can also mean that shareholders gain through company reform.

The Scorecard

During the first eight months of 2003, 17 proxy contests came up for shareholder vote. En addition, two proxy contests, **Celeritek** and **Ladish,** had definitive **SEC** filings but were settled before they were put to vote. In all, there were 13 settlements in which dissidents either took board seats or gained boardroom access. (Table 1.)

Table 1: Proxy Contests (January – August 2003)

Incumbent Victories (13)	Dissident Victories (4)*	Settlements/Drops (13)
Alaska Air Group Inc.	Computer Horizons Corp.	Anacomp Inc.
Cotelligent Inc.	Del Global Technologies Corp.	Applix Inc.
Croghan Bancshares Inc.	Independence Federal Savings Bank	Boston Biomedica Inc.
Dave & Buster's Inc.	Itex Corp.	Brantley Capital Corp.
EL Paso Corp.		Celeritek Inc.
GA Financial Inc.		Diasys Corp.
Hercules Inc.		Fisher Communications Inc.
Post Properties Inc.		Haggar Corp.
Salix Pharmaceuticals Ltd.		Keynote Systems Inc.
The First Year's Inc.		Ladish Company Inc.
		National Semiconductor

United National Bancorp	Corp.
VISX Inc.	Register.corn Inc.
Warwick Valley Telephone Co.	Mercer International Inc.

** Excludes two mutual fund proxy contests, **MVC Capital** and **SmallCap Fund** (where dissidents won), because a fund's performance is primarily driven by performance of its stock portfolio, which is not impacted by the proxy fight.*

Impact on Stock Price Performance

The proxy contests resulted in positive excess returns, which is defined as the difference between a company's stock price returns and the returns of a benchmark index. Around the proxy solicitation period, the contested companies' stock price outperformed their benchmark index by 17.8 percent. The average solicitation period from the time the dissidents publicly filed their intent to launch a proxy contest to the meeting date was 72 days, which suggests that the annualized excess return was 83.3 percent. (Table 2.)

In those proxy contests won by dissidents, the overall excess return was higher (20.9 percent) than in cases won by incumbents (16.8 percent). Striking as this finding is, it must be called tentative because of the small sample size.

Still, in the instances where dissidents won, the returns were significantly higher upon announcement of the vote outcome and somewhat higher upon the announcement of the proxy contest compared to corresponding returns in proxy contests where incumbents won. By contrast, during the period leading up to the meeting date, proxy contests won by incumbents showed significantly higher returns compared to those won by dissidents.

This may suggest that in cases where dissidents won, the shareholders either had an irreparable loss of confidence in incumbents, or that incumbents in the period leading up to the meeting date failed to take corrective steps to alleviate dissidents' concerns. On the other hand, where incumbents won they likely took steps to address the problems.

Before the business scandals of recent years, corporate incumbents could weather proxy contests with little concern. "It used to be that management was popping champagne corks and saying, 'On with business,"' Elson told *The Friday Report*. But the paradigm has shifted so much that it's often a question now of just who gets to make the fixes that in turn boost the stock price: the **old,** original management or new, dissident-approved leaders.

Table 2: Impact of proxy contest on stock price performance

Abnormal adjusted stock returns*	Incumbent wins	Dissidents wins	All
On proxy contest announcement (1)	5.3%	6.9%	5.7%
Leading up to the meeting date (2)	9.5%	3.8%	8.2%
Post-meeting (3)	1.1%	9.7%	3.1%
Total (4)	**16.8%**	**20.9%**	**17.8%**

Source: ISS analysis based on Compustat data
(*) ***Adjusted** for the benchmark **index.***

1. Five days prtor to the announcement to five days after the announcement
2. Five days after the announcement to one day prior to the stockholder meeting
3. One day prior to the meeting date to five days after the meeting
4. Five days prior to the announcement to five days after the meeting. [Note that the subtotals in 1, 2, and 3 do not add up exactly to the total in **4,** as the time period returns

are in percentages.]

Shortcomings as a Change Vehicle

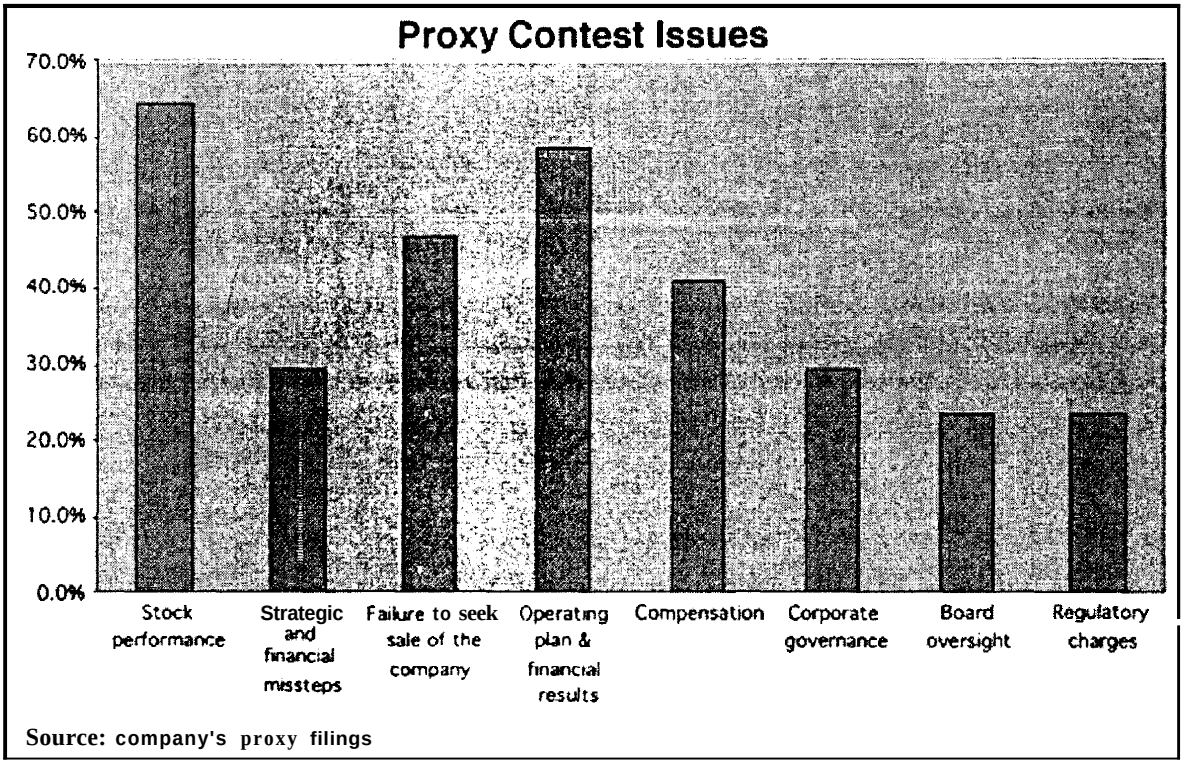
The unusual excess returns, however, were realized at a significant expense to the dissidents, who on average spent roughly $1million on a proxy contest. The most expensive campaign launched by the dissidents this proxy season was for **Post Properties,** where estimated costs reached $6.35 million. At the other end of the scale, dissidents waged an "Internet only" campaign against management at the Alaska Air Group, spending $500 or less on the whole contest. The **Alaska Air** dissidents wanted to determine *if* shareholders with modest means could launch a successful proxy solicitation. The answer? They lost. (Table 1).

The other drawback of the proxy contests is the familiar "free rider" problem faced by the dissidents, i.e., the challengers bear the costs *of* a campaign while the benefits are captured by all shareholders, including rivats. This was illustrated in the average 5.23 percent ownership of the dissidents in the contested companies.

Proxy Contest Issues

While the dissidents leveled a spectrum of charges against the incumbents (Chart 1), their main concerns related to issues of poor stock-price performance, questionable operating plan and weak financial performance, failure to execute strategic sale of the company, and egregious executive compensation. Contests ranged from a single complaint (compensation at **Itex**) to a host of issues (Post Properties and **Hercules).**

Tough economic times and **dry** capital markets exacerbated the failure of companies' strategic initiatives. Similarly, a lack of clear growth plans led dissidents to demand strategic alternatives, including the sale of the company. In this context of poor stock and business performance, excessive executive compensation served as a lightning rod for indignation.



Source: company's proxy filings

The Battle of El Paso

If people remember only one proxy contest this year, it would probably be El Paso. Characterized

as "a welcome brawl" by the *Wall Street Journal* and heavily covered by the news media, it was the one of only two S&P 500 companies that had a proxy contest (Hercules was the other). And even though it came down to the wire, with the incumbents barely winning, the contest illustrated common dissidents' concerns in the wake of the stock market mettdown, as well as the Sisyphean task of dislodging incumbents.

Selim K. Zilkha, who went from maternity-clothing stores to energy drilling, and Oscar S. Wyatt Jr., an outspoken natural-gas magnate, led the dissidents. They fielded a nine-member slate to replace Et Paso's 12-member board.

Chief among their complaints was the precipitous drop in El Paso's securities after a series of missteps by the incumbents. The missteps included repeated changes in business strategy and failed forays into telecommunications and liquefied natural gas businesses with disastrous results. The dissidents argued the incumbent board authorized excessive indebtedness that begat liquidity problems and credit rating downgrades. And they expressed concerns over the company's $1.7 billion Western Energy Settlement with California authorities over charges that El Paso contributed to the West Coast energy crisis in 2000 by manipulating natural gas supply.

Zilkha and Wyatt also claimed that the board unjustly rewarded top management as El Paso suffered. Prior to the meeting date, management adopted much of the dissident agenda, in a move that mirrored that of other boards that have beaten back insurgent shareholders. Management fired several top executives, replaced conflicted board members with independents who have industry experience, and made substantial changes *to* the company's business plan.

Though they poured *$5.9* million into the contest, the dissidents narrowly lost, receiving **46.9** percent of the total shareholder votes, According to some observers, shareholders put concerns over management continuity above those cf reforming curporate governance. Karl Miller, a reform advocate and former El Paso executive, declared it "a sad day for corporate governance and Corporate America."

If so, shareholders could find consolation in El Paso's stock price. It jumped 83.7 percent in the period from five days prior to the dissidents' announcement launching the proxy fight to one day prior to the meeting date. Then the stock price fell 7.2 percent for the period one day prior to the meeting date to five days after the meeting date, when preliminary vote results were announced. Still, that amounted to a stock price gain of nearly 70.6 percent. Adjusted to its benchmark index, El Paso's abnormal return during that period rose nearly 30.8 percent.

Del Global Hit by Steel

Like El Paso, **Del Global's** proxy contest represented a fight for board control, with dissidents seeking four of the five board seats. But unlike the dissident defeat at El Paso, dissidents at Del Global emerged victorious.

Steel Partners II LP, whose principal business *is* investing in the securities of small-cap companies, led the dissidents. Together with certain of its affiliates, Steel Partners is the largest Del Global stockholder with 18.7 percent of the company's common stock. Their main concerns revolved around the company's poor corporate governance procedures and practices. This included Del Global's failure to hold an annual meeting in over three years, the elimination of stockholders' rights to call a special meeting, the adoption of a shareholders rights plan without shareholder approval, and, until April 2003, the failure to create nominating and corporate governance committees.

The dissidents also expressed concern about the company's recent dismal financial performance, including its delisting from Nasdaq's national market, which Steel Partners believed was indicative of management's lack of accountability. **All** of the dissidents' nominees were comfortably elected at Del Global's annual shareholder meeting, receiving 62.1 percent of the total votes cast per director. The company's newly elected board has since terminated the **old** shareholder rights plan and reinstated the right of major shareholders to call a special meeting.

Still, despite the new team's aggressive actions, Del Global's stock performance has been mixed at

best. The stock price rose 2.7 percent in absolute terms but fell 13.2 percent in terms of excess adjusted returns, as measured from the price five days before the proxy fight announcement to the price five days after the meeting. Why? Likely because the company's securities trade over the counter as a pink-sheet stock. The average trading volume for the stock has been less than 0.1 percent of the company's float. With trading that illiquid, the stock-price movement is likely to be inefficient, failing to reflect its true value.

It's becoming clear that proxy contests benefit stockholders even though they don't always result in board or management changes. And while the price tag and chances of victory remain daunting, the recent economic and corporate governance climate is spurring them on.

ISS analysts Dennis Harding and Solomon Luke contributed to this article.

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Labor: Unions Brandish Stock to Force Change

By Joann S. Lublin
Staff Reporter of The Wall Street Journal

Shareholder activism is wearing a union label.

And few wear it more proudly than William Patterson, corporate affairs director of the Teamsters union. The 1.4 million-member union, whose 175 pension funds have assets of $48 billion, is one of the most active advocates of corporate-governance reforms this year.

Yesterday, the 47-year-old Mr. Patterson took his act to Time Warner Inc.'s annual meeting, where he unsuccessfully pushed a Teamsters proposal to split Gerald Levin's job as chairman and chief executive officer into two positions. Also this week, the union's bid to kill a "poison pill" antitakeover device won a respectable 36% of the votes cast at the annual meeting of Tenneco Inc., the Greenwich, Conn., conglomerate.

The Teamsters may be leading the charge, but 11 other major unions, including the Service Employees and the Carpenters, are using shareholder activism as a bully pulpit -- and scoring a growing number of victories. So far this spring, six of 87 union-related proposals on corporate governance issues have won more than half of the votes cast. Some corporate governance experts think the final tally this year might reach a dozen. In 1993, just two out of 16 union-related resolutions garnered that level of support, according to the Investor Responsibility Research Center in Washington.

Mr. Patterson says it is a matter of protecting interests of union members whose retirement funds are at stake. Others, however, question both the confrontational tactics and motives of corporate America's newest gadflies,

A recent attack by the Teamsters on executive pay at Union Pacific Corp., for example, coincided with a bitter fight over organizing new union members at the railroad company's Overnite Transportation unit. "They didn't appear at any annual meetings before the organizing drive started," says Gary Schuster, a Union Pacific spokesman,

Whatever their motives, unions have tapped the support of some institutional shareholders. Companies "will have a difficult time if they try to label the message and the messenger as the same thing," says Patrick McGurn, director of corporate programs at Institutional Shareholder Services Inc., a Bethesda, Md., proxy advisory firm. He adds that institutional investors often look at issues involving greater board accountability "very favorably."

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Mr. Patterson, who joined the labor movement in 1969 as a $5-a-week organizer for the United Farm Workers' grape boycott, has learned to talk the language of big investors. Shareholder activism, he says, is the best way to protect unions' stake in corporate America. With union pension funds now holding $250 billion of assets, "governance structures affect the retirement income of the employees we represent," he says.

An intense intellectual who sometimes works 70-hour weeks, Mr. Patterson spends hours on the phone lobbying for audiences with business leaders. "He is tenacious," admits a vice president of one major company that narrowly defeated a Teamsters resolution this spring. "He understands the game."

Dana Mead, Tenneco's chairman and CEO, gave Mr. Patterson a 20-minute private audience before Tuesday's annual meeting. His aides then ushered the activist to a front-row seat alongside the top brass.

But critics say Mr. Patterson is merely trying to bolster his union's collective-bargaining and organizing clout by putting public pressure on top executives. Indeed, he employs some standard union tactics to get attention. On the day of Union Pacific's annual meeting last month, the Teamsters ran a full-page newspaper advertisement decrying the company's "runaway executive pay" and many directors' alleged lack of independence from Drew Lewis, the company's chairman and chief executive. Outside the meeting, Teamsters and members of other unions carried protest signs about the executive-pay issue. But in the end, they received scant support for a floor resolution that sought to separate the two top jobs.

Mr. Patterson sparked an outcry in March, when he unveiled a list of what he called "America's Least Valuable Directors." The list cited 23 directors for alleged poor attendance, conflicts of interest or service on the boards of underperforming concerns. Critics contended the Teamsters used flawed research. About 10 directors called Mr. Patterson to complain, and some pleaded that the scorecard singled them out unfairly.

Mr. Patterson insists the Teamsters couldn't focus on individual directors' shortcomings without naming them. To drive home his point at Tenneco's meeting, Mr. Patterson told fellow investors that board member M. Kathryn Eickhoff -- seated stone-faced nearby -- showed up on the tally for "not contributing to shareholder value." He then handed out copies of his list to every Tenneco director present.

"I was very upset" and saddened by the Teamsters report, says Ms. Eickhoff, a member of several other boards and owner of an economic-consulting firm in Washington. The union measured companies' performance arbitrarily, she contends.

But Mr. Patterson says he increasingly practices "quiet diplomacy.''After five months of negotiations with Sears, Roebuck & Co. officials, he recently

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agreed to withdraw a resolution that would have separated the two top posts at the giant retailer.

The activist's cooperative tack hardly signals his retreat from public proxy duels. On the road three days a week during the current annual-meeting season, he expects his next confrontation at Kmart Corp.'s meeting Tuesday in Detroit. The Teamsters and the Union of Needletrades Industrial and Textile Employees are proposing measures that would eliminate staggered terms for directors, drop retirement benefits for outside board members and authorize "a formal study to review all options for restoring Kmart share value."

Though a Teamsters-supported candidate dropped his bid for a Kmart board seat last month, Mr. Patterson vows that the union's first pursuit of directorships won't be its last. "We have an opening to change the governance of the companies we own," he says. "I want to be at the center of that debate."

---- INDEX REFERENCES ----

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The great motivator

Unions and pension funds heat up the corporate governance debate and Delaware loses *an* edge

by David Marcus

The corporate governance gang couldn't have picked a better time for its latest gathering than the first Friday in October. Marty Lipton had recently been dressed down by The New York Times for playing too many sides in the Dick Grasso versus the New York Stock Exchange debate; the Securities and Exchange Commission was due to issue a proposed set of rules meant to make it easier for shareholders to propose candidates for election to a company's board.

So the atmosphere was notably charged when the usual suspects from bar, bench, academia and the media, along with private investors—most notably Michael Price—SEC officials, and various institutional investors descended on Harvard University on Oct. 3 to debate the proper scope and structure of shareholder involvement in corporate elections. Underlying the debate—and for the most part not addressed by it—was a nagging question: Does corporate governance matter economically. or is it merely the meaningless topic of a moralistic crusade?

As Robert Pozen. a former vice chairman of Boston mutual fund giant Fidelity Investments now at Harvard Law School. noted, money managers usually respond to a company's poor performance by selling its stock, not by campaigning for corporate reform. The former is certain and easy. the latter too time-consuming to consider.

A *mass* of academic research supports the logic in the approach Pozen described. Having a majority of independent directors on a company's board probably has little effect on its stock price, for example. and an auditor's provision of tax and consulting advice to a company does not increase thr chance thar the client will have to restate earnings.

Furthermore. Price. who shared a panel *with* Pozen. said those investors who want to pressure management already have the tools they need. They can run proxy fights, call out management in public and communicate with other shareholders. And he would know—he's been harassing corporate laggards for years.

Why, then, setting aside issues of how corporate America should be perceived, should anyone care about improving corporate governance, or should shareholders agitate for increased access to the process of electing directors?

Silvers: *vocal presence for union*

According to Lipton. a co-founder of **Wachtell, Lipton, Rosen & Katz** and one of the confab's headliners, the crusade is a thinly veiled attempr by labor unions and public pension funds to increase their influence over corporate America in order to further private agendas. This idea was seconded by Charles Nathan. a partner at **Latham & Watkins** in New York who chaired the American Bar Association committee that cornmenred on the shareholder access rules.

By threatening to contest the reelection of a sitting director. Nathan argued. a union or public pension fund can try to pin other concessions: a better deal for the union, or the continued operation of a plant in a politically importanr jurisdiction. Safe Harbor hadn'r heard so much power attributed to labor unions since the last Oliver Stone movie.

This seemed a perplexing argument. notwithstanding the vocal presence of AFL-CIO associate general counsel Damon Silvers and Sarah Teslik, the director of the Council of Institutional Investors, at the debate. Labor has never been shy about using its voice to get what it wants ar companies where it has sway. but how many public companies now have unionized work forces? Will, say, a Virginia bank *or* a Silicon Valley chipmaker care in the least what Damon Silvers thinks?

But by challenging directors, unions could allay fears thar their managements are corrupt or, in the tradition of bureaucracies everywhere, they could buff their images as doers rather *than* paper-shufflers, both motives that would resonate with the state employees who run public pension funds.

Unions and pension funds haw another compelling reason to push for greater influence in the corporations whose shares they own. Both classes of investors index a substantial percentage of the money they invest. Though Price chided them for this approach, it's probably the most rational one for institutions with austere budgers and billions and billions of dollars to put to work.

The problem with indexing is that the investor loses the most powerful tool he has: the right to sell the stock. If displeased indexers want to convey their opinions to a company. they have to be able to threaten an underperforming management.

Whether such threats do any good is another question. When asked which corporate directors he would most like to unseat, Silversbellicosely singled out Frank Savage, a former Enron director who now sits on the board at **Lockheed Martin Corp.**. which in the last year has lost about 25% of its value while hoth the Dow and Standard & Poor's 500 indexes have gained 25%. Such a result is especially poor because Lockheed is a defense company, and this is an era of increased defense spending.

Oddly, Silvers didn'tfocus on Lockheed's stock, instead, he fulminated that corporate America continues to ig-

continued on page 49

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SAFE HARBOR *continued from page 31*

nore the implications of scandals such as Enron. But the choice does suggest a productive use for selected shareholder attacks on directors.

It seems most **unlikely** that removing Savage, an independent director, from the Lockheed board will reverse the company's sub par performance, but he may be the most **easily** targeted symbol of it. And given Lockheed's stock price, it'd be hard to fault a shareholder's effort to light a fire under the company's board and management.

Call it corporate governance **by** threat of humiliation. It's harder to quantify than the number of independent directors or the amount of **tax** advice a company's auditor provides, but it may well be a better **motivator**.

Safe Harbor's Harvard excursion inspired us to survey the recent academic literature in corporate governance. Not **having an** advanced degree in econometrics, we found our reading of many papers limited to the abstracts summarizing them, but a few were written in English.

One **of** the more provocative of those **was** Guhan Subramanian's study of the effect of incorporating in Delaware on the value of **a** public company. The Harvard Law School professor argues that Delaware companies were worth about 3% more than non-Delaware companies between 1991and 1993 and **2%** more between 1994 and 1996 but that the difference **is** now "statistically and economically insignificant."

Subramanian offers two explanations for the change. First, he argues that the takeover battles of the mid-1990s showed that the "just say no defense"—the right of a company's board to refuse to negotiate with a hostile bidder—was alive and well in Delaware. Decisions the state's courts issued at the time supported a target's ability to fend off a hostile bid.

Second, he notes rhat the gradual increase in board independence and the massive increases in CEO stock compensation in the 1990s may have made companies more willing to sell themselves regardless **of** their legal ability to fight **a** takeover.

This, in turn, diminished the effect of any advantage Delaware law may have given to bidders relative to the law of other states.

Delaware hasn't rested on its laurels, so Subramanian's study may nor be the last word on the subject. In the past year, the Delaware Supreme Court has issued several rulings favoring shareholders over company management. most notably **Omnicare Inc.** v. **NCS Healthcare Inc.**, in which the court ruled that a target may not irrevocably lock up a deal

The First State isn't about to give up its corporation franchise without a fight. ■

Postmortem *continued from page 47*

Enter WaMu, which **gladly** paid **a** *$77* million fee to bust **up** that deal to **buy** Dime itself for **$1.4** billion in cash and 92.3 million WaMu shares. Eastward expansion was so compelling to Killinger that he was willing to more than double North Fork's offer.

Jefferies & Co. analyst Charlotte Chamberlain says Dime was worth it, noting that WaMu's **deals** have increased the size of the thrift but shouldn't be seen as transforming it. "The mortgage business is a scale business, so the more servicing you can put on a given platform, the more profitable it becomes," she says.

> "DIME SEEMS TO HAVE DONE EVERYTHING THAT WASHINGTON MUTUAL HAD HOPED FOR IN VISIBILITY AND ACCESS IN A NEW MARKET"
> *Tom Burnett*

Killinger has complemented the spare of deals with an aggressive program of organic growth. He aims this year **to** open 320 branches, focusing on New York, Florida and Chicago. Operationally, the thrift has tightened up—nonperforming loans account for 0.82% of its book down from 0.9% at the end of the first quarter.

The only synergy that WaMu promised during the spree was $150 million in savings from the Dime transaction, which could easily be achieved, given Dime's roughly $7 billion in annual noninterest expenses. The bank's efficiency ratio has risen 4.5 percentage **points.** to 52.5%, largely because it hired temporary staff during the refinancing boom.

The buying spree appears over for now At 8 times estimated 2004 earnings. WaMu stock can't really be used as **deal** currency In fact. for more than a year now. Killinger and his team have been quietly integrating the various acquistions. and analysts **expect** there **will** he little activity in the next few months. "They're the best at getting **these** things done. integrating them and moving on." Chamberlain says

Which means it may he an opportunity for Killinger to fix what has the **folks** in Texas, Minnesota and hack home in Seattle so upset. And to begin to look around again. ■

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Article

*771 UNION 'CORPORATE CAMPAIGNS' AS BLACKMAIL: THE RICO BATTLE AT BAYOU STEEL

Herbert R. Northrup [FNa1];Charles H. Steen [FNaa1]

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*773 I. Introduction

On October 29, 1997, Bayou Steel Corporation and the United Steelworkers of America (USWA) entered into a confidential settlement agreement ending the company's civil RICO lawsuit based on the Steelworkers' 'corporate campaign.' [FN1] The settlement was reached after the close of discovery, and just before Bayou Steel's deadline to respond to the Steelworkers' motion for summary judgment. [FN2] Accordingly, an actual judicial resolution of the issues raised in the litigation will have to wait for another case. A substantial amount was learned from this case, however, and some new trails were blazed. This paper examines the Steelworkers' war against Bayou Steel. analyzes the core legal issues raised and sharpened in the course of that dispute, and concludes that union corporate campaigns constitute actionable racketeering.

II. Overview of Federal Racketeering Law

The Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968, ('RICO') takes an organizational approach to penalizing unlawful conduct by reaching upstream from 'street-level' conduct to the management and control levels of organizations. Specifically, RICO § t962 (c) makes it unlawful for a 'person' to 'participate in the conduct of the affairs' of an 'enterprise' through a 'pattern' of 'racketeering activity.' [FN3] Some of RICO's elements are easier to grapple with than others. For example, a labor union clearly satisfies RICO's broad definition of a 'person.' [FN4] Similarly, as set out

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in detail infra, the tactics which *774 together comprise a corporate campaign constitute a 'pattern' of activity. [FN5] Indeed, these elements were not disputed in Bayou Steel's RICO suit against the Steelworkers. [FN6] RICO's racketeering, participation, and enterprise elements, however, are relatively harder to understand and apply.

A. 'Racketeering Activity' Means 'Predicate Acts'

RICO defines racketeering activity according to an array of 'predicate acts.' [FN7] Among these are: (1) mail and wire fraud; (2) violations of the federal Travel Act; and (3) any act or threat involving extortion chargeable under state law that is punishable by imprisonment for more than one year. [FN8] Each of these potential predicate acts breaks down, in turn, according to its own elements. Mail and wire fraud, for example, each have two elements: (1) a scheme or artifice to defraud; and (2) use of the mail or wires, [FN9] Similarly, the Travel Act makes it unlawful to travel in interstate commerce with the intent to 'promote, manage, establish, carry on, or facilitate the promotion, management, establishment, or carrying on, of any unlawful activity.' [FN10] As set out in detail infra, a corporate campaign generally will involve use of the mail and wires, and interstate travel.

Perhaps the most interesting and significant of the predicate acts likely to be present in a corporate campaign is state law blackmail, which is a species of extortion. [FN11] Indeed, applying RICO to corporate campaigns comes down, in large measure, to understanding the crime of blackmail under state law, and recognizing that—legally speaking--corporate campaigns are, at *775 bottom, a pattern of blackmail. [FN12]

B. The 'Enterprise' and 'Participation' Elements of RICO

The 'enterprise' and 'participation' elements of RICO probably are the most difficult to conceptualize and apply. The statutory definition of 'enterprise' is very broad, including 'any union or group of individuals associated in fact although not a legal entity.' [FN13] Accordingly, a RICO enterprise may include 'virtually any de facto or de jure association.' [FN14] An association of entities, therefore, with or without the individuals who own or control the entities, may together constitute a RICO enterprise. [FN15] Ultimately, a RICO enterprise may be comprised of any combination of individuals, corporations, or other entities. [FN16] Moreover, whether the evidence in a particular case establishes an enterprise is a question of fact for the jury to decide. [FN17]

RICO, however, also distinguishes between its 'person' and 'enterprise' elements. Indeed, a recumng issue in the RICO case law is whether the defendant-person and the alleged enterprise are really the same entity, versus being sufficiently distinct to *776 satisfy the RICO model. [FNI8] For example, where a parent corporation and its wholly-owned subsidiary are alleged to be both a RICO person and enterprise, the distinctiveness requirement is not met. [FN19] In this instance courts reason that the subsidiary lacks an independent will and, therefore, as a practical matter, there is insufficient separateness between the person and enterprise. [FN20]

RICO § 1962 (c) also requires that the defendant-person 'participate in the conduct of the affairs' of the enterprise. [FN21] As interpreted by the Supreme Court, this element requires that the RICO person must have participated in the operation or management of the enterprise. [FN22] For example, a corporation's outside auditors who do not make decisions for the company are not considered to participate in the conduct of its affairs within the meaning of RICO. [FN23] A sole proprietorship, however, can be an enterprise, even though the owner is the sole RICO person. [FN24] Therefore, for RICO to apply in a particular case, the defendant RICO persons must be separate, but not too separate, from the RICO enterprise.

This Article analyzes the direct RICO implications of the Steelworkers' corporate campaign against Bayou Steel. In the process, this Article also evaluates the sometimes potentially competing implications of federal labor policy, as well as the more general constitutional policies relating to free speech and the right to seek redress of grievances.

*777 III. Overview of the Steel 'Mini-Mill' Industry

While major steel companies were closing facilities and downsizing during the last three decades, steel making 'mini-mills' grew in size, number, and product mix. [FN25] Unlike traditional steel mills, mini-mills do not use ore as their primary production input. Rather, mini-mills recycle steel scrap and, accordingly, can be (and are) located in virtually every region of the country, with the largest concentration in the Southeast. Mini-steel companies initially were small concerns that focused on relatively basic products such as bars, flats, strips, and standard angles. Now, led by Nucor Corporation, the largest of the mini-mill companies, [FN26] several such concerns have advanced to produce sheet metal for automobiles. Indeed, mini-mill

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companies accounted for 46.4 percent of total United States steel production in 1997, and are expected to produce most of the industry's output by the turn of the century. [FN27] The automated nature of mini-mill steel production lends itself to round-the- clock operations with lean complements of managers and labor. Most mini-mills are non-union, especially those in the Southeast. Those that are unionized have contracts permitting considerable managerial flexibility, and personnel policies that emphasize strong employee-management communications and individualized worker treatment.

IV. The Steelworkers' Corporate Campaign Against Bayou Steel

A. Bayou Steel--Before the Strike

Bayou Steel is located in La Place, Louisiana, on the Mississippi River, about thirty-five miles northwest of New Orleans. The company was founded in 1981 as an American subsidiary of Voest-Alpine, Austria's state- owned steel company. Voest-*778 Alpine, however, had great difficulties in dealing with American workers, lost money, and sold the company in 1986 to RSR Corporation, which took it public. [FN28] Soon thereafter, Bayou Steel recognized the Steelworkers as the sole collective bargaining agent for its employees and adopted a six-year collective bargaining agreement. [FN29]

Unfortunately, Bayou Steel's productivity and profits remained substantially below its competitors because of the high cost of benefits and the absence of an incentive plan to stimulate productivity and reduce absenteeism. [FN30] Accordingly, when new contract negotiations began in January of 1993, the company sought reduced wages and benefits and a productivity-based incentive plan. [FN31] The Steelworkers demanded major wage increases and strongly opposed productivity-based pay. Negotiations broke down and, on March 21, 1993, the approximately three hundred members of Steelworkers' Local 9121 were directed to strike Bayou Steel, beginning the longest strike in Louisiana history.

In key respects, by August of 1993, Local 9121's traditional strike had simply failed. [FN32] At the start of the strike, temporary *779 replacement workers were immediately hired [FN33] and, despite serious violence and threats, [FN34] approximately one-third of Local 9121's rank and file members crossed the picket line and returned to work. [FN35] Soon the company was producing at pre-strike levels. [FN36] Despite strike- related costs of $100,000 per month, Bayou Steel was operating profitably and carried a record backlog of orders. [FN37] In August of 1993, the Steelworkers acted.

B. The Steelworkers Launch the Corporate Campaign

For three brutal years--from August, 1993 through September, 1996--the Steelworkers waged an exhausting 'corporate campaign' against Louisiana's only steel company. [FN38] Although *780 rumors had been circulating among the Steelworkers and Bayou Steel executives for several weeks before its formal announcement, the corporate campaign began in earnest with a press release and news conference held by the Steelworkers on August 2, 1993, in Kenner, Louisiana. [FN39] At the time of the Steelworkers' announcement, no one could have anticipated fully the impact on the legal landscape of the Steelworkers' corporate campaign, or Bayou Steel's subsequent civil racketeering lawsuit to combat it. Even with the full benefit of hindsight-- after more than three years of corporate campaign activity, extensive legal briefing, discovery answers amounting to tens of thousands of pages of documents, and scores of depositions, both factual and expert—the Steelworkers' initial announcement launching the corporate campaign, perhaps as well as any other single piece of evidence, illustrates why union corporate campaigns constitute actionable racketeering.

C. Steelworkers Local 9121, on Strike for Forty-Two Months

When Steelworkers Local 9121 walked out of Bayou Steel on March 21, 1993, Bayou Steel immediately sought protection from the Saint John Parish Court and, on March 24, 1993, the company and the union entered into an agreed injunction to govern striker conduct and picket line organization. [FN40] For several reasons, this was one of the most significant judicial orders entered during the strike. First, although Local 9121 had never been on strike before, the United Steelworkers International ('the International') provided virtually no pre-strike training and, hence, threats, violence, and property destruction were extreme at the beginning of the strike. Moreover, Bayou Steel continued to operate its plant using temporary replacement workers and union members who crossed the picket line, [FN41] This created a substantial amount of genuine anger on the picket line, and tempers exploded. [FN42] The *781 agreed injunction gave Bayou Steel quantified standards against which striker conduct could be measured, which resulted in several orders for contempt during the strike. [FN43] Second, it gave Bayou Steel a benchmark against which striker misconduct could be measured effectively after the strike in disciplinary and termination arbitrations. Third, as discussed below in the section on union ratification of striker misconduct, the agreed injunction imposed a duty upon the Local and the International to control striker conduct, potentially making the

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union directly responsible, and liable, for individual striker's violence and threats. [FN44]

The Steelworkers and Bayou Steel will always disagree about whether, over the course of the entire forty-two month strike, the violence and threats were extreme, fairly typical, or relatively mild. Moreover, one can only ponder and surmise from conflicting evidence about the extent to which Local 9121 and the International actually or tacitly encouraged striker violence and threats, Some things are certain, however. First, Bayou Steel endured a significant amount of property damage--for instance flooded and spray-painted residences and flat tires--that it knew or believed was caused by strikers. Second, several of Bayou Steel's managers and replacement workers, and their family members, were threatened by strikers with murder, assault, rape, and property destruction. [FN45] Indeed, during the first weeks of the strike, the company was effectively under siege; managers and non-striking employees worked, ate, and slept on-site. The company's top managers were assigned personal body guards and electronic protection, which lasted throughout the strike and, in some cases, for many months after the strike ended. Third, significant physical improvements to Bayou Steel's plant had to *782 be made to maximize employee safety. Ingress and egress from Bayou Steel were completely reconfigured and fortified. Vulnerable windows were bullet proofed. Employees were given training and strict instructions on how to conduct themselves to minimize their risk of being harmed. Fourth, beginning on day one of the strike, Bayou Steel began video taping the picket line from multiple locations, and continued this practice throughout the forty-two months the strike lasted. Bayou Steel's videos tapes and corresponding custodial records accumulated into a significant archive of evidence that was successfully used in several contempt proceedings, disciplinary arbitrations, and depositions taken as part of the company's RICO suit. [FN46]

For this Article, striker misconduct--specifically violence, threats, and property destruction—is important primarily as it relates to Bayou Steel's RICO litigation. Thus, this Article is relatively less concerned with specific violence and threats, and relatively more concerned with the implications of such conduct in the legal context of racketeering. Nevertheless, it must be noted that the violence and threats experienced at Bayou Steel will have very long lasting effects in La Place, Louisiana.

D. AFL-CIO Encouragement of Corporate Campaigns

Before turning to a description of the Steelworker campaign against Bayou Steel, a word about changing AFL-CIO policy is in order. Prior to the current administration of President John Sweeney, corporate campaigns were the product of individual unions assisted by the Industrial Union Department (IUD). Sweeney has been a long-time advocate of such programs and utilized them during his prior tenure as President of the Service Employees International Union (SEIU). In the latter capacity in 1988, he sponsored and wrote the foreword *to* the SEIU's Contract Campaign Manual, a major portion of which is devoted to corporate campaigns and the related 'inside game' tactics. [FN47] Since taking over the AFL-CIO presidency, Sweeney has established a corporate campaign organization directly under him, and abolished the IUD *so* that the Bayou Steel campaign may have been the last one in which the IUD played a role. Henceforth, the AFL-CIO is likely both to encourage and to be involved directly *783 in similar situations.

E. Overview and Chronology of the Corporate Campaign Against Bayou Steel

As indicated in the Steelworkers' announcement of **August** *2,* 1993, and in the general literature on corporate campaigns, the core tactics in a corporate campaign involve getting the target company's outside interests involved in the union's dispute. [FN48] For example, all sizeable manufacturing corporations--and steel making is perhaps paradigmatic--are regulated by a plethora of federal, state, and local authorities. **At** the federal level these include the Securities and Exchange Commission, the Environmental Protection Agency, the Coast Guard, **and** the Occupational Safety and Health Administration **of** the Department of Labor, among others. Bayou Steel, as is typical, also is regulated at the state level by the Louisiana Board of Commerce and Industry and the Louisiana Department of Environmental Quality ('LDEQ'), among others. Although these agencies all play valid roles in modern industrial markets, each potentially can be misused. [FN49] When complaints are made to these agencies, mandatory processes are set in motion. Thus, for example, when a complaint is made by a union to a federal or state environmental agency that a particular company is violating *784 the environmental laws, complaint handling and investigative processes begin. As discussed below, this tactic, called 'Regulatory Harassment'--a term coined in the Steelworkers' promotional literature [FN50]--exploits this dynamic, and snowballs the agencies' investigative processes with professionally-executed publicity to maximize on as many interlocking fronts as possible the distraction and compliance costs that must be borne by the target company. These processes, which can include unannounced major inspections, massive document requests, management interviews, permit and license delays, litigation, and so forth, always are distracting and expensive to defend. In addition to the agencies, there are also the courts which can be used for regulatory harassment. [FN51] indeed, regulatory harassment was the hallmark of the Bayou Steel campaign [FN52] and, due to its clear effectiveness, is expected to constitute an even more Fundamental corporate campaign tactic in the future.

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According to the Steelworkers, the Bayou Steel campaign was operationally organized in four broad component parts: (1) a Corporate Part (focusing on banks and corporate directors); (2) an Environmental, Health, and Safety Part; (3) a Political Part (including both state and federal); and (4) a Public Relations Part. [FN53] Different team members--those referenced in the August 2, 1993 announcement--each brought specialized resources and expertise to the Bayou Steel campaign's various parts. [FN54] Conspicuously absent from the Steelworkers' model, however, was a part denoted 'collective bargaining.' Although *785 viewing the Bayou Steel campaign in its component parts is essential to analyzing its impact and understanding its unlawfulness, the dynamics are best introduced from a chronological perspective.

1. Origins in Ravenswood Campaign

The corporate campaign against Bayou Steel did not begin in a vacuum. As suggested in the Steelworkers' August 2, 1993 announcement, the Bayou Steel campaign had its genesis in the Steelworkers' twenty-month campaign against Ravenswood Aluminum Corporation, Parkersburg, West Virginia. It was in the Ravenswood campaign—which resulted in a substantial ouster of management and the return to work of more than 1700 steelworkers—that many, if not most, of the major tactics used against Bayou Steel were developed and refined. Hence, understanding the Bayou Steel campaign requires periodic references to the Ravenswood campaign. [FN55]

The Ravenswood and Bayou Steel campaigns each began with a mustering of experts. The IUD joined the Bayou Steel campaign 'team' to head up the Corporate Part. Washington, D.C.-based Fingerhut, Powers, Smith & Associates took the laboring oar in developing the Steelworkers' political communications and publicity. Disposal Safety, Inc., a Washington, D.C.-based environmental consulting firm, provided expertise for the Environmental Part. The International supervised and funded the corporate campaign, while members of Local 9121 performed much of the task-based work and put a human face on the union's cause. The rank and file members of Local 9121, as usual, also maintained a forty-two month picketing vigil at Bayou Steel in conjunction with the more sophisticated tactics of the corporate campaign.

At the Steelworkers' initial press conference on August 2, 1993, Richard Davis--a veteran of the Ravenswood campaign, then-Director of USWA District 36, and who later became an International Vice President during the Bayou Steel campaign--*786 stated that the union had the names of Bayou Steel's directors and planned to make contact immediately. [FN56] Steelworkers' Vice President George Becker, who became President of the International during the Bayou Steel campaign, said investigations into the board of directors would cover both personal and business aspects of their lives. [FN57] Becker admonished that during the Ravenswood campaign, the union chased members of the board of directors across five continents and twenty-two countries. [FN58] Further, he cautioned that Ravenswood had lost so much business that it was having difficulty regaining financial stability. [FN59] The stage for the Bayou Steel campaign was set.

2. Initial Director Engagement

As Davis and Becker had stated, one of the first tasks undertaken in the Bayou Steel campaign was the identification of Bayou Steel's directors. [FN60] By a letter dated October 12, 1993, Local 9121, together with the International, contacted Bayou Steel's directors, urged the directors to compel the company to resume collective bargaining, and made it clear that the corporate campaign would be both costly and personal. [FN61] The Steelworkers *787 wrote:

We regret that some in the company expect that it will easily be able to return to normal operations while it engages us--and our Union--in a broad, national struggle. A struggle that will bring to light every aspect of Bayou's operations and ownership, from environmental issues to it's [sic] current $44 million in property tax exemptions, and beyond . . . . These long and costly struggles, such as the ones our Union was forced to conduct against Ravenswood Aluminum Corporation last year and J.T. Ryerson & Son and the Boston Gas Company this year, could almost always be avoided were it not for management misjudgments made at the onset . . . . Nor, do we believe, that you would favor Bayou being the target [of] a long and intensive national corporate campaign which, inevitably, will be costly for your company . . . . [FN62]

The threat in the above-quoted statement is clear; unless the directors intervened in restarting collective bargaining, the company would face intensive and expensive regulatory harassment. As set out infra, this letter and the Steelworkers' initial announcement have legal significance. Moreover, as threatened in their initial announcement, the Steelworkers were, by October of 1993, reaching beyond the company's collective bargaining representatives to bring the force of outside interests to bear on the dispute. [FN63] The union's harassment of Bayou Steel's officers and directors continued throughout the corporate campaign.

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3. The DSI Report: From Baton Rouge to Wall Street in Sixty Days

The first major environmental volley in the Bayou Steel campaign came on December 10, 1993 when Disposal Safety, with the Steelworkers, released and distributed the first in a series of reports entitled 'Environmental Audit: Bayou Steel *788 Corporation' (the 'DSI Report'). [FN64] Indeed, the DSI Report became the centerpiece of the Environmental Part of the Bayou Steel campaign, and its usage illustrates well the compounding of informational dynamics that characterizes regulatory harassment. [FN65]

The DSI Report was announced with substantial fanfare, including professionally written press releases, and was distributed simultaneously to an array of potential Achilles heels. [FN66] There is no question that the DSI Report was highly critical of Bayou Steel's environmental compliance practices, as it was intended to be, [FN67] or that it employed a number of creative regulatory noncompliance theories to portray Bayou Steel as a serious environmental offender and an outlaw as a matter of corporate philosophy. Whether the DSI Report was mainly true or false, objective or slanted, or intentionally harmful or socially responsible, will forever remain points of disagreement between the Steelworkers and Bayou Steel. It is clear, however, that the DSI Report was commissioned by the Steelworkers and written by Disposal Safety to portray Bayou Steel in the worst environmental light possible in order to stir up a hornet's nest of trouble on as many fronts as possible, with environmental regulatory agencies being only the most obvious venues.

The first immediately effective use of the DSI Report occurred in connection with a meeting of the Louisiana Board of Commerce and Industry ('BCI') where certain of Bayou Steel's tax abatements were scheduled to be renewed. As the Steelworkers explained in connection with their motion for *789 *summary* judgment, 'On several occasions between 1993 and 1995, the USWA participated in efforts to persuade the Louisiana Board of Commerce and Industry not to renew tax abatements granted to Bayou Steel by the state of Louisiana, in an attempt to increase Bayou Steel's costs and impose economic pressure on Bayou Steel.' [FN68] Pointing to the new DSI Report as an authoritative compliance audit by a highly-respected and independent environmental consulting firm, the Steelworkers appeared before BCI and argued that Bayou Steel should not be allowed to receive special tax treatment in light of its shameful environmental practices, and that the Board should withhold approving any tax deferrals until the Louisiana Department of Environmental Quality could determine whether the company was in compliance. The Steelworkers also accused Bayou Steel of hiring non-Louisiana workers. In light of the Steelworkers' accusations, BCI, a political body, had no real alternative except to postpone further action on the company's tax abatements until the Steelworkers' accusations could be checked out by the appropriate state agencies. [FN69]

Thus, the DSI Report had its desired initial effect. Further, BCI's prudence handed the Steelworkers a significant tactical opportunity which the Steelworkers seized upon to publicize that: (1) an 'independent environmental audit' had found Bayou Steel to be engaged in a 'pattern of non-compliance'; (2) the company was under environmental investigation by LDEQ; (3) due to LDEQ's investigation, Bayou Steel's tax deferrals had been postponed; and (4) the Steelworkers had performed an important public service by exposing Bayou Steel. But this was just the beginning. The Steelworkers' tactical maneuvering then moved on to the Securities and Exchange Commission and to Wall Street.

During the winter of 1993-94, Bayou Steel was exploring prospects in the credit markets of refinancing its mortgage bonds, and had submitted a prospectus for $75 million in mortgage notes to the SEC for registration. [FN70] The Steelworkers were quick *790 to assert to the SEC that Bayou Steel's prospectus had a number of potentially material misstatements, including failure to disclose that its environmental practices were under investigation by LDEQ, that the company's preferential tax treatment had been delayed by BCI, and that the company was facing numerous unfair labor practice charges from the National Labor Relations Board (NLRB). [FN71] The Steelworkers acknowledged in their *summary* judgment papers that they intervened at the SEC to put economic pressure on Bayou Steel. [FN72]

It is important to note that, as with BCI, simply by raising these issues the Steelworkers were able to get the SEC's attention and the desired result. The underlying merits of the Steelworkers' allegations, or lack thereof, were actually of only tertiary importance. What mattered was that the company's disclosures in a $75 million bond prospectus had been challenged in a facially colorable fashion, thus prompting the SEC to seek explanations from the company as to why these matters either were or were not material to investors and, if they were material, how they might affect the company's ability to repay its notes. Thus, to engage the SEC's processes it was enough for the Steelworkers to assert to SEC that these omissions might be material.

Getting its issues into the SEC was a tremendous accomplishment for the Steelworkers. Moreover, the piggy-backing of

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apparent third-party credibility— under investigation by LDEQ, tax deferrals withheld by **BCI** based on **an** 'independent environmental audit' and, in turn, the SEC's involvement--was truly remarkable.

During the **SEC** registration process, the Steelworkers were actively working to dissuade potential investors from buying Bayou Steel's mortgage notes. On February 7, 1998--the same day that Bayou Steel conducted its 'road show' meeting with potential investors in New York--the union placed a tombstone advertisement in the Wall Street Journal relating to the mortgage notes stating:

Bayou Steel Corporation: FINED. UNDER INVESTIGATION. CHARGED . . . . An independent *791 environmental audit found Bayou engaged in a ' pattern of non-compliance' . . . . The **USWA has** launched a coordinated campaign against Bayou--similar to that used successfully against Ravenswood Aluminum Corporation between 1990 **and** 1992--in **order** to resolve a year-long unfair labor practice strike. [FN73] Further, in what Reuters described as an 'unprecedented tactic,' the IUD sent a representative into the investor meeting to confront investors and distribute the **DSI** Report. [FN74] Reuters reported that after the IUD was escorted out of the investor meeting, 'the union said it will make direct contact with institutional investors to provide them with copies of the audit.' [FN75] Following the meeting, ***Gary*** Hubbard, the International's Communications Director, was quoted by Reuters **as** saying 'that the union was frying to 'keep **Bayou** Steel from finding investors' for its debt deal,' and stating that the union hoped the **DSI Report** would dissuade investors from buying Bayou Steel's notes, making it more expensive for Bayou Steel **to** issue debt. [FN76] Similarly, the IUD's **Ed** Keyser was quoted as stating 'We think it's a bad investment because the plant has environmental problems. ' [FN77]

Bayou Steel's notes eventually were priced and sold. [FN78] Toappreciate *792 the impact **Bayou** Steel experienced from this first flurry of corporate campaign tactics, however, it must be remembered that the entire sequence--from the initial release of the **DSI** Report to the New York investor meeting--spanned only **sixty** days.

4. The RSR Connection

The **next** significant tactics used in the Bayou Steel campaign involved RSR Corporation **and** its principals. In the lexicon of securities law, Dallas- based RSR Corporation and Bayou Steel are 'affiliates,' that is, they share a common controlling shareholder, Howard M. Meyers. [FN79] Based on this, the Steelworkers 'believed that pressure on RSR would help to cause Bayou Steel to change its attitude at the bargaining table.' [FN80]

RSR's principal line of business is the recycling of used lead-acid batteries into lead ingots and basic lead products, Without broaching the environmental moralism debate, it will suffice here to observe that lead, which **has** been around as **a** useful material for centuries, is a dangerous product, although its toxicity was not recognized for many years. **As a** result, many, if not all, of the lead-related industrial facilities in the United States have their share of environmental clean **up,** compliance problems, and related litigation. Thus, it **is** easy to portray lead-related *793 companies, including RSR Corporation, **as** environmental villains. The Steelworkers exploited this. By painting with a wide brush, the Steelworkers were able **to** portray RSR and Meyers in an environmentally unflattering light. **and** to extrapolate that Bayou Steel was **part** of **an** environmentally immoral corporate family. [FN81] In turn, lenders and others with financial ties to Bayou Steel were publicly portrayed **as** being culpable for supporting **and** perpetuating the immorality. The Steelworkers' environmental publicity against Bayou Steel and RSR was relentless. [FN82]

*794 V. Legal Analysis

As noted above, Bayou Steel's RICO litigation was settled at the *summary* judgment stage. This, however, is **as far** as any RICO case based on a corporate campaign has ever progressed through the courts. [FN83] Accordingly, the legal analysis presented here is meant both to evaluate the case in light of its procedural posture, for example, by examining whether the case properly could have advanced to a jury trial, and also to consider the case in terms of a potential final judgment. **As** litigators know, successfully taking a case past the **summary** judgment threshold, so that evidence can then be presented to a jury, is itself legally significant and, therefore, merits analysis. [FN84]

The analysis set out below makes two important assumptions that are taken from the Steelworkers' summary judgment papers. First, it is assumed herein that the Bayou Steel campaign was conducted solely for the purpose of obtaining a collective bargaining agreement acceptable to the union. [FN85] That is, for purposes of analysis, it is assumed arguendo that the Steelworkers sought only legitimate collective bargaining objectives--for example, wages, hours, and working conditions--from the corporate campaign. Second, it **is** assumed *795 arguendo that the Steelworkers' publicity and

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complaints to various regulatory agencies and the public were entirely true. [FN86]

A. Labor Law Is Not The Appropriate Model For Analyzing Corporate Campaigns

It is axiomatic that a corporate campaign pits a union against an employer. Thus, it is tempting to look to labor law, which typically controls the allocation of rights and liabilities between employers and organized labor, for the applicable rules of conduct and corresponding sanctions. This perspective leads, in turn, to seeing corporate campaigns as potentially unfair labor practices under the National Labor Relations Act ('NLRA') and, accordingly, falling within the exclusive jurisdiction of the National Labor Relations Board ('NLRB'). Making the conceptual leap from the simple fact of a union-employer conflict to labor law and NLRB's exclusive jurisdiction, however, is neither necessary nor is it particularly illuminating in the context of corporate campaigns.

*796 Labor unions are not specially privileged by federal labor law, or any other source of law, to commit murder, arson, robbery, fraud, blackmail, or a host of other possible offenses--even in pursuit of legitimate collective bargaining objectives—without facing the very same legal sanctions that apply to everyone else. Thus the idea that disputes concerning the lawfulness or unlawfulness of corporate campaign activity must be resolved within the purview of NLRB actually is not well-founded. Moreover, corporate campaigns are by definition comprised of nontraditional tactics directed toward objectives that cannot be attained using traditional means such as elections, collective bargaining, and withholding labor en masse. In other words, corporate campaigns are intended by unions to take theu disputes with employers outside the traditional labor law model for one simple reason: from the unions' perspective, the model embodied by labor law is inadequate for the unions' purposes. Accordingly, it is valid and worthwhile to analyze the lawfulness of corporate campaign tactics under non-labor laws and particularly under RICO.

B. Thinking Outside the Box of Federal Labor Law

On August 10, 1995, Bayou Steel filed suit against the United Steelworkers International, the IUD, and Local 9121, in the United States District Court for the District of Delaware, alleging that the corporate campaign violated the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961- 1968. [FN87] Venue was based on a shareholder suit in Delaware Chancery Court filed by the International as part of their corporate campaign. [FN88] *797 The complaint alleged securities fraud and an array of state law tort claims. After briefing and a hearing, Bayou Steel's RICO and state law tort claims survived the Steelworkers' motion to dismiss for failure to state a claim pursuant to Fed. R. Civ. P. 12(b)(6). The analysis set out here, however, is directed less toward the theories of recovery as they were originally pleaded, and more toward the theories of liability that emerged from the parties' experience in discovery. This comports with the liberal amendment model of the Federal Rules of Civil Procedure.

1. Federal Labor Law Does Not Preempt Federal Racketeering Law

When state law overlaps with federal law, state law is generally preempted. [FN89] That is, state law can neither make lawful that which is unlawful under federal law, for example possession of narcotics. Nor can it prohibit that which is made lawful under federal law, for example federal civil rights. Thus, where state law overlaps and conflicts with federal labor law, state law is preempted and federal labor law alone controls. [FN90]

Where two federal statutes overlap, however, the state law preemption rule does not apply. [FN91] Where conduct is made *798 unlawful under several federal statutes, each statute generally can be enforced separately without preemption of the others. [FN92] Thus, for purposes of preemption analysis, when a labor union violates a federal non-labor statute, it does not matter that the same conduct arguably could also constitute an unfair labor practice. Accordingly, if a corporate campaign violates RICO, it is not an obstacle to the recovery of damages that the same conduct also constitutes unfair labor practices falling within the primary jurisdiction of the NLRB.

This analysis is strengthened by the decision in the Palumbo Brothers case. [FN93] Here the Seventh Circuit ruled, and the Supreme Court denied certiorari, in a case in which an indictment alleging RICO violations was brought against an employer premised upon mail and wire fraud acts. The court held that these acts, which also constituted unfair labor practices, were not preempted by the NLRA. According to the Seventh Circuit, 'the indictment specifically charges the defendants with criminal violation of RICO, mail fraud, and ERISA, and the prosecution of those criminal violations interferes with neither the NLRB's jurisdiction nor conflicts with labor policy. ' [FN94] This ruling *799 demonstrates that state law preemption analysis is not applied to conflicting federal statutes.

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In the Mariah Boat case [FN95] which followed Palumbo, the court refused to preempt an employer's civil RICO action based upon mail and wire fraud and obstruction of justice during an organizing campaign. The court held that the Garmon doctrine [FN96] preempts federal statutes when the underlying conduct is actionable only by virtue of the NLRA. As such, the Court concluded, 'Civil RICO charges may survive Garmon preemption if the predicate acts are violative of federal law independent of the NLRA . . . . Although all of the underlying acts are arguably protected or prohibited by the NLRA, none of the predicate acts are premised on labor law alone.' [FN97] This court also recognized that preemption is not applicable between multiple causes of action stemming from independent federal statutes.

Closely related to preemption and the NLRB's primary jurisdiction is the rule of Bill Johnson's Restaurant v. NLRB. [FN98] The consequences of Bill Johnson's Restaurant in the Bayou Steel RICO case present an object lesson for employers regarding what not *to* do in a civil RICO case based on a corporate campaign.

2. Summary of Bill Johnson's Restaurant Case [FN99]

In Bill Johnson's Restaurant, the Supreme Court determined whether, and under what circumstances, the NLRB could enjoin a state court lawsuit fled by an employer against employees, allegedly for exercising federally-protected labor rights. [FN100] The case grew out of the firing of a waitress, Helton, who had attempted to organize the restaurant's employees. The NLRB investigated her allegations of wrongful discharge, and issued an unfair labor practice complaint asserting violations of Section *800 8(a)(3) of the NLRA. [FN101] On the day the complaint was issued, Helton and several others picketed the restaurant calling for a boycott. Their picketing included distributing leaflets accusing the employer of making improper sexual advances and of having filthy restrooms.

The employer sued in state court alleging mass picketing, customer harassment, interference with public access to business, threats to public safety, and libel, and sought a temporary restraining order, preliminary and permanent injunctions, and compensatory and punitive damages. The state court refused to enjoin the leafletting, but otherwise temporarily restrained the picketers. After a hearing, however, the court denied the preliminary and permanent injunctions. Helton, in turn, filed additional charges with the NLRB alleging that the state court lawsuit itself constituted unlawful retaliation against her for filing her original charges, a violation of NLRA Section 8.

The NLRB issued a complaint. The Administrative Law Judge (ALJ) concluded after a trial that the state court civil suit was retaliatory and that it lacked a reasonable basis. The ALJ based his determination on the record and on his own assessment of the witnesses. On appeal, the NLRB adopted the ALJ's findings and initiated enforcement proceedings against the employer, including enjoining the state court lawsuit and compensation orders for Helton's litigation costs and expenses.

The Supreme Court vacated the NLRB's order, holding that its rule that a state law action must be prohibited if its purpose was to retaliate against the exercise of protected tights under the NLRA ran afoul of the First Amendment's guarantee of the right to seek redress. [FN102] The Supreme Court reasoned that state court actions by employers that (1) are motivated by retaliation; and (2) lack a reasonable basis, or are based on intentional falsehoods, or upon knowingly frivolous claims, are not protected under the First Amendment. [FN103] The Court also set out a procedural rule for the NLRB. Specifically, in assessing a retaliatory civil action, where the NLRB determines that 'there is a genuine issue of material fact that turns on the credibility of witnesses or on the proper inferences to be drawn from undisputed facts, it cannot . .. be *801 concluded that the suit should be enjoined.' [FN104] Rather, upon finding that a genuine issue of material fact exists, the NLRB must proceed no further and must stay proceedings on the unfair labor practice charge until the civil action proceedings are concluded. [FN105] The Court reasoned :hat the NLRB should decide this issue with reference only to documentary evidence, but it did not rule out conducting a hearing to determine whether a case involves genuine issues of material fact or law. [FN106] Thus, ordinarily the NLRB should allow state legal issues to be decided by the state courts whenever there is 'any realistic chance' that the employer's legal theory might be adopted. [FN107]

The Supreme Court concluded that where an employer ultimately prevails in its litigation, any related Section 158 charges must be dismissed. Where the employer does not prevail in the suit or withdraws it, however, the NLRB should proceed with the charge to determine whether it had a reasonable basis in light of its resolution. [FN108] If the complainant prevails on the charge, attorney's fees and other defense-related expenses can be awarded. Accordingly, the Court vacated the NLRB's order and remanded the case, holding that the ALJ should only have determined whether there existed a genuine issue of fact for decision in the civil trial, and should not have acted as a finder of fact. [FN109]

Thus, under the reasoning of Bill Johnson's Restaurant, it is appropriate for an employee who has been retaliated against for

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exercising protected labor rights by the filing of a civil lawsuit to file an unfair labor practice charge seeking costs and expenses incurred in connection with defending against the civil suit.

3. Bayou Steel: An Object Lesson in What Not to Do

The NLRB issued a complaint against Bayou Steel asserting that the company's RICO suit was filed in retaliation for the Steelworkers having filed unfair labor practice charges. Specifically, one of Bayou Steel's deposition witnesses, a vice president who testified pursuant to Rule 30(b)(6) of the Federal *802 Rules of Civil Procedure, stated that one of the reasons Bayou Steel filed its RICO action was to stop the steelworkers from filing unfounded and frivolous complaints with regulatory agencies, including the NLRB. Even though this witness absolutely was mistaken regarding the NLRB, [FN110] his testimony, understandably, was sufficient for a complaint to issue, despite the company's efforts to correct the record. Although the NLRB did not enjoin Bayou Steel's lawsuit, and eventually dismissed its complaint, the deposition testimony set in motion a dynamic that exposed Bayou Steel to the possibility of an adverse judgment from the NLRB that could have required it to pay the Steelworkers' costs and attorney's fees incurred in defending against the company's RICO action.

This is an object lesson, however, because Bayou Steel's witness knew the company was not basing any part of its RICO suit on the union's charges to the NLRB. In early parts of his testimony he was, in fact, very clear on this point. He nevertheless inadvertently and incorrectly stated just the opposite in a later part of his testimony. Thus, no matter how well prepared a witness may be for examination, mistakes can happen. Accordingly, as a practitioners' note, (1) a company should never use RICO in retaliation for the filing of unfair labor practice charges; and (2) a company's witnesses always must be advised--clearly and repeatedly—about Bill Johnson's Restaurant and its implications. [FN111]

*803 C. Analysis of the Elements of RICO in the Context of a Corporate Campaign

1. Two Views of Regulatory Harassment

These days, most companies have a fairly good understanding of what to expect from corporate campaigns. [FN112] Indeed, labor unions themselves have made it a point to assure that this is so because if a target company cannot form an expectation about its consequences, raising the specter of a corporate campaign will have little impact. [FN113]

As noted above, the hallmark of many corporate campaigns is regulatory harassment. In its most benign interpretation, regulatory harassment means a union going to agencies and courts for the purpose of 'telling the truth' about a target company. Thus, from a collective bargaining perspective, the union's silence can be purchased, with the price being a collective bargaining agreement acceptable to the union.

In the Bayou Steel RICO litigation, the Steelworkers steadfastly asserted that the corporate campaign was intended only to obtain a collective bargaining agreement. [FN114] As the Steelworkers argued in their briefs, upon reaching a collective bargaining agreement the corporate campaign would cease. [FN115] Thus, from the Steelworkers' perspective, the corporate campaign was merely a form of 'economic pressure' or 'hard bargaining.' [FN116] Bayou Steel *804 held the view that having to purchase the Steelworkers' forbearance from regulatory harassment by acquiescing in the union's collective bargaining demands was not bargaining at all, but rather it was extortion.

The Steelworkers' characterization of corporate campaign tactics as 'economic pressure' or 'hard bargaining' has an initial appeal that suggests lawfulness. After all, a lawful strike is itself a form of economic pressure. Intuitively, however, something also seems very wrong with this notion. Indeed, it goes too far and includes too much. Not all forms of 'economic pressure' are lawful. Bribery, arson, kidnapping, misappropriation, and blackmail, for example, are forms of 'economic pressure,' but nevertheless are crimes.

2. The Paradox of Blackmail: Two Lawful Acts Together Become Unlawful

Some threats are extortionate. [FN117] Indeed, it is easy to see the extortion inherent in threats to do violence or otherwise to destroy another's property. [FN118] Moreover, it is long settled that *805 blackmail is a species of extortion. [FN119]

Unlike extortion based on threats to do unlawful acts, however, in blackmail, acts which are lawful in isolation combine to create a crime. [FN120] For example, generally it is not unlawful to accuse a person of a crime or regulatory infraction. [FN121] Also, it is not generally unlawful for a person to demand a legal right, such as payment on a valid debt,

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compensation for tort damages, or performance on a contract. However, when a person threatens to accuse another of a crime or infraction unless a debt is paid, tort damages are paid, or performance under a contract is rendered, that person commits blackmail. [FN122] In such cases the lawfulness of *806 the debt, the validity of the *tort* claim, and the right to performance under the contract are irrelevant to the blackmailer's guilt. [FN123] Likewise, it is irrelevant to a blackmailer's guilt whether the blackmail victim actually committed the crime or infraction the blackmailer threatened to expose. [FN124] When a blackmailer threatens to disclose damaging information about a victim to the public, the truth of the threatened disclosure is irrelevant to guilt. [FN125] Indeed, blackmail does not even require a preexisting relationship between the blackmailer and the victim. [FN126] Accordingly, it is blackmail for a person to threaten a winning auction bidder with a lawsuit contesting the procedures used in a sheriff's sale unless the successful bidder pays money, regardless of the merits of the threatened suit. [FN127]

Not every 'threat' is blackmail, however, and there are many obvious examples. [FN128] When one 'threatens' litigation on a claim *807 unless money is paid, generally there is no blackmail. [FN129] When one 'threatens' not to perform under a contract unless the terms of consideration are met, there similarly is no blackmail. And, indeed, when a labor union 'threatens' to strike or file charges with the NLRB unless an acceptable collective bargaining agreement is reached, there *is* no blackmail. Thus, it is not obvious how courts distinguish lawful threats from unlawful ones.

The key to distinguishing blackmail from lawful hard bargaining lies in noting blackmail's distinctive triangular structure. [FN130] Characteristically, and invariably, blackmail involves not only a blackmailer and a victim, but third-party interests as well. [FN131] These third-party interests may be those of a person, [FN132] a discernible group, [FN133] the state, [FN134] the general public, [FN135] or combinations of these. In each instance, however, the blackmailer threatens to bring third parties into a dispute with the victim, unless the blackmailer's silence is purchased. [FN136] Thus, the *808 hallmark of blackmail is a disjunction between the blackmailer's genuine interests and the genuine interests of the third parties whose leverage is used for the blackmailer's personal gain. Stated concisely, in blackmail the blackmailer threatens to exploit third-party interests to exert pressure--usual1y economic pressure--on the victim; that is, the blackmailer plays with someone else's 'chip,' and absent such third-party interests there is no blackmail. [FN137]

When the case law is read with this structure in mind, the courts' holdings form a logical and legally meaningful whole. Louisiana law--which applied in the Bayou Steel campaign--is in full accord. [FN138]

It is important to note that blackmail can be established based on an integrated continuum of conduct [FN139] and that there is no *809 specific list of magic words that must be used to establish a blackmailer's threat. [FN140] Threats may be established from innuendo, suggestion, or from the totality of the circumstances under which the alleged threats are made, including the relations between parties. [FN141] Moreover, it is for the jury to decide the intent of an alleged blackmailer. [FN142] Thus, in Bayou Steel's RICO case, the jury would have been responsible for finding threats in the Steelworkers' overt words and actions, such as, for example, the announcement of the corporate campaign or in subsequent references to the Ravenswood campaign.

3. Corporate Campaigns Constitute State Law Blackmail

Threats to accuse another, or to expose any secret, or to do any other harm, in order to obtain value, constitute blackmail when the crime's characteristic triangular structure is present. [FN143] It is, of course, axiomatic that a corporate campaign pulls third-party interests into a labor dispute and. indeed, blackmail's characteristic triangular structure was overt in *the* Steelworkers' August 2, 1993 announcement. The Steelworkers' plans to involve third parties in the dispute with Bayou Steel was its central message. The object of the Bayou Steel corporate campaign was clear—the Steelworkers launched the Bayou Steel campaign to obtain a collective bargaining agreement with terms acceptable to the union. The element of threat was equally express— the corporate campaign would continue until a contract was agreed upon. Thus, the Steelworkers' silence--their forbearance from telling the 'truth' about Bayou Steel--was for *810 sale, and its price was an acceptable collective bargaining agreement. Technically, that is blackmail.

Even so, before going to a jury something more intuitive is needed to understand at a moral level why blackmail is a crime, particularly since it is not always apparent why this is *so*. [FN144] On the one hand, when one uses threats of physical force to compel some form of payment from a victim, it is intuitively easy to see the immorality of the threat. On the other hand, if one threatens to expose an unflattering truth about another, for example, to the authorities, a spouse, or the general public--unless that person repays the money he borrowed--it is less apparent why such a threat should constitute a crime. Similarly, in the preceding overview of the Bayou Steel campaign, and keeping the assumption that everything the

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Steelworkers said or planned to say about Bayou Steel was true, then arguably all the Steelworkers did was undertake to tell people—regulators, investors, and the public--a number of unflattering truths about Bayou Steel. Posed in this way, one is tempted to think that such truthful disclosures, and particularly a campaign of such disclosures, generally should be considered a good and lawful thing.

But this is a canard because the analogy thus far is not properly focused. Following the triangular structure that distinguishes blackmail from other forms of hard bargaining, one must look first to the relationship between the blackmail victim and the third party whose interests the blackmailer seeks to invoke. For example, suppose it is true that a particular company is not in compliance with the environmental laws, but that the regulators have not detected the noncompliance because the company has concealed the truth. The company, then, has engaged in a deceit or fraud against the regulators. When a blackmailer goes to the company and states that unless he is treated fairly he will tell the regulators the truth, he actually is offering to join the company in its deceit, In other words, blackmail works by expanding the scope of fraud and deceit, and only results in more truth being disclosed when it fails. Thus, the moral difference between blackmail and lawful hard bargaining, and what properly makes blackmail a crime, is that blackmail breeds fraud and deceit.

Accordingly, if it is true that the Steelworkers began and *811 intended to continue the Bayou Steel campaign to reach an acceptable collective bargaining agreement, then it follows, both technically and morally, that the corporate campaign was blackmail. Thus, blackmail--which is punishable by imprisonment for more than one year in all fifty states—generally passes muster as a predicate act of racketeering.

4. Federal Labor Law Does Not Preempt State Law Against Blackmail

State laws--potentially including state laws against blackmail--are preempted by federal labor law if the conduct complained of arguably falls within either the protections or proscriptions of the NLRA. [FN145] As shown below, however, federal labor law does not preempt blackmail by labor unions.

NLRA Section 157 confers certain rights on employees, but not expressly upon unions. [FN146] The protections extended to labor unions are derivative of employee rights and are limited to include only so much conduct as is necessary to assure that employees are able to exercise their labor rights. [FN147] Thus, in a case where a union representative seeks to assist employees in exercising their protected labor rights, such as the right to form a local union, the union enjoys a derivative right of reasonable access. [FN148] However, there is neither authority nor basis for a union to have any derivative rights either to assist employees in doing things that are unlawful, or for the union to itself engage in *812 unlawful conduct for the benefit of employees where the same conduct would be unlawful if done by employees. Thus, NLRA Section 157 will not protect a union seeking access to an employer's property for purposes of assisting employees in violence. Nor will NLRA Section 157 protect union violence or other unlawful union conduct done to benefit employees. Accordingly, if corporate campaign tactics constitute blackmail— irrespective of the actor (employee or union)--then the derivative protections of NLRA Section 157 are not implicated. Hence, although labor unions conceive, plan, organize, and execute corporate campaigns for the ostensible benefit of employees, the protections of NLRA Section 157 are not implicated in a RICO action founded on unprotected predicate acts. To construe NLRA Section 157 any other way would confer absurd rights upon labor unions--for example, rights to commit arson. bribery, fraud, and blackmail--which simply are not protected employee rights.

NLRA Section 158(b) enumerates the classes of conduct that are proscribed as unfair labor practices by a union. [FN149] NLRA Section 158(b), however, does not grant unions any special rights of speech. Rather, NLRA Section 158(b) expressly removes expressions of a union's views and opinions from federal proscription as an unfair labor practice. [FN150] Thus, federal labor law neither arguably protects labor unions' speech, nor arguably proscribes their speech. Indeed, the fact that an employer cannot assert *an* unfair iabor practice charge for injurious speech by a union assures that federal labor law does not preempt state blackmail law. [FN151]

*813 5. The Enmons Defense Does Not Limit State Law

In United States v. Enmons, [FN152] the Supreme Court held that union violence used to secure legitimate labor objectives does not violate the federal extortion statute, the Hobbs Act. [FN153] Specifically, the Supreme Court reasoned that the Hobbs Act, which makes it a federal crime to obstruct interstate commerce by robbery or extortion, does not reach the use of violence to achieve legitimate union objectives because in that situation, there is no 'wrongful' taking of the employer's property. [FN154] Thus, under Enmons, the Hobbs Act is not violated unless the alleged extortionist uses force or fear for a wrongful purpose.

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It is tempting, at least initially, to read and apply Enmons as a general jurisprudence of extortion law. So applied, the Enmons case would provide unions with a solid defense to civil RICO actions based on state law blackmail so long as their goals remained legitimate labor objectives (such as wages, hours, and working conditions). This, however, actually would turn Enmons upside down.

In Enmons, the Supreme Court determined that union violence used to achieve a legitimate union objective--conduct which the Court acknowledged violated state law--should not be swept up into federal criminal law simply because of its effect on interstate commerce. [FN155] Thus, the Hobbs Act does not make a federal crime out of every punch thrown on a picket line. Rather, Enmons limited the reach of the Hobbs Act in light of state criminal law. [FN156] Moreover, in Enmons the Supreme Court clearly did not use the Hobbs Act to decriminalize conduct made unlawful under state law; rather, it expressly affirmed the district court's ruling that *814 the strike violence at issue was 'undoubtedly punishable under [s]tate law.' [FN157] Indeed, the Enmons Court concluded that in enacting the Hobbs Act, Congress did not change 'the federal-state balance' by defining 'as a federal crime conduct readily denounced as criminal by the [s]tates.' [FN158] Rather, as the Court explained, the Hobbs Act was passed to remedy Congress's disapproval with one portion of the Supreme Court's prior opinion in United States v. Local 807, [FN159] which would have allowed labor unions to demand money, and use violence to get it, even though no work was to be performed. [FN160] The Hobbs Act, according to the Court, narrowly overruled that portion of Local 807 and otherwise left the law unchanged. [FN161] As the Court stated in Local 807 and reaffirmed in Enmons:

The power of the state and local authorities to punish acts of violence is beyond question. It is not diminished or affected by the circumstance that the violence may be an outgrowth of a labor dispute. The use of violence disclosed by this record is plainly subject to the ordinary criminal law. [FN162]

Thus, using Enmons to legalize conduct made crimtnal under state law would turn Enmons upside down.

Using Enmons to limit state criminal law also would directly conflict with the Supreme Court's jurisprudence applying the Travel Act. [FN163] The Travel Act makes it a federal crime to cross state lines or to use interstate facilities to commit certain enumerated state and federal law crimes, one of which is state law extortion. [FN164] Thus, part of the Travel Act's basic foundation is state law crimes involving interstate travel. The Travel Act does not, however, list state law blackmail per se as one of its enumerated crimes. As a consequence, it was at one time arguable that the Travel Act's envelope included blackmail in those states with integrated extortion statutes--meaning statutes *815 integrating common law extortion and blackmail into a single extortion statute, such as Louisiana--while not including blackmail in states, such as Pennsylvania, that punished common law extortion and blackmail under separate statutes. However, in United States v. Nardello the Supreme Court held that the Travel Act reaches state law blackmail regardless of whether a particular state criminalizes blackmail through its extortion statute, or through a separate blackmail statute, or even in some different statute all together. [FN165]

Like the Travel Act, RICO is based on enumerated state and federal law crimes, including state law extortion. [FN166] Thus, following Nardello, blackmail as it exists in state law logically must come within the RICO envelope of predicate acts. Indeed, the propriety of applying state law blackmail without a special federal gloss is aptly supported by the fact that violations of the Travel Act are also predicate acts under RICO. [FN167] Thus, applying the Enmons defense to state law blackmail would lead to the inconsistent result that in RICO cases, predicate acts of state law blackmail would be judged under federal law, whereas acts of state law blackmail that violate the Travel Act, and in turn constitute RICO predicate acts, would be judged according to state law.

To extend Enmons to limit state criminal law uould also directly overrule a substantial body of state court jurisprudence. For example, in State v. Moore [FN168] the Louisiana Supreme Court was squarely confronted with the paradox of blackmail; two separately lawful acts combined through a threat to become a crime. Moore, a police officer, approached a parked vehicle on a secluded road. In the vehicle were two young adults having sex. Moore informed them that they were committing public obscenity, and that he would have to arrest them. In isolation this was a perfectly lawful act. Moore, however, also asked the woman to consent to having sex with him. In isolation this, too, was a lawful act, and not a 'wrongful purpose.' But Moore did not do these two lawful things in isolation. Rather, he combined *816 them; he would not arrest the couple if the woman would consent to sex with him. Stated conversely, Moore threatened to arrest the couple--that is, to tell the truth about them--unless the woman consented to sex, Thus, Moore had a lawful objective, consensual sex, and only threatened to do a lawful act, arrest the couple. [FN169] The woman consented. After having intercourse, Moore told the couple they were free to go. Moore kept his promise to destroy his police report and tell no one about the couple's violations of the public obscenity law. [FN170]

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Under the 'wrongful purpose' prong of Enmons, Moore's conduct would not have been unlawful because his threat was only to do something lawful. But that is not how state extortion law works. Thus, the Louisiana Supreme Court affirmed Moore's conviction and his sentence of eleven years in prison at hard labor. [FN171]

Properly understood, Enmons thus limits the reach of the Hobbs Act. It is not a case of general extortion jurisprudence. The folly of extending Enmons 'wrongful purpose' prong to state law blackmail can clearly be seen in Arthur L. Goodhart's Essays in Jurisprudence and the Common Law, which relates Sir Herbert Stephen's response, in a letter to The Times of London on April 26, 1928, to Lord Scrutton's argument in Hardie & Lane, Ltd. v. Chilton that one may demand property without committing any offense where 'you have a legal right to do the thing which you threaten to do.' [FN172]

If this is really the test, some remarkable consequences follow. Suppose a man writes, 'Unless you give me £100 I will show So-and-so your letter to Such- a-one', or 'If you don't want me to prosecute you for the affair you know of, you must send me €100 by tomorrow's post. ' In each case the alternative to payment is something which the writer of the letter has 'a legal right to do.' In the latter case it might even be his legal duty to do it. I have known, I suppose, some dozens of cases where men have been sent to penal *817 servitude, sometimes for long terms, for sending letters exactly to the above effect. If Scrutton, L.J.'s view of the law is correct, they would all seem to have been wrongly convicted. [FN173]

In short, it is blackmail to threaten to expose the truth about a person unless that person conveys economic value.

6. The 'Participation' and 'Enterprise' Elements of RICO

Although no court has yet decided the precise issue (as set out below) in the context of corporate campaigns, there likely is to be sufficient distinctiveness between the defendant labor unions that fund, manage, and control a corporate campaign and the actual 'team' that implements the campaign--which will typically be comprised of individuals and specialists from several distinct disciplines--to satisfy RICO's distinctiveness test.

a. The Corporate Campaign 'Team' as a RICO Enterprise

On August 3, 1993, George Becker announced the Bayou Steel corporate campaign. [FN174] At the press conference, Becker stated that the same 'team' previously used in the Ravenswood campaign would be brought together from Washington, D.C. and Pittsburgh to be used against Bayou Steel. [FN175] Thus, the corporate campaign 'team' was at that time a discernible and identifiable entity, and it suited the Steelworkers' needs in connection with launching the corporate campaign for it to be so. The team, it was learned over the course of the Bayou Steel campaign, was comprised of individual actors from several sources, including the International; the IUD; Local 9121; Disposal Safety, Inc.; and Fingerhut, Powers, Smith & Associates.

These entities were not organized in a fashion analogous to a corporate parent-subsidiary relationship, particularly in the sense of ownership. Local 9121 is an autonomous labor union; the IUD was an autonomous department of AFL-CIO; and Disposal Safety, Inc. and Fingerhut Powers are independent corporations. These entities did not combine or merge into a single entity to conduct the Bayou Steel campaign, and their identities did not *818 become subsumed into or synonymous with the Bayou Steel campaign. Rather, each remained autonomous and carried on its regular non-corporate campaign activities, and each contributed a part of its resources to the corporate campaign, delineated by specialization and expertise, according to the campaign's component parts. Further, each member participated in the corporate campaign voluntarily and could have withdrawn from the 'team' at any time. Thus, the Bayou Steel campaign 'team' was a discernible association-in-fact, was not identical to or owned by the RICO persons, and, therefore, a jury would have been sustained in finding that it constituted a RICO enterprise. [FN176] Moreover, the fact that the International, the IUD, Disposal Safety, Inc., and Fingerhut Powers previously combined their resources in the same ways to conduct the Ravenswood campaign establishes the Bayou Steel campaign 'team' as a RICO enterprise as a matter of law. [FN177]

Conspicuously missing from the corporate campaign's list of component parts was one called collective bargaining. Indeed, this is because the corporate campaign team was not involved in collective bargaining. The team had its own people, methods, objectives, and decision structure, which did not include the International's collective bargaining negotiators.

At the summary judgment stage of the litigation, the Steelworkers argued that, as a matter of law, the corporate campaign 'team' did not really exist but, rather, that the corporate campaign was merely the International acting through its employees and agents. [FN178] From this the Steelworkers invoked a line of Third Circuit cases--B.F. Hirsch v. Enright Refining Co.

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[FN179] and its progeny--to argue that the corporate campaign's tactics were merely the normal affairs of the International, conducted through its employees and agents, and that, therefore, the only RICO enterprise was really just the International and thus RICO's *819 distinctiveness requirement could not be met. [FN180] Although this argument has some initial RICO appeal, it is not correct.

In Enright the Third Circuit held that a RICO 'person' cannot be the same entity as the RICO 'enterprise.' [FN181] In Brittingham v. Mobil Corp. the court expanded on Enright's distinctiveness rule, and held that a parent corporation, alleged to be a RICO person, ordinarily will not be sufficiently distinct from its wholly owned subsidiary for the subsidiary to constitute a RICO enterprise. [FN182] Subsequently, in Lorenz v. CSX Corp., the Court held that alleging that a parent 'directed its subsidiary's fraudulent acts does not satisfy the distinctiveness requirement' of Brittingham. [FN183] One year later, in Gasoline Sales, Inc. v. Aero Oil Co., the Court held that for RICO purposes a parent corporation, as a RICO person, was insufficiently distinct from its two subsidiaries for the subsidiaries to constitute a distinct RICO enterprise, even if officers from both the parent and subsidiaries, as additional RICO persons, helped direct the subsidiaries' fraudulent acts [FN184]. Finally, in Jaguar Cars, Inc. v. Royal Oaks Motor Car Co., the Third Circuit overruled a significant amount of its prior case law and brought its jurisprudence substantially into line with other circuits. [FN185] Specifically, the Court in Jaguar adopted the Seventh Circuit's analysis in McCullough v. Suter, and held that 'when officers and/or employees operate and manage a legitimate corporation, and use it to conduct, through interstate commerce, a pattern of racketeering activity, those defendant persons are properly liable under [RICO].' [FN186] Thus, the Third Circuit's jurisprudence can fairly be summarized as follows: a RICO enterprise exists where any group is associated in fact, with the exception where a parent corporation (possibly with employees and agents who conduct the parent's normal affairs) is alleged to be a RICO person and the corporation's subsidiaries are alleged to constitute a RICO enterprise, where the distinctiveness rule of *820 Enright does not apply.

At the heart of the Enright line's distinctiveness rule is a realistic understanding of modern industrial organization; that is, parent corporations control and direct their subsidiaries in the conduct of their normal affairs. [FN187] Those qualities were not present in the Bayou Steel corporate campaign. Obviously, the International is not a corporation, and it does not 'own' Local 9121, the IUD, Disposal Safety, Inc., or Fingerhut Powers, as these all are separate and autonomous organizations. Thus, Enright is not analogous to parent-subsidiary corporate structure and, therefore, does not apply.

Further, the corporate campaign simply was not, on the facts, part of the International's normal affairs within the meaning of the Third Circuit's jurisprudence. Specifically, in the conduct of its 'normal affairs' the International is the agent of Local 9121, and not the other way around. In their summary judgment brief, however, the Steelworkers cast Local 9121 as the agent of the International. [FN188] If in connection with the corporate campaign Local 9121 was the International's agent, then it follows that the corporate campaign was not part of the International's 'normal affairs' and that, therefore, Brittingham, Lorenz, and Gasoline Sales do not apply. Moreover, for the Steelworkers to argue that the International was responsible for the conduct of the affairs of the corporate campaign team actually reduces the argument to admitting that the International is a properly named RICO person.

b. Participation in the Conduct of the Affairs of the Corporate Campaign Team Under Reves

In Reves v. Ernst & Young, the Supreme Court held that an accounting firm that was hired to audit a cooperative's records, and which reviewed a series of transactions and certified, allegedly improvidently, that the records fairly portrayed the *821 transactions, did not participate in the conduct of the affairs of the cooperative within the meaning of RICO. [FN189] Rather, to come within the reach of RICO, a person must participate in the operation or management of the enterprise itself. [FN190] RICO liability is not, however, limited to those with primary or formal responsibility for an enterprise's affairs. [FN191] Liability is not limited to upper management, but may extend to lower-rung participants under the direction of upper management. [FN192]

Based on Reves, the Steelworkers argued at summary judgement that only the International had management authority over the corporate campaign and that, therefore, the IUD and Local 9121, along with DSI, Fingerhut Powers, and any other agents of the International, were not viable RICO persons. [FN193]

There is no dispute that Richard Davis, Vice President of the International, had ultimate control of the Bayou Steel campaign. [FN194] As Reves makes clear, however, RICO reaches other significant persons than just an enterprise's top decisionmaker if they participate in its operation or management. In the Bayou Steel campaign, the IUD and Local 9121 actively

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participated in the operation of the corporate campaign. The IUD ran the corporate part, while Local 9121 supplied basic manpower for picketing the homes of directors and officers and complaining to agencies. Thus, unlike the auditors in Reves who merely improvidently gave the cooperative's transactions a clean bill of health, the IUD and Local 9121, along with the International, actively participated in the execution and operation of the corporate campaign. That is sufficient for Reves. Moreover, other corporate campaign actors, such as DSI and Fingerhut Powers, arguably were liable for conspiracy pursuant to RICO § 1962 (d).

*822 D. The First Amendment Does Not Protect Blackmail

1. Noerr-Pennington Issues

In their *summary* judgment brief, the Steelworkers argued that the Noerr-Pennington doctrine shields any allegations or complaints that were made to state and federal agencies and the courts. [FN195] That argument is not correct. As set out above, it *is* blackmail to threaten to accuse a person of a crime or regulatory infraction unless a tribute is paid. [FN196] The fact that the Steelworkers used government agencies as the venue for blackmail does not make it protected conduct. [FN197]

The Noerr-Pennington doctrine broadly protects persons seeking redress from government. [FN198] However, protection under this doctrine requires a genuine interest in the redress sought. [FN199] One may not exploit governmental processes merely 'as a means *823 of imposing cost and delay. ' [FN200] As the Supreme Court stated, '[t]he 'sham' exception to Noerr-Pennington encompasses situations in which persons use the governmental process--as opposed to the outcome of that process--as an anticompetitive weapon.' [FN201] Thus, 'private action that is not genuinely aimed at procuring favorable government action' is considered a sham. [FN202]

An exception to Noerr-Pennington immunity is most likely to be found where multiple proceedings are involved. [FN203] Accordingly, sham *is* found in 'repetitive lawsuits carrying the hallmark of insubstantial claims.' [FN204] Repetition, however, is but one indicium of the exception, and other forms of reprehensible practice--particularly those which corrupt administrative or judicial processes--also will prove the exception. [FN205] Moreover, where an orchestrated plan to use governmental processes to cause expense and delay is shown, the fact that some of the claims made as part of the plan resulted in relief will not absolve the plan under Noerr-Pennington. [FN206] Further, an unlawful plan is not *824 magically transformed into protected speech under Noerr-Pennington by invoking governmental processes to execute it. [FN207]

The exception also can apply where a single lawsuit is involved. [FN208] To establish the sham exception to Noerr-Pennington immunity in the special case of a single objectionable lawsuit, the plaintiff ordinarily must first prove the existence of objectively baseless claims, and then prove that subjectively the governmental process was used to impose costs and delay. [FN209] This is not a test of universal application, however, because it is limited to cases involving a single objectionable lawsuit that is not otherwise tainted. [FN210] A whole series of legal proceedings has far more serious implications than a single lawsuit. [FN211] Moreover, *825 abuse of governmental processes simply is not the conduct Noerr-Pennington seeks to protect. [FN212] Thus, 'the inquiry in such cases is prospective: were the legal filings made, not out of a genuine interest in redressing grievances, but as part of a pattern or practice of successive filings undertaken essentially for purposes of harassment?' [FN213] At bottom, the Noerr-Pennington cases share a common, unifying theme: 'the right of the people to inform their representatives in government of their desires with respect to the passage or enforcement of laws.' [FN214] Where this quality is absent, as is true for 'Regulatory Harassment,' Noerr-Pennington's protections do not apply. [FN215]

The regulatory harassment of Bayou Steel was part of an intentional plan, not to raise and resolve bona fide issues, but rather to obtain a collective bargaining agreement. Therefore, *826 even as an initial matter, the First Amendment is not implicated under Noerr-Pennington, or any other rule of immunity. [FN216] Moreover, it is of no consequence that the corporate campaign was executed by invoking a series of governmental processes. [FN217] The Steelworkers invoked these processes 'not out of a genuine interest in redressing gnevances. but as part of a pattern [and] practice of successive filings undertaken essentially for purposes of harassment [[[.]' [FN218] Therefore, Noerr-Pennington does not protect the Bayou Steel campaign.

2. General First Amendment Law Does Not Protect Blackmail

In their summary judgment brief, the Steelworkers also invoked several general First Amendment cases, [FN219] including NAACP v. Claiborne Hardware Co., [FN220] which merit analysis. Claiborne arose after black citizens boycotted white merchants from 1966 to 1972 in Claiborne County, Mississippi seeking an end to racial segregation, institutionalized

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humiliation, and centuries of abuse. [FN221] White merchants of Claibome County sued under state law to recover their economic losses from the boycott. [FN222] The Supreme Court found that '[t]he right of the [s]tates to regulate economic activity could not justify a complete *827 prohibition against a nonviolent, politically motivated boycott designed to force governmental and economic change and to effectuate rights guaranteed by the Constitution itself. ' [FN223] Although the Claiborne defendants intended to inflict economic injury on white merchants, their campaign was not motivated by a desire to get an economic contract, but by the aim of vindicating the fundamental rights of equality and freedom. [FN224] But obtaining a contract simply does not rise to the ideals sought by the Claiborne defendants--rights guaranteed by the Constitution itself. Moreover, the Claiborne defendants genuinely wanted what they demanded from government officials in Claiborne County, Mississippi. [FN225] In the Bayou Steel campaign, the Steelworkers did not genuinely desire the ends they nominally sought from the agencies and courts--SEC disclosures, changes in corporate governance, denials of tax breaks, and so forth—but merely sought a contract for wages, hours, and working conditions. Thus, Claibome is inapposite and not analogous.

In contrast, however, purely economic interests have been analyzed under the First Amendment. In Federal Trade Commission v. Superior Court Trial Lawyers Ass'n, the Supreme Court unanimously reversed the Court of Appeals and held that a well-publicized boycott by District of Columbia lawyers who regularly represented indigents was not protected by the Constitution. [FN226] The lawyers had together agreed not to represent indigent criminal defendants in the District of Columbia Superior Court until the District of Columbia Government increased the lawyers' Compensation. [FN227] The Court ruled first that the lawyers' unlawful boycott was not protected by Noerr, even though their objective was the enactment of socially beneficial legislation. [FN228] *828 The Court then determined that the lawyers were not protected by Claiborne. The Court observed that

[t]hose who joined the Claiborne Hardware boycott sought no special advantage for themselves. They were black citizens in Port Gibson, Mississippi, who had been the victims of political, social, and economic discrimination for many years. They only sougbt the equal respect and equal treatment to which they were constitutionally entitled. [FN229] With respect to the lawyers, the Court found that '[n]o matter how altruistic the motives of respondents may have been, it is undisputed that their immediate objective was to increase the price that they would be paid for their services.' [FN230]

By analogy, the Steelworkers engaged in the corporate campaign solely for their own economic purposes and, therefore, under Superior Court Trial Lawyers Ass'n the corporate campaign was not protected by the First Amendment.

The Steelworkers also cited the Supreme Court's opinion in De Bartolo Corp. v. Florida Gulf Coast Building & Construction. [FN231] De Bartolo held only that the peaceful leafletting of consumers by a union—urging them not to patronize a firm until a non-union contractor to the firm promised to pay fair wages—was not an unfair labor practice. [FN232] The Court in no way condoned coercion, blackmail, threats, abuse of process, or any other conduct that is unlawful under state law. Nor did the Court even hint at a decision on the lawfulness of regulatory harassment.

E. Ratification of Violence, Threats of Violence, and Intimidation of Bayou Steel, its Officers, and Directors

Even though very few of Local 9121's members had ever been on a strike before, they were given virtually no pre-strike training in the lawful conduct of a strike. Moreover, although most of the *829 especially serious incidents occurred in the first months of the strike, Bayou Steel endured for three and one-half years varying amounts of violence, threats, and the use of fear directed against its officers, employees, and its directors. Bayou Steel and the Steelworkers always will disagree about the seriousness of the striker's violence, intimidation, and property damage, but it is beyond any tenable dispute that this conduct was substantially unlawful, and that it had continuity and relationship to the strike and, in turn, the corporate campaign. From Bayou Steel's perspective, striker violence and the corporate campaign were cumulative, thus establishing a continuum of union conduct.

One highly intimidating tactic employed in both the Ravenswood and Bayou Steel corporate campaigns was the dramatic personalization of hostility directed toward executives and directors. For example, Bayou Steel's President, Jerry Pitts, was virtually a daily focus of picket line threats and hostility from the beginning of the strike. After the corporate campaign was launched, however, conduct directed at Pitts increased to include the erection of an unflattering billboard bearing his photograph near his home; protest parades through his suburban neighborhood that included strikers, their spouses, and their children; and recurring picketing in front of his home, including video- taping the family as they would come and go, and through windows. The company's chief financial officer suffered similar hostilities in his neighborhood. Strikers also traveled to Dallas, Texas to parade and picket in front of the home of Howard Meyers, Bayou Steel's chairman of the board. There

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were other examples of personalized harassment of directors and executives, but these few serve to illustrate the point that, from the perspective of Bayou Steel, these tactics were cumulative of picket line hostilities. Moreover, the off-picket line activities directed at Bayou Steel's executives and directors were part of the corporate campaign, as announced on August 2, 1993. As discussed below, whether based on the evidence or inferences that may be drawn from the evidence, and which the International, the IUD, and Local 9121 embraced and augmented, and thereby ratified, striker violence and intimidation present a question of fact to be decided by a jury.

*830 1. The Legal Standard for Ratification

Pursuant to the Noms-La Guardia Act of 1932, [FN233] a union's ratification of striker violence, threats, and fear may be established by clear proof of their knowing tolerance of such conduct; that is, whether they intentionally drew upon the violence and threats for their force. [FN234] Although the clear proof standard requires more than the ordinary civil burden of persuasion, the standard does not require surmounting the criminal standard of beyond a reasonable doubt. [FN235] Accordingly, where a union is informed by a company of its members' unlawful conduct, and the union does not act affirmatively to investigate and curb further excesses, 'a reasonable jury could conclude that the Union 'knowingly tolerated' the situation, and thereby ratified it.' [FN236] No more is required to support a finding of ratification. [FN237] Further, where, as in Bayou Steel's case, a union is subject to a court-ordered injunction, [FN238] the lack of effective action by the union to curtail and repudiate misconduct by individual members can amount to 'silent approbation and acquiescence in such activities and the objective of its offending members.' [FN239] In such circumstances, oral admonitions to union members by a union officer, without also taking effective affirmative action to enforce those admonitions, are insufficient to absolve the union *831 ofresponsibility for violations of the court's orders. [FN240] Finally, it is settled law that ratification is a question for the jury to decide upon proper instructions from the court. [FN241]

2. Application of the Standard: The Evidence Was Sufficient for a Jury to Find that the International, the IUD, and Local 9121 Ratified the Use of Violence, Threats, and Fear

Discovery in the Bayou Steel litigation adduced significant evidence that the International, the IUD, and Local 9121 ratified striker violence and intimidation as follows:

*832 • Local 9121's members were given virtually no pre-strike training, even though Local 9121 had never been on strike before, few of its members had any previous strike experience, and many members were in an obvious state of rage. Rather, Local 9121's President, Ron Ferraro, gave the members repeated assurances that everyone would get their jobs back after the strike.

• From the first hours of the strike, and continuing on a regular basis for three and one-half years, Bayou Steel informed Local 9121 and the International of unlawful conduct by strikers both on and off the picket line. Thus, there was no question that the union knew of the strikers' misconduct. Even so, the International left the conduct of the picket line to Local 9121.

• The International and Local 9121 were parties to a stipulated, state court injunction issued to protect Bayou Steel and the public safety. Even so, the injunction was repeatedly violated. Numerous strikers, and Local 9121 itself, were held in contempt of court during the strike. [FN242]

• Local 9121's President threatened Bayou Steel's managers on numerous occasions throughout the strike.

• Leaders from the International and Local 9121 were present before and during some of the most extreme incidents of picket line violence.

• The homes of managers were picketed for weeks, and in some cases for months, often when the targeted manager was away, while only his family members were home.

• The corporate campaign increased the level of public vilification directed at executives and directors. By doing so, the Steelworkers drew upon the strikers' intimidation and violence for its persuasive force.

• International Vice President Davis was aware of misconduct by Local 9121's president, but took no action to repudiate or curtail him. Rather, the International generally praised the job he was doing handling Local 9121 and, indeed, rather than

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repudiate his handling of Local 9121, Becker, as president of the International, suspended Local 9121's constitutionally required election of officers.

• Carl LaBorde, a picket captain, was found by an arbitrator to have engaged in 'overly abusive and abrasive conduct.' *833 LaBorde

violated the [injunctive] order's prohibition against 'threatening and intimidating' Company employees and agents/customers by his name calling, cursing and threats . . . . [LaBorde's] threats and intimidation went well beyond any reasonable notions of protected Union conduct, either on the picket line or in any setting, as those limits have been established by the NLRB, the courts and arbitrators. [FN243]

The local union and the International Union were well aware of LaBorde's conduct, yet they allowed him to serve as a picket captain in charge of observing and instructing others.

Whether these facts establish clear proof of knowing tolerance must be considered in light of the fact that the International and Local 9121 were subject to a state court injunction. Accordingly, *Bayou* Steel's burden of proof under the Norris-La Guardia Act was substantially lowered, [FN244] and it would have been appropriate for a jury to find that the lack of effective action by the International, the IUD, and Local 9121 to curtail and repudiate striker misconduct by individual members amounted to 'silent approbation and acquiescence in such activities and the objective of its offending members. ' [FN245] Moreover, mere oral admonitions to Local 9121's members by union officers—admonitions that were not backed up with affirmative enforcement actions--are, as a matter of law, insufficient to absolve the union of responsibility for violations of the court's orders. [FN246] Whether these facts together establish by clear proof the International and Local 9121's knowing tolerance of violence is a question of fact for the jury to decide. Further, whether the evidence of the IUD's role in personalizing the vilification of Bayou Steel executives and directors shows that the IUD drew upon the force of local violence and threats similarly presents a question of fact for the jury.

*834 3. Analysis of Potentially Contrary Legal Authority

Not every threat or act of violence by an individual union member can be imputed to a union via ratification. Moreover, because the legal standard is 'clear proof,' vigilant evidence collection and record keeping regarding misconduct is essential to carrying the burden of 'clear proof.' Further, it is easy to find cases wherein clear proof of ratification was not established. Those cases, however, are not analogous to the Bayou Steel case. [FN247]

For example, ratification does not require express authorization of violence or other misconduct. Therefore, the Supreme Court's holding in United Brotherhood of Carpenters v. United States—that it was error to impute to a union the criminal acts of individuals without giving the jury an instruction embodying Section 6 of the Norris-La Guardia Act--is inapposite. [FN248] Rather, as set out above and as explained in United Brotherhood of Carpenters, where a union ratifies the unlawful conduct of its members, no showing of 'authorization' is required. [FN249]

In United Mine Workers of America v. Gibbs. [FN250] the Supreme Court observed that the international union representative, immediately upon learning of two days of violence, went to the scene of the problem and took direct, affirmative, and successful steps to curtail further violence. Specifically. the international union dispatched its representative with 'firm instructions to return to the scene. to assume control of the strike, to suppress violence, to limit the size of the picket line, and to assure that no other mines were affected.' [FN251] This evidence, when weighed by the Court against the countervailing evidence which the Sixth Circuit had conceded was only 'sketchy,' was not sufficient to support a finding of clear proof as required by the Noms-La Guardia Act. [FN252] In the Bayou Steel case, the use of coercion was chronic, and there was no countervailing evidence that the *835 International, even after being informed repeatedly of the use of violence, threats, and fear, *took* any of the exculpating steps found to be significant by the Supreme Court in Gibbs. Indeed, the International conceded that it did nothing to curtail violence, [FN253] but rather praised Local 9121's president and suspended the local's elections. [FN254] Moreover, the factual basis for the Supreme Court's reasoning in Gibbs did not occur against the backdrop of a state court injunction--a fact that, as set out above, leads to a less restrictive analysis. The Supreme Court in Gibbs did state. however. that the proof requirements of the Norris-La Guardia Act can be satisfied by showing that the union drew upon member violence for its persuasive force. [FN255] As set out above, in the Bayou Steel case there was substantial evidence that the corporate campaign added to and augmented the intimidation and coercion of executives and directors and, therefore, drew upon their persuasive power. Furthermore, as the Supreme Court reasoned in Gibbs, where a local union has ratified the misconduct of its members, a less demanding standard of proof applies to the

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imputed liability of the international union. [FN256] In the Bayou Steel strike, the local union president and, indeed, the local union itself were held in contempt of court for improper conduct including threats.

In Federal Prescription Service, Inc. v. Amalgamated Meat Cutters, [FN257] the Eighth Circuit evaluated the scope of an international union's involvement in a strike marked with numerous threats and instances of property damage. [FN258] Although the court found that the local union was liable under the clear proof standard, the court found that the international's involvement in the strike was limited to the normal functions that occur during the progress of normal strikes, and not more. [FN259] Thus, Federal Prescription is clearly distinguishable from Bayou Steel's case because it did not involve a corporate campaign that was personally supervised by an international vice president. *836 Similarly, in Falls Stamping Co. v. International Union, UAW, [FN260] and United Steelworkers of America v. Lorain, [FN261] the Sixth Circuit found that the international unions' performance of ordinary functions did not constitute clear proof of ratification of violence. These cases, however, also did not involve international union-led corporate campaigns and thus are not analogous to Bayou Steel's experience with the Steelworkers.

Taken together then, Bayou Steel was entitled to take its liability case to trial.

F. RICO Damages: Intuitive Hurdles, Statutory Mandates, and Optimal Damages Theory

RICO provides for the recovery of treble damages for harm to business and property. [FN262] Unfortunately, there is no case law, RICO or otherwise, setting out the rules for calculating blackmail-based civil damages. [FN263] Further, RICO is peculiar in that it permits the recovery of damages based on violations of state criminal laws against blackmail, which generally are sanctioned with fines and incarceration instead of civil damages. Accordingly, divining a theory of blackmail-based RICO damages requires reference to the general damages literature. Moreover, the process requires scaling certain conceptual obstacles.

For example, as part of the regulatory harassment of Bayou Steel, the Steelworkers complained to OSHA that Bayou Steel was in violation of various health and safety regulations. [FN264] As a consequence, a wall-to-wall inspection of Bayou Steel was conducted, which caused Bayou Steel to incur costs, including legal fees, to defend itself. [FN265] Although the vast majority of the Steelworkers' complaints did not result in any adverse findings by OSHA, some deficiencies were found, and Bayou Steel was *837 assessed a penalty. Absent the Steelworkers' corporate campaign, however, these costs would not have been incurred. From this example, three possible damages scenarios emerge.

First, in light of the partial merits of the Steelworkers' complaints to OSHA, one could argue that the union should pay no damages at ail because its complaint was not groundless. [FN266] This theory is troubling, however, because it effectively would render meaningless blackmail's proscription against threats to tell the truth. Second, at the opposite end of the spectrum of possibilities, one could argue that the Steelworkers should pay damages based on the entirety of the costs Bayou Steel incurred, including reimbursement of fines and related legal costs. This theory imposes liability for truth-based blackmail, and compensates the blackmail victim for the blackmailer's intentional harm. This theory, however, is troubling precisely because it results in the Steelworkers reimbursing Bayou Steel's fines and related legal costs. That is, intuitively there seems to be something wrong with a damages rule requiring a person who brings infractions to the attention of regulators to reimburse the violator's fines and legal costs. Third, one could argue for a middle ground; that Bayou Steel's damages should be apportioned to reflect the costs incurred in defense of false allegations, as distinguished from true allegations. [FN267] Although this rule would exclude reimbursement of Bayou Steel's fines and related legal costs, this third rule is troubling because it opens a veritable Pandora's box of complex line drawing problems based on unknown parameters. For example, it requires determining whether damages should be limited to costs incurred in defense of only knowingly-made false allegations, or allegations based on unsubstantiated or unverified reports, or good faith but ultimately erroneous allegations, or only those allegations that resulted in final agency findings of violations, and so on. Tautologically, this third possible rule would not reach truth-based blackmail.

Thus, each damage theory has its appeal, and each has its problems. The legal scholarship on optimal darnages and the RICO statute itself, however, together lead to the conclusion that *838 the second theory, requiring full damages, is the correct measure.

1. The Legal Scholarship on Optimal Damages

The legal scholarship on optimal damages theory is very well developed. [FN268] At the heart of this literature, two social

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objectives are optimized: deterrence and punishment. [FN269] Indeed. the basic theory adopted here is the standard theory upon which economically-oriented scholars widely agree. [FN270] Specifically, the ***839** proper magnitude of damages is value of the harm caused, multiplied by a factor reflecting the probability of escaping liability. [FN271] This behavioral deterrence rule makes defendants pay on average for the net social harm actually done, and thus is thought to lead to socially desirable behavior in terms of people taking precautions and participating in socially worthwhile but risky activities. [FN272]

Part of the optimal damages analysis--specifically, divining the multiplier to be used to reflect the probability that wrongdoers might escape liability-- is very straightforward in RICO analysis because Congress already has provided for treble damages and, therefore, the punitive component of the rule's objectives is fixed by the statute. [FN273] What remains, then, is to determine the correct measure of damages needed to deter blackmail-based racketeering. setting the probability that blackmailers cannot escape detection at one. [FN274]

Following the optimal damages literature, divining the correct ***840** measure of blackmail-based racketeering requires that the focus of the rule must be on adjusting the behavior of would-be blackmailers through economic disincentives. and not on divining a measure that compensates blackmail victims. [FN275] That is, the goal of the optimal damages rule is to take away from the blackmailer an appropriate amount of money; specifically, the amount that will extinguish the blackmailer's economic incentive to commit blackmail. Thus, one must examine the kinds of conduct blackmail damages should deter.

As discussed above, it is blackmail to threaten to tell the truth unless a tribute is paid. Accordingly, if the object of the optimal blackmail damages rule is to deter all varieties of blackmail, the rule must deter threats to tell the truth. Thus, the second rule satisfies the optimal damages rule. It follows from the nature of blackmail itself, however, that the first and third possible damages rules suggested above, each of which would permit the use of truth as a defense to damages, cannot be optimal because they inherently fail to deter truth-based blackmail. The intuitive problem with the second rule, however--which would reimburse Bayou Steel's fines--yet remains. Thus, a choice must be made between optimal damages and allowing an 'unclean hands' defense to blackmail damages.

2. Damages Implications from the RICO Statute

When criminal sanctions are imposed pursuant to RICO, liberty and money can be taken away. This is functionally **and** economically equivalent to assessing civil damages and then throwing the money into the sea. Paying full RICO damages to racketeering victims accomplishes the same level of deterrence on a dollar for dollar basis. Less racketeering deterrence will result, however, if an unclean hands defense to RICO damages is integrated into the damages rule. Thus, the issue comes down to determining how much blackmail Congress intended to deter under RICO. [FN276]

***841** The consensus in the RICO commentary is that RICO's primary purpose is prosecutorial, and not compensatory. [FN277] Indeed, RICO is a malum in se statute which presupposes by fiat the absence of an efficient level of racketeering. [FN278] Although this view is not incapable of valid criticism, even critics of RICO's malum in se structure acknowledge that Congress crafted RICO to be first and foremost a penalty-maximizing statute, [FN279] and that by design it **is** unconcerned with who receives civil damages so long as violators' resources are duly depleted. [FN280] Thus, judges **and** practitioners do not have to be concerned with determining how much blackmail Congress wanted to deter under RICO; Congress condemned all of it. Moreover, the potential for strategic moral hazard--that Bayou Steel might intentionally violate regulations if it can recover its penalties and legal costs--is so **highly** attenuated that it falls outside the scope of practical **and** legal concern. Civil damages simply are not recoverable for ordinary blackmail, and thus the specter of strategic moral hazard does not arise unless one is somehow capable of inducing all the elements of a RICO case--that is, a full- blown corporate campaign.

Taken together then, (1) if the object of RICO is to deter all forms of blackmail, including threats to tell the truth, then the optimal damages rule is the correct rule; and (2) Congress intended for civil RICO to reach all forms of racketeering. including organized blackmail. Therefore, the second rule is the correct measure of blackmail damages in civil RTCO actions.

***842** VI. Summary and Conclusions

A. Future Economics of Corporate Campaigns in the 'Mini-Steel' Industry

The contract the International finally accepted in September of 1996, without submitting it to Local 9121 for a vote, strongly favored Bayou Steel. Local 9121's members received no base wage increases, the company's productivity-tied wage plan was

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adopted, and employee health care contributions were increased. Moreover, no back pay was paid to returning strikers, and a negotiated, company-deferential standard for arbitration of employment terminations based on striker misconduct was adopted. [FN281] As a result, none of Local 9121's officers returned to work after the strike; some officers' discharges were affirmed in arbitration, [FN282] and the rest were settled on money terms acceptable to Bayou Steel. Thus, from the union's perspective the strike and corporate campaign decidedly failed to accomplish any tangible objectives. Measured against this outcome, one must ask why the Steelworkers found it economically rational to throw the full weight of the International and the IUD--spending more than three years and approximately three million dollars-- into the Bayou Steel fight? [FN283]

Two standard economic considerations seem to have driven the International's decision. First, union representation in the mini-mill industry, particularly in the Southeast, historically has been minimal. For example, the International's efforts during the 1970s to organize Florida Steel Corporation generally failed. [FN284] *843 Similarly, the International's efforts to compel union recognition at LTV, Inc.'s new mini- mill project in Decatur, Alabama, named LTV-Trico Steel, Inc., at the same time as the Bayou Steel strike generally was failing. [FN285] Thus, the apparent marginal value to the International of controlling even a small 'toe-hold' mini-mill such as Bayou Steel was very high. Second, the Steelworkers' experience in the Ravenswood campaign generally was a source of optimism regarding the efficacy of corporate campaign tactics. Moreover, as compared to Ravenswood, Bayou Steel represented a fairly small target. [FN286] Thus, from the perspective of an ex ante rational decisionmaker, the decision to launch the corporate campaign—that is, the marginal value of controlling Bayou Steel net of the expected marginal cost of the corporate campaign--may have seemed economically rational. Ex post, however, the Steelworkers' experience in the Bayou Steel campaign fundamentally changed that calculus.

The difference between the two campaigns, we believe, lies in certain real economic differences between Bayou Steel and Ravenswood Aluminum. Ravenswood principally manufactured sheet aluminum for beverage cans, thus placing the company's products in close commercial proximity to genuine consumer goods, goods that were susceptible to consumer boycotts even *844 though no significant amounts were successfully boycotted. [FN287] Bayou Steel's products--unfinished steel billets, standard channels, and angles--in contrast, are far removed from consumer brand choices and, therefore, not susceptible to consumer identification or boycotts. The Steelworkers also had an easy target-- an American citizen who fled to Switzerland after being indicted in 1983 for tax evasion, racketeering, and oil deals with Iran, and who is considered one of the world's wealthiest individuals--in Marc Rich who controlled Ravenswood. [FN288] Bayou's controlling stockholder had no such disabilities, and despite being personally attacked, held firm throughout the ordeal. This, of course, implies that steel mini-mills are relatively corporate campaign resistant and that, accordingly, the mini-steel industry is relatively unlikely to experience further such campaigns. A dozen years ago, Perry's seminal book on corporate campaigns correctly called attention to the fact that corporate campaigns against companies making products directly for consumers were likely to be much more vulnerable to corporate campaigns than those producing products sold only to other producers and not easily distinguishable in the marketplace. [FN289] The Bayou Steel case illustrates the factual basis of Perry's analysis.

B. Legal Conclusions

In this country, no one can be forced to work against his or her will; that is, without an acceptable agreement. People also have the right to protest and to petition for the redress of grievances. Labor law further empowers employees to bargain collectively and, if an acceptable contract is not reached, to withdraw their *845 labor en masse. Moreover, in connection with collective bargaining, when an employer or a labor union bargains 'unfairly,' labor law provides the substantive and procedural rules for obtaining a resolution. As disputes are decided, collective bargaining progresses toward a final result--either a contract or an impasse. Labor law does not function costlessly or instantly, however. Rather, it is imperfect, costly, and sometimes it seems exceedingly slow. Even so, it is the model that governs collective bargaining: offer, rejection, counteroffer, rejection, dispute, resolution, another offer, and so on until the process is completed.

A corporate campaign aimed at obtaining a contract is designed to win more from an employer than a union can achieve utilizing labor law processes alone. Otherwise. it serves no economically rational purpose. Indeed, it would be irrational for a union to spend its scarce resources on a campaign to obtain a result the same as, or inferior to, that which results from labor law processes. Stated differently, in a corporate campaign directed at getting a contract, unions seek wages, hours, and working conditions using means that are beyond what is contemplated by the labor law model.

Ordinarily, one may not use blackmail to obtain a contract. Indeed, the racketeering laws make it a federal crime to use organized extortion to force contracts (at least where interstate commerce is affected). In addition, although labor unions enjoy special privileges in our society, such as the right to bargain collectively, withdraw labor en masse, and to file unfair labor practice charges, nothing in the law specially empowers labor unions to use blackmail to obtain contracts with

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employers. Indeed, except within the special purview of labor law, unions are subject to the same general laws that apply to all citizens. Therefore, not to allow civil recovery under RICO for damages incurred as a consequence of union corporate campaigns would be tantamount to saying, as a matter of law, that labor unions, in addition to their special rights under federal labor law, also are specially privileged to commit organized blackmail in violation of state law to get contracts. This, of course, is not the law.

*846 Appendix Pr Newswire

Monday, August 2,1993

STEELWORKERS ANNOUNCE CORPORATE CAMPAIGN TO FORCE BAYOU STEEL INTO MEANINGFUL NEGOTIATIONS

NEW ORLEANS, Aug. 2 /PRNewswire/--The United Steelworkers of America (USWA) announced today the beginning of a corporate campaign against the Bayou Steel Corp. (AMEX: BYX) intended to force the company to end its unfair labor practices, begin meaningful collective bargaining and halt a five-month work stoppage at its LaPlace, La., operations.

George Becker, USWA International vice-president for administration, told a news conference here that the corporate campaign is designed to bring pressure on the company from individuals and institutions with direct financial or other interest in its performance.

'Labor disputes are no longer restricted to the picket line,' said Becker. 'There are other players in our society who can have, and have had, significant influence in helping to resolve labor conflicts. We intend to inform them fully of the events here, and of Bayou management's outrageous conduct. We have every reason to believe they will want to get involved once they hear the facts.'

Becker led the union's successful corporate campaign against the Ravenswood Aluminum Corp., which began in November 1990, and ended in victory for the union's members in June 1992. In that dispute, the union said Ravenswood Aluminum locked out 1,700 USWA members, hired scabs as permanent replacements and refused to negotiate. In the 20-month struggle that followed, the union said it succeeded in ousting company management, winning a new contract and returning its members to their jobs. The union has conducted similarly successful efforts against the Marathon Oil (NYSE: MRO) division of USX Corp. and the Noranda Corp., among others.

The same team that directed the USWA's campaign against Ravenswood is being brought here from the union's International headquarters in Pittsburgh and the AFL-CIO headquarters in Washington.

*847 Local Union 9121, following a series of unfair labor practices by the company, struck on March 21, and the USWA filed a charge with the National Labor Relations Board alleging Bayou committed 22 violations of the National Labor Relations Act, the union said. The union also contends that the company's actions amount to a lockout under Louisiana law.

Among other things, the union charged that Bayou. after receiving notice of the local's intent to strike on March 19, submitted a retaliatory 'final offer' on that day that was markedly inferior to the one the workers had rejected by a vote of 268-6 on March 18.

The union said the March 19 'final offer,' clearly intended to punish the workers, was for a six-year contract that included an absolute ban on union activities on company time--a proposal that violates the National Labor Relations Act on its face; a $1 an hour cut in wages and benefits; huge employee contributions to health insurance premiums; a two-tier wage system; and an incomplete incentive plan that did not even contain rates. Incredibly, the company demanded the sole right to determine the ultimate contents of the incentive plan, and insisted that the plan be excluded from the grievance and arbitration process, the normal dispute settlement mechanism, the union said.

On March 20, the company made another 'final offer' which contained a few contractual improvements, but attached a threat--if the employees did not accept the March 20 offer, the company would unilaterally implement its March 19 offer--another labor law violation, the union said.

Under auspices of federal mediators, the union and company have had several post-strike negotiating sessions, including one on May 13 during which Bayou management offered a 'new' incentive plan proposal--consisting of a single sentence saying

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there would be such a plan in any contract eventually agreed to, and the terms would be decided by the company. This, too, violated the National Labor Relations Act, the union said. As with the previous proposal, this incentive plan would not be subject to the grievance procedure. If any doubt existed that the company was not interested in settling, it evaporated at that moment, the union said.

The two sides have not met in face-to-face negotiations since June 3.

'Given the company's unyielding and extreme positions, any impartial observer would have to conclude that Bayou management had no interest in reaching agreement,' Richard *848 H. Davis, director of USWA District 36, told the news conference. 'For its own reason--and we believe it was to get rid of the union—the company chose confrontation over compromise, forced our members into a comer and gave them no choice but to strike.

'Our goal from the beginning was to negotiate a contract that works to the advantage of both the workers and the company. That's the nature of collective bargaining. Bayou management elected not to bargain, so we have decided to take our case to Bayou investors, creditors, customers, the public and others. Bayou wouldn't listen to its workers. Maybe it will pay attention to these other interested parties.

'We're certain that the state of Louisiana and St. John the Baptist Parish, which have granted tax waivers in excess of $44 million, would not condone management's contemptible treatment of our members and their communities. We're equally certain that Bayou bondholders will be alarmed to learn they are at great financial risk because of management's business practices, and that government agencies and private groups will deplore its environmental practices.'

Under terms of the previous six-year contract, which expired last Feb. 28, the workers wages rose only 69 cents—with a 15 cents an hour wage increase on March 1, 1987; and 18-cents an hour in cost-of-living adjustments in each of the final three years. During the same period, Bayou reported profits of $30 million and projected profits of $4 million this year.

[FNa1]. Professor Emeritus of Management; Formerly, Director Industrial Research Unit; Chairman, Labor Relations Council; and Chairman, Department of Industry, The Wharton School, University of Pennsylvania. A.B., 1939, Duke University; A.M., 1941, Ph.D. (Economics), 1942, Harvard University. Dr. Northrup served as consultant and testifying expert labor economist for Bayou Steel Corporation in its RICO litigation against the Steelworkers.

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[FN1]. See Bayou Steel, Steelworkers Settlement Complaints against Union, Company, Daily Lab. Rep., Oct. 31, 1993, at A1; Connna C. Petry, Bayou, USW Agree; Two Sides Settle Rico, Labor issues, Am. Metal Mkt., Oct. 31, 1997, at 12.

[FN2]. More than one year before the settlement, the parties had reached an agreement to end the Steelworkers' 42-month strike. See Bayou Steel *Corp.*, Steelworkers Bargain Six-Year Pact Ending 42-Month Strike, Daily Lab. Rep. (BNA), Sept. 25, 1996, at A8; Corinna C. Petry, Workers Return to Bayou (81 of 206 Ex-strikers Return to Bayou Steel *Corp.), Am.* Metal Mkt., Nov. 8, 1996, at 2.

[FN3]. 18 U.S.C. § 1962(c) (1994).

[FN4]. See 18 U.S.C. § 1961(3) (1994) ("[P]erson' includes any individual or entity capable of holding a legal or beneficial interest in property ....').

[FN5]. See 18 U.S.C. § 1961(5) (1994) ("[P]attern' of racketeering activity requires at least two acts of racketeering activity, one of which occurred after the effective date of this chapter and the last of which occurred within ten years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity ....').

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[FN6]. See generally Brief in Support of Defendants United Steelworkers of America's and Industrial Union Department's Motion for Summary Judgment, Bayou Steel v. United Steelworkers of America, No. 95-494-RRM, (D. Del. filed July 28, 1997), [hereinafter 'Steelworkers' Summary Judgment Brief].

[FN7]. See 18 U.S.C. § 1961(1) (1994) (specifically identifying 'predicate acts' as any of a number of state and federal crimes including, among others, murder, kidnapping, extortion, bribery, mail fraud, and wire fraud).

[FN8]. See id.

[FN9]. See 18 U.S.C.§ 1341 (1994) (mail fraud); 18 U.S.C.§ 1343 (1994) (wire fraud).

[FN10]. 18 U.S.C.§ 1952 (1994).

[FN11]. See infra notes 115-40, and accompanying text.

[FN12]. See infra notes 141-42, and accompanying text

[FN13]. 18 U.S.C. § 1961(4) (1994) ("[E]nterprise' includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity ....'). See United States v. Turkette, 452 U.S. 576, 580-81 (1981) ('There is no restriction upon *the* associations embraced by the definition: an enterprise includes any union or group of individuals associated in fact.').

[FN14]. Seville Indus. Mach. Corp. v. Southmost Mach, Corp., 742 F.2d 786,789 (3d Cir. 1984).

[FN15]. See e.g., River City Mkts. v. Fleming Foods West, 960 F.2d 1458, 1461 (9th Cir. 1992) (dismissing for failure to plead association-in-fact enterprise was error where defendant entities associated in a business relationship akin to a joint venture); Fleischhauer v. Feltner, 879 F.2d 1290, 1297 (6th Cir. 1989) (determining that a jury had ample basis to find that five parties involved in association constituted a RICO enterprise where the enterprise consisted of three corporations, their owner, and an attorney who was an officer of each corporation); Battlefield Builders, Inc. v. Swango, 743 F.2d 1060, 1064 (4th Cir. 1984) (reversing dismissal of complaint where plaintiff alleged that three individuals formed a loose joint venture through which a pattern of extortion was conducted); Standard Chlorine of Delaware, Inc. v. Sinbaldi, 821 F. Supp. 232, 241, nn. 8 & 9. (D. Del. 1992) ('Standard pleads an 'association in fact' of two individuals, [AS] and [MS], and certain corporations some of which AS and MS had some interest in and some of which they did not.').

[FN16]. See United States v. Perholtz, 842 F.2d 343, 353 (D.C. Cir. 1988) (surveying authority from the Third, Fifth, Seventh, and Eleventh Circuits, and upholding jury's conviction of individuals who conducted racketeering through an association-in-fact enterprise comprised of individuals. corporations, and partnerships).

[FN17]. See, e.g., Cullen v. Margiotta, 811 F.2d 698, 728-29 (2d Cir. 1987) (analyzing the court's interrogatories to jury seeking a determination as to the existence of a RICO enterprise based on various permutations of the defendant entities).

[FN18]. See Jaguar Cars, Inc. v. Royal Oaks Motor Car *Co.*, 46 F.3d 258, 262 (3d Cir. 1995) (reasoning that a RICO person must be distinct from the RICO enterprise). See generally B.F. Hirsch v. Enright Ref, *Co.*, 751 F.2d 628, 633 (3d Cir. 1984) (discussing the distinctiveness requirement of 18 U.S.C. § 1962(c)).

[FN19]. See Brittingham v. Mobil Corp., 943 F.2d 297. 301 (3d Cir. 1991) (holding that a parent corporation, alleged to be a RICO person, ordinarily will not be sufficiently distinct From its wholly owned subsidiary for the subsidiary to constitute a RICO enterprise).

[FN20]. See id.

[FN21]. 18 U.S.C. § 1962(c) (1994).

[FN22]. See Reves v. Ernst & Young, *507* U.S. 170 (1993).

[FN23]. See id. at 185.

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[FN24]. See United States v. Benny, 786 F.2d 1410, 1415 (9th Cir. 1986) (upholding conviction of sole proprietor where RICO 'enterprise' was his proprietorship); McCullough v. Suter, 757 F.2d 142, 143 (2d Cir. 1985) ('Hence [plaintiffs] are entitled to recover damages under the RICO statute provided that a sole proprietorship can be an 'enterprise' with which the proprietor can be 'associated.' We think it can be.').

[FN25]. For a study of the development of the mini-steel industry from its inception to 1985, see Donald F. Barnett & Robert W. Crandall, Brookings Institute, Up from the Ashes - The Rise of the Steel Minimill (1986). For more current treatments, see Terrence P. Pare, The Big Threat to Big Steel's Future, Fortune, July 15, 1991, at 106; John Holusha, A Flexing of Muscle in American Steel, N.Y. Times, July 5, 1998, at 4BU.

[FN26]. Nucor Corporation had revenues of $4.2 billion in 1998, and ranked 374 on Fortune magazine's list of the 500 largest American companies. See Fortune 5 Hundred Largest U.S. Corporations, Fortune, Apr. 26, 1999, at F23.

[FN27]. See Holusha, supra note 25, at 4BU.

[FN28]. See John Schriefer, The Battle of Bayou Steel, New Steel, June 1995, at 30. Bayou Steel's common stock trades on the American Stock Exchange (ticker BYX).

[FN29]. See id.

[FN30]. See id. at 31. In 1991, the one mini-mill without an incentive system that had high absenteeism was Bayou Steel. Incentive plans curb absenteeism and tardiness because they require near perfect attendance during a week if an incentive is to be paid. Since incentive pay can account for up to 50 percent of total wages received, this is a powerful curb on absenteeism See Herbert R. Northrup, The Twelve-Hour Shift in the North American Mini-Steel Industry, 12 J. Lab. Res. 261,272-73 (1991).

[FN31]. See, e.g., Alan Sayre, Bayou Steel Denies Out-of-state Hiring, Baton Rouge Advoc., Aug. 6, 1993, at 5C ('The company claims its hourly wage workers averaged more than $43,000 in pay and benefits in 1992. It said it wanted to put savings from making employees pay a larger share of health insurance into an incentive plan that could earn workers up to $6,000 annually.').

[FN32]. See Drew Broach, Strike Routine, New Orleans Times-Picayune, Aug. 14, 1993, at 37. Broach states:
As the strike lumbers through the dog days of summer toward the five-month mark, the essentials for picketing Bayou Steel Corp. in La Place are these: Sunglasses, patience, a short-sleeved shirt, short pants, an extensive vocabulary of curse words and a raspy voice that sounds like sneakers crunching gravel. And a wristwatch. When one of the big trucks approaches from River Road to enter the steel mill, one of the half-dozen or so pickets outside the main gate quits jawboning, rises from a lawn chair, walks nonchalantly into the driveway, checks his watch and begins pacing. The trucks, for the most part, stop. A few steps this way, a few steps back. Check the watch. The truck's engine idles. Just inside the gate, a video camera remotely operated by a security guard records the scene. Pace. Idle. Record. Check the watch. At 90 seconds, the picket nonchalantly returns to his lawn chair and resumes jawboning. The truck lumbers through the gate and onto the scales, and the scene repeats itself.
Id.

[FN33]. See Sayre, supra note 31, at 5C ('Hank Vasquez, the company's vice president of human resources, said only four out-of-state workers were among the 200 hired since the strike began.').

[FN34]. See, e.g., Striker's Serious Misconduct on Picket Line Warrants Discharge, BNA Labor Relations Reporter: Analysis/News & Background Information, LRR-News, Sept. 29, 1997, 156 LRR 129 d17. The Labor Relations Reporter summarizes a post-strike arbitration ruling:
The 52 segments of videotape the employer took of the grievant on the picket line are compelling evidence of his guilt, Baroni finds. Not only do they show him violating the court's guidelines for conducting the picketing, Baroni says; they also are replete with examples of threats and intimidation he used in his attempts to provoke drivers at the mill's main gate to get out of their vehicles and confront him. Given the repeated and extreme nature of the grievant's conduct, which included employing highly personal racial, sexual, and ethnic slurs, it was serious enough to warrant discharge, Baroni holds. After repeatedly examining the videotapes, Baroni discounts the grievant's assertion that many of the incidents were the result of provocation. Some of the incidents were totally unprovoked, Baroni notes, and when there was some provocation, the

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grievant's reactions were generally excessive and not always in proportion to it.
Id. The violence was capped by shots fired through the windows of the automobile of Henry ('Hank') Vasquez, Bayou Steel's chief labor negotiator, as he was driving home not far from the plant on the evening of February 15, 1995. Although Vasquez was not seriously hurt, he narrowly missed being killed. No one has been arrested for this act. See Reward Goes up in Steel Dispute, New Orleans Times-Picayune, Aug. 12, 1995, at B3 ('Bayou Steel Corp. has increased its reward to $150,000 for information leading to the arrest and conviction of people involved in the Feb. 15 attack of its chief negotiator in a labor dispute with striking steelworkers').

[FN35]. See Mike Beime, Bayou Offering Reward after Shooting Incident, Am. Metal Mkt., Feb. 20, 1995, at 1 ('The plant has been operating with temporary replacement workers and more than 100 steelworkers who crossed the picket line.').

[FN36]. See Schriefer, supra note 28, at 34.

[FN37]. See Keith Darce, Bayou Steel Rebounds, New Orleans City Bus., Jan. 9-15, 1995, at 1.

[FN38]. See Statement of Uncontroverted Facts in Support of Defendants United Steelworkers of America's and Industrial Union Department's Motion for Summary Judgment, Bayou Steel Corp. v. United Steelworkers of America, No. 95-496-RRM, 1996 WL 76344 (D. Del. filed July 28, 1997) [hereinafter 'Steelworkers' Facts'], PP 49-67, 74-215.

[FN39]. See Steelworkers' Facts, supra note 38, at P 49. The Steelworkers' press release issued August 2, 1993 is reproduced in full at the Appendix.

[FN40]. See Steelworkers' Facts, supra note 38, at PP 30, 36.

[FN41]. See Steelworkers' Facts, supra note 38, at P 34.

[FN42]. See, e.g., Judgment, entered Oct. 8, 1993, Bayou Steel *Corp.* v. United Steelworkers of America (40th Judicial Dist., Parish of St. John the Baptist, LA) at 2 ('This Court takes seriously Mr. Walker's threats of physical violence. Mr. Walker advised the security guard that his bullet proof vest wouldn't protect him, that his head was wide open for a bullet wound .... Additionally, Mr. Walker advised the individual who was attempting to exit the plant that he wanted his 'm[...] f[...]ing ass and he would get him if he found him at Walmart, Delchamps or K-Mart.' Mr. Walker simulated the use of a gun on two (2) occasions during this incident.').

[FN43]. See id. (holding Local 9121 and five strikers in contempt, ordering fines and jail time, but seemingly in all cases, this and future ones, substituting community service for more severe punishment).

[FN44]. See infra Part IV.D.

[FN45]. *See* e.g., Judgment, entered May 4, 1994, Bayou Steel *Corp.* v. United Steelworkers of America (40th Judicial Dist., Parish of St. John the Baptist, LA), at 6 ('Paragraph 34 alleges that ... Willie Walker intimidated and threatened Hank Vasquez [Bayou Steel's Vice President of Human Resources] with death threats. The Court finds that Willie Walker, by using his hands, mimicking the actions of a gun, did threaten to do physical harm to Hank Vasquez ... and Orders [Willie Walker] to spend three (3) days in the Parish jail for his contempt.').

[FN46]. See supra note 42.

[FN47]. For a description of inside game tactics, see Northrup, infra note 48.

[FN48]. *See* Herbert R. Northrup, Union Corporate Campaigns and Inside Games As a Strike Form, 19 Emp. Rel. L.J. 507 (1994); Charles R. Perry, Union Corporate Campaigns, 4-5 (1987). The Industrial Union Department (IUD) claimed a 'critical role' in the corporate campaign against Bayou Steel. See IUD News, Oct./Nov., 1996, at 10 ('The IUD played a critical role in assisting the USWA with its coordinated [corporate] campaign against Bayou Steel.'). It defines a corporate campaign as one which '[a]pplies pressure to many points of [[[corporate] vulnerability to convince the company to deal fairly and equitably [[from the union's point of view] with the union .... It means vulnerabilities in all of the company's political and economic relationships-- with other unions, shareholders, customers, creditors, and government agencies--to achieve union goals.' See IUD, Developing New Tactics: Winning With Coordinated Corporate Campaigns, 1 (1985).

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[FN49]. See Herbert R. Northrup, Corporate Campaigns: The Perversion of the Regulatory Process, 17 J. Lab. Res. 345 (1994) [hereinafter Northrup, Corporate Campaigns]; Herbert R. Northrup & Augustus T. White, Construction Union Use of Environmental Regulation to Win Jobs: Cases, Impact, and Legal Challenges, 19 Harv. J.L. & Pub. Pol'y. 55 (1995); see also Dan La Botz, A Troublemaker's Handbook, 127 (1997). La Botz states:

Both public institutions and private companies are subject to all sorts of laws and regulations, from the Securities and Exchange Commission to the Occupational Safety and Health Act, from the Civil Rights Act to the local fire codes. Every law or regulation is a potential net in which management can be snared and entangled. A complaint to a regulatory agency can cause the company managerial time, public embarrassment, potential fines, and the costs of compliance. One well-placed phone call can do a lot of damage.

Id. (emphasis in original).

[FN50]. See United Steelworkers of America, A Union for the 21st Century 7 (1995) [hereinafter '21st Century Pamphlet'].

[FN51]. See infra notes 60-63 and accompanying text, discussing the Steelworkers' lawsuits against Bayou Steel as shareholders; see, e.g., steelworkers' Facts, supra note 38, at PP 165-70.

[FN52]. The US Environmental Protection Agency (USEPA) and Louisiana Department of Environmental Quality (LDEQ), and on two occasions, the U.S. Coast Guard, conducted more than thirty inspections of Bayou Steel's facility between March 21, 1993 when the Union went on strike and December 6, 1995. In the first year of the strike alone, union complaints resulted in a 400 percent increase in inspections compared to previous years. See Declaration of Al Pulliam Pursuant to 28 U.S.C. § 1746, USPIRG v. Bayou Steel, No. 96-0432, (E.D. La. Filed Mar. 26, 1996). In addition to the NLRB, the corporate campaign involved complaints to: OSHA, USEPA, LDEQ, SEC, Tennessee Department of Environmental Conservation, Louisiana Board of Commerce and Industry, St. John's Parish Council, the Coast Guard, the School Board, and Louisiana Dept. of Transportation. See Steelworkers' Facts, supra note 38, at P 63.

[FN53]. See Steelworkers' Facts, supra note 38, at PP 49-67.

[FN54]. See id.

[FN55]. The Steelworkers' campaigns against Marathon Oil (Division of USX Corporation), J.T. Ryerson & Son, Boston Gas Company, and Noranda Corporation also share similarities with the Bayou Steel campaign, although the Ravenswood campaign presents the most recognizable model.

[FN56]. See Brad Hoeschen, Strike Turning Personal, L'Observateur, Aug. 4, 1993.

[FN57]. See Steelworkers' Facts, supra note 38, at P 49.

[FN58]. See id.

[FN59]. This statement has been contradicted by members of the management at Ravenswood that were displaced by Steelworker pressure after the fugitive financier, Marc Rich, who was a one-third owner, withdrew his support from the management. We shall note later that the union claimed that several major firms withdrew their business from Ravenswood as a result of Steelworker pressure. In fact it appears that the only major company that did so was Stroh, the nation's sixth largest brewery. Members of the former management in interviews pointed out to Dr. Northrup that Ravenswood had four so-called 'pot lines.' One had been shut down by the original owner, Kaiser, about five years before the strike. As the strike neared, operating management shut down a second one because it doubted that it could obtain enough workers during the strike to operate three lines. Three weeks later, it found that replacements were available, and reopened this line; then, several weeks later it opened the fourth line as business and operations were going well. Major companies like Coca-Cola, Pepsi Cola, and others continued to do business with Ravenswood, and its rolling mill went full speed throughout the strike. If the Steelworkers claims were correct, the company might well have been required to shut down. After the strike ended, and the old ways of operating were reinstated, the new management returned to a labor force of 1,700, about one-third more than ran the plant during the strike. This could be the reason why financial stability was difficult to attain.

[FN60]. Because Bayou Steel is a publicly traded corporation on the American Stock Exchange (ticker BYX), identifying its directors and corporate history was a straightforward exercise.

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[FN61]. See Letter from James Pepitone, USWA Staff Representative, and Ron Ferraro, President Local 9121, to Albert P. Lospinoso, Director Bayou Steel Corp. 2 (Oct. 12, 1993) (on file with author).

[FN62]. Id.

[FN63]. See Steelworkers' Facts, supra note 38, at P 50 ('The USWA's ' corporate campaign' was 'an effort to take the [USWA's] message beyond the picket line to the public, *to* the stockholders, to all the audiences that could help [USWA ¶ to encourage the management of Bayou Steel to return to the bargaining table and negotiate a fair and equitable agreement.").

[FN64]. See, e.g., Steelworkers' Facts, supra note 38, at P 101.

[FN65]. DSI performed similar work for the Steelworkers in the Ravenswood campaign. See Bob Regan, Ravenswood Facility Gets Pollution Check, Am. Metal Mkt., Apr. 10, 1992, at 2. Regan reports:
Ravenswood Aluminum also charged the USW has been using what it described as 'essentially a one-man environmental consulting firm' in its 'propaganda campaign.' It identified this company as Disposal Safety Inc. Early in April the USW fired off a joint statement with Disposal Safety and other members of what was described as 'an environmental coalition to oppose waste permits for Ravenswood Aluminum,' citing environmental reports 'detailing serious, illegal pollution of the Ohio River by Ravenswood Aluminum.'
Id.

[FN66]. See Steelworkers' Facts, supra note 38, at P 103 ('At various times, persons acting on behalf of USWA sent copies of the DSI Report to the EPA, LDEQ, BCI, other public officials in Louisiana, potential investors in a mortgage note offering by Bayou Steel, and members of the media.').

[FN67]. See id. at P 99.

[FN68]. Id. at P 146.

[FN69]. See Tom Guarisco, Vote on Bayou Steel Tax Break Postponed, Baton Rouge Advoc., Dec. 16, 1993, at E1 ('A vote on a controversial tax break request by Bayou Steel Corp. was postponed until the February meeting of the state Board of Commerce and Industry, but not before a union-financed environmental audit critical of the LaPlace company was presented to board members and the media.').

[FN70]. *See* Steelworkers' Facts, supra note 38, at PP 157-58.

[FN71]. See id. at P 162.

[FN72]. See id. at P 164 ('The USWA communicated with the SEC and with potential mortgage note investors in order to put pressure on the company to negotiate a collective bargaining agreement with the USWA.').

[FN73]. Wall St. J., February 7, 1994, at C16.

[FN74]. See Adam Entous, Reuters Information Services, Inc., Feb. 7, 1994; Mike Beirne, Bayou Union Tries to Crash Investor Meeting, Am. Metal Mkt., Feb. 9, 1994, at 16.

[FN75]. Entous, supra note 72.

[FN76]. Id.

[FN77]. Id.

[FN78]. See Despite Labor Dispute, Steel Manufacturer Brings Junk Deal, Bondweek, Feb. 28, 1994 at 1. Bondweek reports:
After a month-long delay engineered by the United Steelworkers of America and Local USWA 9121, a $ 75 million junk bond offering by Bayou Steel got the *go-* ahead from the Securities and Exchange Commission last week, Still, union officials were pleased by the success of their activities and plan to pursue similar tactics in future labor disputes, says Jim Valenti, USWA safety, health and environment specialist.
Saying that SEC officials have limited resources at their disposal to investigate the accuracy of a company's prospectus,

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Valenti adds he sees unions playing a growing role in informing investors of potential risks in public offerings. Predicting Bayou ultimately will be forced to close down its Louisiana facility and will be unable to service the debt, Valenti told Corporate Financing Week, a sister publication, 'Many investors will take heed next time to what the unions have to say.
The unions tried to scuttle the issue and in fact were successful in delaying it by complaining to the SEC that the prospectus did not spell out all of the risks to potential investors, say officials close to the situation ....
The unions targeted the planned issue for negative publicity in order to gain concessions in a year-long contract dispute centering on the company's environmental record and good-faith bargaining, says Ed Keyser, senior investment advisor with the USWA's industrial union department. Besides approaching the SEC, union officials stood outside of a road-show in New York and gave potential investors information packets on issues the unions wanted disclosed in the prospectus, Keyser notes. Packets were also mailed to many large high-yield funds, he adds.
Id.

[FN79]. The precise relationship between these companies is more complicated, but a detailed description of their ownership and governance structures is beyond the scope of this discussion. For present purposes, it will suffice to observe that Bayou Steel is not a subsidiary or sister company of any RSR-related company. Rather, the two are affiliated through common controlling shareholders. At various times the two have shared one or two directors (a consequence of stock ownership), and at one time shared a common general counsel. See Steelworkers' Facts, supra note 38, at PP 190-97.

[FN80]. Steelworkers' Facts, supra note 38, at P 189. In important respects the Steelworkers' attack against RSR was a foible from its inception. Bayou Steel and RSR are separate companies and, therefore, their directors are duty- bound as fiduciaries to act separately in each company's best interests, regardless of the pain felt by the other. Thus, in dealing with the Steelworkers, Bayou Steel's directors, managers and collective bargaining representatives were duty bound and legally foreclosed fiom yielding to harm directed against RSR. The Steelworkers, it seems, either did not understand this corporate reality, or believed that Bayou Steel's directors could be compelled to place the interests of RSR above Bayou Steel's.

[FN81]. On February 14, 1994, Disposal Safety released its report entitled 'Waste Management Practices of RSR Corporation.' See Letter from John J. Sheehan, the International's Legislative Director and Assistant to the President, to Carol Browner, Administrator USEPA (Feb. 18, 1998) (on file with author). Sheehan writes:
We commissioned a detailed study of RSR's waste management practices and a comprehensive environmental audit of its affiliated company, Bayou Steel Corporation with whom we have an unfair labor practice dispute. These two reports are enclosed. Our consultants' investigation of this company shows it is an environmental outlaw.
....
The United Steelworkers of America requests a coordinated multimedia enforcement effort, involving federal and state agencies, to bring this company into compliance with the law ....
... We promise our support for vigorous action against this law-breaker.
Id. See also Edward Worden, USW-funded Study Rips RSR's Environmental Record, Am. Metal Mkt., Feb. 21, 1994, at 16 ('An environmental report commissioned by the United Steelworkers union alleges that lead recycler RSR Corp. has managed to 'delay, obfuscate and ultimately evade its legal and financial responsibilities'.... The report was prepared by Disposal Safety Inc., Washington, described by the union as an independent company specializing in the analysis of toxic waste management practices.').

[FN82]. See, e.g., Edward Worden, Union Carries Fight with RSR to Europe, Am. Metal Mkt., May 3, 1994, at 7.
A union spokesman in Pittsburgh said Friday 'our campaign is going to extend to Europe—we are going to chase this company and expose it for what it is.' Dallas-based RSR is 'the biggest and baddest of the secondary lead smelters in the world,' the spokesman, Gary Hubbard, communications director, said. But he conceded the union's crusade ... is an attempt to improve the union's chances of getting a contract at Bayou Steel Co., La Place, La., which the USW struck a year ago.
....
Another tactic involved the posting of skull-and-cross-bones billboards in Aiken County, S.C., where RSR [sought] to build a new secondary smelter.
Id. See also Letter fiom James J. Valenti, the International's Health and Safety Specialist, to Mario Cuomo, Governor, New York 1 (Aug. 11, 1994) (on file with author) ('Our union has been conducting research into the environmental record of RSR Corporation, which operates the Revere Smelting and Refining Corp. lead smelter in Wallkill, New York, We have found that RSR/Revere has a very poor record of environmental compliance and clean-ups.').

[FN83]. See Order Denying Motion to Dismiss, Texas Air Corp. v. Airline Pilots Ass'n Int'l, No. 88-0804, 1989 WL 146414 (S.D. Fla. filed July 14, 1989) (denying dismissal in RICO action based on corporate campaign allegedly conducted to

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compel Texas Air to sell Eastern Airlines to unions. Thereafter, Eastern disappeared in bankruptcy). Other RTCO cases based on corporate campaigns typically have stalled after briefing on motions to dismiss.

[FN84]. See, e.g., Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986); Anderson v. Liberty Lobby, Inc., 477 U.S. 242 (1986); Celotex *Corp.* v. Catrett, 477 U.S. 317 (1986).

[FN85]. See Steelworkers' Facts, supra note 38, at P 50 (quoting the deposition of International Vice President Davis,'The USWA's 'corporate campaign' was 'an effort to take the [USWA's] message beyond the picket line to the public, to the stockholders, to all the audiences that could help [USWA] to encourage the management of Bayou Steel to return to the bargaining table and negotiate a fair and equitable agreement.'); Steelworkers' Facts, supra note 38, at P 51 ('The sole purpose of the corporate campaign throughout the labor dispute was to exert pressure on Bayou to reach a collective bargaining agreement with USWA.'); Steelworkers' Summary Judgment Brief, supra note 6, at *36* ('The record allows of no conclusion other than the obvious one--the objective of the union activities that are the subject of Bayou's complaint was to obtain a collective bargaining agreement.').
On the other hand, it is believed that an analysis could show that, since Bayou was one of the few unionized mini-steel plants in the Southeast, the Steelworkers might well have preferred initially to shut it down if an agreement satisfactory to the union's interest could not be achieved. When that proved impossible, Bayou became an embarrassment to the union, and it settled close to Bayou's terms. Here, of course, is not the place to discuss this issue in detail.

[FN86]. See Steelworkers' Facts, supra note 38, at P 65 ('No communications made on behalf of the USWA about Bayou Steel or its affiliates in the course of the labor dispute was deliberately false or misleading, and it was repeatedly emphasized by USWA representatives that accuracy in communications was critical in order that the campaign maintain its credibility with the various government agencies, many of which the USWA had ongoing investigations across the country.'); Id. at P 66 ('USWA representatives instructed that all complaints to government agencies had to be well-founded, specifically that all complaints had to be based in good faith on the best available information.'); Steelworkers' Summary Judgment Brief, supra note 6 at 40 ('The undisputed facts demonstrate that the USWA did not communicate anything with intent to deceive. Without exception, the USWA representatives testified that they believed all of their assertions to be true when they made them and that they believed in good faith that their sources of information were accurate.').
In fact, many of the environmental charges, especially those made by Local 9121, did not stand the test of examination. After numerous unsupported allegations of environmental offenses. the Deputy Secretary of the Louisiana LDEQ reacted rather strongly. He wrote the Chairman of Local 9121's safety and environmental committee as follows:
The numerous special inspections in response to your frequent unsupported allegations have not resulted in any findings of significant danger to the environment or human health, nor an emergency, nor the discovery of an abandoned hazardous waste site, nor any findings of significant violations of the Environmental Quality Act. This office can no longer reasonably believe your unsupported allegations against the above referenced facility.
Submit significant, verifiable evidence to support your allegations against the above referenced facility, and this office will investigate in an appropriate manner.
Northrup, Corporate Campaigns, supra note 49, at 353-54 (quoting Letter from Filmore P. Bordelson, III, to Maurice Simoneaux, Chairman, Safety and Health, United Steelworkers. Local 9121 (November 17, 1994)).

[FN87]. See generally Plaintiffs' Second Amended Complaint, Request for Injunctive Relief and Request for a Jury Trial, Bayou Steel Crop. v. United Steelworkers of America. No. 95-496-RRM, 1996 WL 76344 (D. Del. filed Oct. 10, 1998).

[FN88]. See United Steelworkers of America v. Bayou Steel Corp., Nos. 13817 and 13818 (Del. Ch. filed October 18, 1994); USWA News Release entitled 'Steelworker Shareholders Sue Bayou Steel for Annual Meeting; Announce Plans to Offer Resolution Shaking Up Board,' dated October 18, 1994. Such shareholder suits, when they are part of a corporate campaign, may be improper in courts of equity. See Carpenter v. Texas Air Corp., No. 7976, 1985 WL 11548 (Del.Ch. Apr. 18, 1985) (Plaintiffs, shareholders of Texas Air and members of the Airline Pilots' Association International Union, sought to inspect the list of stockholders of Texas Air, alleging that their purpose was to communicate with shareholders concerning issues related to the corporation's management and affairs, and to its relationship with Continental Airlines. The union was on strike against Continental. Texas Air refused to allow inspection of its shareholders list, alleging that plaintiffs' purpose for inspection was improper. The court of chancery. held that plaintiffs' request to inspect the stockholders list was not for a purpose reasonably related to their status as stockholders. The real party in interest is the pilots' union, who initiated the suit in order to put economic pressure on Continental. The court found this to be an improper purpose and, therefore, denied plaintiffs' request).

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[FN89]. See Machinists v. Wisconsin Emp. Rel . Comm., 427 U.S. 132 (1976); Amalgamated Ass'n of St. Employees v. Lockridge, 403 U.S. 274 (1971); San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236 (1959).

[FN90]. See cases cited supra note 87.

[FN91]. See Connell Constr. Co., Inc. v. Plumbers and Steamfitters Local Union No. 100,421 U.S. 616, 625 (1975) (federal antitrust law not preempted by labor law); id. at 635-36, n.17 ('In most cases a decision that state law is pre-empted leaves the parties with recourse only to the federal labor law, as enforced by the NLRB. But in cases like this one, where there is an independent federal remedy that is consistent with the NLRA, the parties may have a choice of federal remedies.') (citations omitted); Britt v. Grocers Supply Company, Inc., 978 F.2d 1441, 1449 (5th Cir. 1992) (holding that claims under the Age Discrimination Act are not preempted under federal labor law because each provides a separate remedy); Hood v. Smith's Transfer Corp., 762 F. Supp. 1274 (W.D. Ky.1991) (holding that preemption doctrine does not apply in situations where two federal statutes conflict.); id. at 1447 ('Additionally, we have held that claims under Title VII are not preempted by the NLRA.'); id. at 1447, n.8 ('In United States v. International Bhd. of Teamsters, 948 F.2d 98 (2d Cir.1991), vacated sub nom. Yellow Freight Systems, Inc. v. United States, [506] U.S. [802], (1992), the Court determined that the district court was entitled to exercise jurisdiction over the parties pursuant to the All Writs Act, 28 U.S.C. § 1651 (1988), and was not preempted from that jurisdiction by the authority of the NLRB to determine issues concerning unfair labor practices under the NLRA.'). S ee also Teamsters Local 372 v. Detroit Newspapers, 956 F. Supp. 753, 758 (E.D. Mich. 1997) ('RICO and the NLRA are independent of each other in virtually all respects, even though certain conduct by employers or by unions could fall within the bounds of both statutes.'); id. at 760-61 ('In the case at bar, however, many of the alleged predicate acts have no bearing whatsoever on the labor laws. They are unlawful without the need to be so defined by the federal labor laws.'); id. at 764 ('Accordingly, this court finds that conduct alleged to violate the Michigan extortion statute can form the basis of a RICO predicate act.'); Chicago District Council of Carpenters Pension Fund v. Ceiling Wall Sys., Inc., 915 F. Supp. 939, 943 (N.D. Ill. 1996) (finding that the NLRA does not preempt RICO claims based on activity arguably prohibited by the NLRA, namely, alleged use of the U.S. Mail in furtherance of a scheme to defraud employees of economic benefits created in a collective bargaining agreement); MHC, Inc. v. International Union, United Mine Workers of America, 685 F.Supp. 1370, 1376-77 (E.D. Ky. 1988) ('RICO should be read as limited by the exclusive jurisdiction of the NLRA only when the Court would be forced to determine whether some portion of the defendant's conduct violated labor taw before a RICO predicate act would be established .... So long as the predicate acts exist independent of any unfair labor practice resolutions, the NLRB's exclusive jurisdiction is not violated since the Court will not be forced to interpret labor law except as a collateral matter .... This conclusion is consistent with the policies and purposes of both the NLRA and RICO.') (internal citations omitted).

[FN92]. See e.g., United States v. Boffa, 688 F.2d 919, 931 (3rd Cir. 1982) ('[W]e decline to accept the proposition that the NLRA precludes the enforcement of a federal statute that independently proscribes that conduct as well.'); O'Rourke v. Crosley, 847 F. Supp. 1208 (D.N.J. 1994) (holding that RICO claims were not preempted by Land Management and Reporting Act claims).

[FN93]. United States v. Palumbo Bros., Inc., 145 F.3d 850 (7th Cir. 1998); cert. denied, 119 S.Ct. 375 (1998). This analysis was contributed by Mark A. Carter, Esq. See High Court Lets Stand Seventh Circuit Ruling That Indictment Nor Preempted by Labor Law, Daily Lab. Rep. (BNA) No 202, at AA-1 (Oct. 20, 1998).

[FN94]. Palumbo Brothers, 145 F.3d at 863.

[FN95]. Mariah Boat, Inc., v. Laborers Int'l Union of North America, 19 F. Supp.2d 893 (S.D. Ill. 1998).

[FN96]. For an explanation of the Garmon doctrine, see San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236 (1959), holding that the NLRB has exclusive jurisdiction over actions arising under the NLRA.

[FN97]. Mariah Boat, 19 F. Supp.2d at 899.

[FN98]. 461 U.S. 731 (1983).

[FN99]. See Mark A. Carter, The Use of 'Bill Johnson's Restaurants' to Defend Labor Organizations in Suits Alleging Civil RICO Violations, presented to American Bar Association, Labor and Employment Law Section, Antitrust, RICO & Labor Law Committee (1997).

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[FN100]. Bill Johnson's Restaurant, 461 U.S. at 733.

[FN101]. 29 U.S.C.§ 158(a)(3) (1994).

[FN102]. See Bill Johnson's Restaurant, 461 U.S. at 743.

[FN103]. See id. at 742 (citing Linn v. Plant Guard Workers, 383 U.S. 53, 65 (1966)).

[FN104]. Id. at 745.

[FN105]. See id. at 746.

[FN106]. See id. at 745, n.11.

[FN107]. See id. at 747.

[FN108]. *See* id.

[FN109]. See id. at 748-49.

[FN110]. In Bayou Steel's RICO complaint, references to the union's complaints to the NLRB are conspicuously absent. This was intentional. The filing of unfair Iabor practices charges not only is protected labor activity but, as explained infra, also is not blackmail as a matter of law. Therefore, in connection with its RICO case, Bayou Steel did not allege that the filing of unfair labor practice charges was actionable as regulatory harassment. Bayou Steel's witness was truthful in testifying that the company believed that many of the union's board filings were frivolous and, therefore, wanted that practice to end. But the witness was simply mistaken when he stated that one reason the company filed its RICO action was to stop that practice. See Letter from Frederick L. Cottrell III, Bayou Steel's Delaware Counsel, to Hon. Roderick R. McKelvie, D.Del. 1-2 (Nov. 8, 1996) ('Bayou Steel has not been seeking nor will it seek damages in this action for NLRB charges filed against Bayou Steel. Further, Bayou Steel wishes to make it clear to the Court and to the NLRB that it has not in the past, does not through this action and will not in the future seek to prevent persons from filing charges or complaints with the NLRB regarding Bayou Steel. Bayou Steel is prepared to reiterate this representation in the pretrial stipulation which will be filed in this case.').

[FN111]. Further, when a union pursues the route of Bill Johnson's Restaurant, it potentially complicates reaching a negotiated settlement. Under Bill Johnson's Restaurant, if an employer dismisses its civil action, the union may be entitled to an award of litigation costs and attorney's fees. Once a complaint is issued, however, the United States takes the role of plaintiff, and the union functionally becomes merely a witness. Hence, the union may not be able to non-suit its NLRB action, making global settlement a three-way problem.

[FN112]. See Northrup, supra note 48; Northrup, Corporate Campaigns, supra note 49.

[FN113]. See supra notes 46-48 and accompanying text.

[FN114]. See Steelworkers' Facts, supra note 38, at P 50 (quoting the deposition of International Vice President Davis, 'The USWA's 'corporate campaign' was 'an effort to take the [USWA's] message beyond the picket line to the public, to the stockholders, to all the audiences that could help [USWA] to encourage the management of Bayou Steel to return to the bargaining table and negotiate a fair and equitable agreement.'); id. at P 51 ('The sole purpose of the corporate campaign throughout the labor dispute was to exert pressure on Bayou to reach a collective bargaining agreement with USWA.'); Steelworkers' Summary Judgment Brief, supra note 6, at 36 ('The record allows of no conclusion other than the obvious one--the objective of the union activities that are the subject of Bayou's complaint was to obtain a collective bargaining agreement.').

[FN115]. *See* Surreply Brief in Support of Motion of Defendants United Steelworkers of America and Industrial Union Department to Dismiss Complaint at 3, Bayou Steel v. United Steelworkers of America, No. 95-494-RRM, 1996 WL 76344 (filed Dec. 19, 1995) ('Although the Company chides defendants for 'declin[ing] to state to the Court that their objectionable conduct will cease if a new [labor] contract is signed,' Bayou's Answering Brief at 7 n. 24, defendants have no reluctance to state to this Court that if a new labor contract is signed, the Corporate Campaign will cease.') (emphasis in original).

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[FN116]. See, e.g., Steelworkers' *Summary* Judgment Brief, supra note 6, at 2-3, 17, and 49 (characterizing corporate campaign tactics as economic pressure).

[FN117]. See, e.g., La. Rev. Stat. Ann. §14:66 (West 1997):
§66. Extortion
Extortion is the communication of threats to another with the intention thereby to obtain anything of value or any acquittance, advantage, or immunity of any description. The following kinds of threats shall be sufficient to constitute extortion:
(1) a threat to do any unlawful injury to the person or property of the individual threatened ...;
(2) a threat to accuse the individual threatened ...;
(3) a threat to expose or impute any deformity or disgrace to the individual threatened ...;
(4) a threat to expose any secret affecting the individual threatened ...
(5) a threat to do any other harm.
See also 18 U.S.C. § 873 (1994):
Whoever, under a threat of informing, or as a consideration for not informing, against any violation of any law of the United States, demands or receives any money or other valuable thing, shall be fined under this title or imprisoned not more than one year, or both.

[FN118]. See Illinois v. Holder, 456 N.E.2d 628 (Ill. App. Ct. 1983) (affirming a conviction where an employee representative threatened that unless employer signed collective bargaining agreement, drivers would strike and mixing drums on employer's already-filled cement trucks would not turn, causing the cement to harden, thus ruining the trucks). The court found that the representative's threat was intended to coerce the employer--'sign or face as an alternative, the consequences'--and rejected arguments that the threat was protected by the Constitution, and that threat was merely permissible economic pressure used as leverage to obtain a union contract. Id. at 631.

[FN119]. See United States v. Nardello, 393 U.S. 286 (1969) (reversing dismissal of indictments and holding that Pennsylvania law against blackmail is extortion within meaning of the Travel Act, 18 U.S.C. § 1952); United States v. Castillo, 965 F.2d 238, 241 (7th Cir. 1992) ('As the evidence unfolded at trial, it became clear that the first line of defense was hopeless. The 'transaction' was not the sale of a business. It was blackmail, a standard form of extortion.'); United States v. Laudani, 134 F.2d 847, 851, n.1 (3rd Cir. 1943) (observing state law merger of the common law crimes of extortion and blackmail) (citing 22 Am.Jur. Extortion and Blackmail § 2, at 234-35); Greenspun v. Gandolfo, 320 P.2d 628, 630-31 (Nev. 1958) (holding that an arrest warrant reciting crime of blackmail was sufficient even though the applicable statute did not use that term). See generally 3 Ronald A. Anderson, Wharton's Criminal Law and Procedure § 1396, at 795 (1957) ('In common parlance, the term 'blackmail' is equivalent to, and synonymous with, ' extortion,' within the nontechnical meaning of the term.'). Blackmail was a crime at common law. See 1 Leon Radzinowicz, A History of English Criminal Law and Its Administration from 1750, at 641 (1948); A.H. Campbell, The Anomalies of Blackmail, 55 L.Q. Rev. 382, 382 (1939). See, e.g., Regina v. Woodward, 11 Mod. 137 (1707).

[FN120]. Commentators sometimes refer to this as the 'paradox of blackmail.' See James Lindgren, Unraveling the Paradox of Blackmail, 84 Colum. L. Rev. 670 (1984) (hereinafter 'Lindgren'); Glanville L. Williams, Blackmail, 1954 Crim. L. Rev. 79, 163; Jeffrie G. Murphy, Blackmail: A Preliminary Inquiry, 63 Monist 156, 156-57 (1980). As set out below, infra notes 130-137 and accompanying text, the key to recognizing and understanding the wrongfulness of blackmail lies in its triangular structure, that is, its involvement of third- parties' rights in the settlement of two-party disputes.

[FN121]. See Landry v. Daley, 280 F. Supp. 938, 962-63 (N.D. 111.1968) (The private citizen 'has the power to initiate criminal prosecution against another and the right to give information and testimony against another. He may make statements injurious to another's reputation, provided he does not commit defamation.'), rev'd on other grounds sub nom. Boyle v. Landry, 401 U.S.77 (1971); Regina v. Pollock, 2 W.L.R. 1145, 1156 (1966) ('If an offence [sic] of indecency, of whatever sort, has been committed, or if a person bona fide believes that such an offence [sic] has been committed, he has a duty to report it. To say, in such circumstances, that one is going to report it, without any intention of using the threat of reporting as a means to extort money or goods, is merely saying that one is going to fulfil [sic] a public duty and is not a criminal offence [sic].'). See, e.g., 26 U.S.C. § 7623 (1994) (providing for payments by the Internal Revenue Service to informers); 33 U.S.C. § 1365(a) (1994) (citizen suit provision of the Clean Water Act); Public Interest Research Group of New Jersey, Inc. v. Windall, 51 F.3d 1179 (3rd Cir. 1995) (public interest group brought suit against Air Force under Clean Water Act); Faul v. Commissioner, 263 F.2d 645 (9th Cir. 1959) (reward to bookkeeper for gathering information showing employer's tax fraud).

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[FN122]. See cases cited in note 210, infra.

[FN123]. See United States v. Coyle, 63 F.3d 1239, 1249 (3rd Cir. 1995) (conviction for blackmail affirmed. Blackmailer had agreed to 'stonewall' FBI in exchange for victim's forbearance from interference with payment of money lawfully owed to him. 'Coyle argues that the district court erred in denying his proposed instruction that he could not be convicted if he was entitled to the benefits he demanded .... However, what is made unlawful by the blackmail statute is Coyle's use of the offer not to report the fraudulent activity or not to cooperate with the authorities as leverage over Cusumano ... whether or not Coyle had a claim of right to the benefits. The blackmail statute thus reaches those who would evade their responsibility to inform the authorities about a violation of the law by exchanging the promise to forebear from giving such information for some benefit.'); Idaho v. Adjustment Dept. Credit Bureau, Inc., 483 P.2d 687, 691 (Idaho 1971) (reversing trial court's dismissal of criminal indictment and holding, 'Finally, the defendant asserts that there was a lawful debt due and owing it by [ ]the debtor, and that this is a defense to the crime charged here. With this contention we do not agree.').

[FN124]. See United States v. Hughes, 411 F.2d 461 (2nd Cir. 1969) (threat to expose homosexual for violating New York statute prohibiting sodomy unless money was paid); Connecticut v. Bassett, 200 A.2d 473 (Conn. 1964) (blackmailer, who entered proprietor's store on a Sunday, threatened to accuse proprietor of violating Sunday closing laws unless money was paid).

[FN125]. See United States v. Castillo, 965 F.2d 238, 241 (7th Cir. 1992) ('Whether the discreditable things were true or false is irrelevant .... Granted, blackmail with false information is less likely to succeed than if the information were true .... Still, there are occasional cases of blackmail with false dirt--enough of them that we know that this form of blackmail is just as criminal as the more common kind.').

[FN126]. *See* Salley v. United States, 306 F.2d 814 (D.C. Cir. 1962) (blackmailer threatened to tell victim's wife that victim had caused an extramarital pregnancy); People v. Goldstein, 191 P.2d 102 (Cal. Ct. App. 1948) (threat to expose extramarital affair unless money was paid).

[FN127]. See New Jersey v. Roth, 673 A.2d 285, 288 (N.J. Super. Ct. App. Div. 1996) (affirming blackmail conviction where pro se real estate dealer claimed he was merely 'playing [economic] hardball' by threatening to file motion to set aside sheriffs sale on technical grounds) (bracketed text in original).

[FN128]. See Lloyd L. Weinreb, Criminal Law 421 (1980) ('All bargaining situations have in them an element of matched 'threats' to withhold what one has to offer ....'); Lindgren, supra note 120, at 701, n.162; Note, A Rationale of the Law of Aggravated Theft, 54 Colum. L. Rev. 84, 90-1 (1954) ('The striking of a legitimate bargain often involves the threat to inflict economic harm if agreement is not reached.'). *See* also United States v. Kramer, 355 F.2d 891 (7th Cir. 1966) (contractor apparently threatened subcontractor that he would exercise hi5 right to terminate the subcontract if the subcontractor did not have his men on the job on the following day; the subcontractor was prevented by a labor union official from supplying workers and lost the subcontract).

[FN129]. See Heights Community Congress v. Smythe, Cramer Co., 862 F. Supp. 204 (N.D. Ohio 1994) (holding that a citizen group's threat to file suit was not extortion under Ohio or federal law).

[FN130]. See Lindgren, supra note 120. at *672-73* ('Recognizing the triangular structure of the blackmail transaction makes clear the parasitic nature of the blackmailer's conduct. Once this structure is understood, it becomes easier to find in blackmail the kind of behavior that concerns the other theorists: immorality, invasiveness, and economic waste.').

[FN131]. See id. See also, 18 U.S.C. § 873 (1994) (defining blackmail, 'Whoever, under a threat of informing, or as a consideration for not informing ....); La. Rev. Stat. Ann. § 14:66 (West 1997) (defining extortion to include threats to 'accuse' or 'expose').

[FN132]. See case cited supra note 124.

[FN133]. See, e.g., United States v. Stirone, 311 F.2d 277 (3rd Cir. 1962) (union official threatened a businessman with the loss of a lucrative contract unless the union official received payoffs).

[FN134]. See, e.g., Commonwealth v. Nevitt, 268 A.2d 121 (Pa. Super. Ct. 1970) (bail bondsman offered to secure the

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dismissal of a drunk-driving charge in return for a payoff).

[FN135]. See, e.g., United States v. Margiotta, 688 F.2d 108 (2nd Cir.1982) (local Republican Party chairman threatened to withhold public contracts unless insurance firm agreed to kick-back scheme).

[FN136]. Reputational blackmail--where a blackmailer threatens to publicize embarrassing facts about his victim, although not accusations of unlawful conduct--is not different, even if nominally it appears that the blackmailer's threatened dispute only concerns the victim's interest in his own reputation. Here the blackmailer exploits the community he believes to be genuinely interested in the victim's reputation. Absent an interested community, the reputational blackmailer has nothing to sell. Cf. United States v. Pignatelli, 125 F.2d 643 (2nd Cir.) (threat to publish a book damaging reputation).

[FN137]. See United States v. Castillo, 965 F.2d 238, 241 (7th Cir. 1992) (citing kindgren, supra note 120, and reasoning that without triangular exploitation of third-party rights there is no blackmail. 'Had Grajeda [[[himself] taken the initiative in seeking to exchange money for forbearance to publish, this would not be a blackmail case.'); Williams v. Grimm, No. 83-C-3779, 1986 WL 10071 (N.D. Ill. 1986) ('Although the concept of blackmail or extortion can be confusing, see e.g. Lindgren, the Court does not believe that the business negotiations in this case rise to the level of unlawful conduct. Plaintiff has cited no authority for the proposition that the extortion statutes apply to ordinary business disputes such as this. Stamatiou v. U.S. Gypsum Co., 400 F.Supp. 431 (N.D.Ill.1975), aff'd, 534 F.2d 330 (7th Cir.1976), cited by plaintiff in support of his position, is wholly inapplicable. In Stamatiou Judge Marshall was applying the same Illinois statute at issue here, however, the facts were significantly different. There the 'extortionist' had threatened to withhold information with respect to another's legal claim.') (internal citations omitted).

[FN138]. See State v. Moore, 419 So. 2d 963 (La. 1982) (affirming extortion conviction of defendant, a police officer, who threatened to arrest a couple for obscenity unless the female had sex with him); Storey v. Stanton, 162 So. 649, 650 (La. 1935) (holding that it is not blackmail to assert one's own claims); Little v. First Nat'l Bank of Jefferson, 616 So. 2d 202, 202-03 (La. Ct. App. 1993) (affirming dismissal of petition and stating, 'Further, demanding more money from the debtor than is owed does not, in and of itself, constitute extortion.'); State v. Daniels, 628 So. 2d 63, 67 (La. Ct. App. 1993) (affirming conviction of defendant who threatened to cut off communication of information about the murder of victim's daughter unless the victim paid him $30,000 to $50,000); State v. Sharlhorne, 554 So. 2d 1317, 1323 (La. Ct. App. 1989) (sustaining a conviction of attempted extortion after the defendant told the victim that he had been 'in jail or Angola', asked the victim for a 'donation' of money, was 'forceful', would not leave the victim's shop, told the victim 'something might happen--people that give me money, things don't happen to their building,' and the victim gave the defendant ten dollars); Campbell v. Parker, 209 So. 2d 337, 339 (La. Ct. App. 1968) ('But even if plaintiff did threaten defendant with suit in the event she defaulted in her payments on the note, such action is not unlawful, since he was informing defendant of his legal rights,').

[FN139]. See Wells v. NLRB, 361 F.2d 737, 743 (6th Cir. 1966) (reversing the NLRB, and reinstating the findings of the Examiner, the court reasoned, 'The Board would dissect the entire program of Becka into separate events and would find each without significance. Its attempt to excuse singly each act of conduct appears to us to be without substance. Viewing the record as a whole, we conclude that the evidence and the reasonable inferences to be drawn therefrom substantially support the findings and conclusions of the Examiner rather than the conclusions of the Board.').

[FN140]. See Pickens-Bond Constr. Co. v. United Bd. of Carpenters, Local 690, 586 F.2d 1234, 1241 (8th Cir. 1978) (a union's 'intent is inferred from the nature of acts performed.').

[FN141]. See Carricarte v. State, 384 So. 2d 1261 (Fla. 1980) (holding that what constitutes improper coercion is an issue of fact to be determined in the context of the circumstances at issue, and vague, indirect and inferential coercion can constitute extortion); Matthews v. State, 363 So. 2d 1066, 1069 (Fla. 1978); Iozzi v. Maryland, 247 A.2d 758, 761-62 (Md. Ct. Spec. App. 1969) (holding that no precise words are necessary to constitute a threat and that the jury may find threats in innuendo or suggestion, may consider all of the Circumstances under which alleged threats are made, including the relations between parties, and must decide what was intended by the alleged blackmailer).

[FN142]. See Iozzi, 247 A.2d at 762.

[FN143]. See supra notes 129-141 and accompanying text.

[FN144]. See generally Richard A. Epstein, Blackmail, Inc., 50 U. Chi. L. Rev. 553 (1983).

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[FN145]. See San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236 (1959) (precluding a state court from awarding damages under state law for activities subject to the NLRA).

[FN146]. 29 U.S.C. § 157 (1994) (enumerating rights of employees). See Lechmere, Inc. v. NLRB, 502 U.S. 527, 532 (1992) (observing the legal distinction between employee and union rights under federal labor law and stating, 'By its plain terms, thus, the NLRA confers rights on employees, not on unions or their nonemployee organizers.' The court held that an employer could bar the union from his property.) (emphasis in original).

[FN147]. See Lechmere, 502 U.S. at 537 (' Babcock's teaching is straightforward: § 7 simply does not protect nonemployee union organizers except in the rare case where 'the inaccessibility of employees makes ineffective the reasonable attempts by nonemployees to communicate with them through the usual channels,' 351 U.S. at 112.') (emphasis in original) (internal citations omitted).

[FN148]. See id.; NLRB v. Tamiment, Inc., 451 F.2d 794, 799 (3rd Cir. 1971) ('It is only after union has made showing that it used reasonable efforts to utilize other available channels of communication off premises that board should proceed to consider total effectiveness of efforts and countervailing inconvenience and injury to employer having union organizers on premises and determine whether employer should be required to allow access to its premises for union representatives attempting to organize its workers.').

[FN149]. 29 U.S.C. § 158 (1994).

[FN150]. 29 U.S.C. § 158(c) (1994) ('The expressing of any views, argument, or opinion, or the dissemination thereof, whether in written, printed, graphic, or visual form, shall not constitute or be evidence of an unfair labor practice under the provisions of this subchapter, if such expression contains no threat of reprisal or force or promise of benefit.').

[FN151]. See Linn v. United Plant Guard Workers of America, Local 114, 383 U.S. 53, 63 (1966) (holding that a suit for injury to reputation is not made available, or made unavailable, under the NLRA and, therefore, such suit is not preempted. Reasoning, 'After all, the labor movement has grown up and must assume ordinary responsibilities.'). Clearly, if the state law tort of defamation is not preempted, because it is at most merely collateral to labor law, then the felony crime of blackmail is not preempted, See also McCandless v. Trans fenn Wax Corp., 840 F. Supp. 371 (W.D. Pa. 1993) (holding that federal labor law did not preempt employees' claims for fraud and breach of contract arising from an employer's alleged breach of representations that led employees to vote in favor of decertification of their union, even though an unfair labor practice charge could be stated on the same facts. and remanding to state court); Pygatt v. Painters' Local No. 277, 763 F. Supp. 1301, 1312-13 (D.N.J. 1991) ('In light of the state's interest in prohibiting conduct that is inherently and 'deeply rooted in local feeling' about what fair people do to one another in pursuit of their livelihoods, the court finds that Brennan's conduct of encouraging Union members to harass Love is peripheral to the NLRA and, therefore, not preempted.').

[FN152]. 410 U.S. 396 (1973).

[FN153]. 18 U.S.C. § 1951 (1970) (amended 1994) ('the Hobbs Act') (making it a felony offense to obtain the property of another through the use of force or fear 'in connection with or in relation to any act in any way or in any degree affecting trade or commerce.').

[FN154]. See Enmons, 410 U.S. at 401 ('The legislative framework of the Hobbs Act dispels any ambiguity in the wording of the statute and makes it clear that the Act does not apply to the use of force to achieve legitimate labor ends.').

[FN155]. Enmons, 410 U.S. at 408-10. But *see* 18 U.S.C. § 1951 (1970) (non-relevant sections amended in 1994) ('Whosoever in any way or degree obstructs. delays. or affects interstate commerce ... by robbery or extortion ....').

[FN156]. 410 U.S. at 411-12.

[FN157]. Id. at 398. See also id. at 412 (Blackmun, J.. concurring) ('This type of violence, as the Court points out, is subject to state criminal prosecution. That is where it must remain until the Congress acts otherwise in a manner far more clear than the language of the Hobbs Act.').

[FN158]. Enmons, 410 U.S. at 411 (quoting United States v. Bass, 404 U.S. 336, 349 (1971)).

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[FN159]. 315 U.S. 521 (1942).

[FN160]. See Enmons, 410 U.S. at 402.

[FN161]. See id. at 402-07.

[FN162]. Local 807,315 U.S. at 536.

[FN163]. 18 U.S.C. § 1952 (1994).

[FN164]. Id.

[FN165]. 393 U.S. 286 (1969) (reversing dismissal of indictments by United States District Court and holding that Pennsylvania law against blackmail is extortion within meaning of the Travel Act, 18 U.S.C. § 1952).

[FN166]. See 18 U.S.C.§§ 1961-62 (1994).

[FN167]. Id.

[FN168]. 419 So. 2d 963 (La. 1982).

[FN169]. Note the characteristic triangular structure of Moore's blackmail. The couple feared arrest and public embarrassment. Thus, the genuine interests Moore brought into play were the state's and the community of people having a reputational interest in the couple. See supra Part V.C.2.

[FN170]. See id. at 965-67. That Moore was on duty, versus a dinner break or off duty and on his way home, did not enter into the court's analysis. That Moore was in uniform mattered only in that this made his threat of arrest a credible threat. Id. at 967.

[FN171]. Id. at 969.

[FN172]. 2 K.B. 306,319 (1928).

[FN173]. Arthur L. Goodhart, Blackmail and Consideration in Contracts, 44 L. Q. Rev. 436, reprinted in Essays in Jurisprudence and the Common Law 177-78 (1931).

[FN174]. See supra note 39 and accompanying text.

[FN175]. See id.

[FN176]. See United States v. Perholtz, 842 F.2d 343, 353 (D.C. Cir. 1988) (surveying authority from the Third, Fifth, Seventh, and Eleventh Circuits, and upholding jury's conviction of individuals who conducted racketeering through an association-in-fact enterprise comprised of individuals, corporations, and partnerships).

[FN177]. See United States v. DeRosa, 670 F.2d 889, 896 (9th Cir. 1982) (upholding conviction of two narcotics dealers finding by virtue of their long association as narcotics dealers, a RICO enterprise was established).

[FN178]. See Steelworkers' Facts, supra note 38 at P 58 ('The USWA was solely responsible for the management, direction and control with respect to tactics employed in the corporate campaign.').

[FN179]. 751 F.2d 628, 633 (3d Cir. 1984).

[FN180]. See Steelworkers' Summary Judgment Brief, supra note 6, at 21-22. Third Circuit law was controlling in the Bayou Steel RICO litigation. The evolution of Third Circuit law is, however, generally instructive.

[FN181]. See Jaguar Cars, Inc. v. Royal Oaks Motor Car Co., 46 F.3d 258, 262 (3d. Cir. 1995) (discussing Enright and its progeny).

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[FN182]. 943 F.2d 297 (3d Cir. 1991).

[FN183]. 1 F.3d 1406, 1412 (3d Cir. 1993).

[FN184]. 39 F.3d 70 (3rd Cir. 1994).

[FNI 85]. 46 F.3d at 262.

[FN186]. Id. at 269.

[FN187]. See, e.g., Gasoline Sales, 39 F.3d at 73 (explaining Brittingham's parent-subsidiary distinctiveness rule: '[t]his is because we have interpreted corporate identity expansively, *so* that the actions of a corporation's agents conducting its normal affairs are constructively its own actions for Section 1962 (c) purposes.').

[FN188]. See Steelworkers' *Summary* Judgment Brief, supra note *6,* at 31 ('As we have stressed, and as every witness for the defendants who was questioned on the matter explained, the Bayou Steel campaign was a USWA campaign and all of the activities that were encompassed by the campaign were under the control and supervision of USWA District Director, later Vice- President for Administration, Richard Davis.').

[FN189]. 507 U.S. 170, 186 (1993).

[FN190]. See id. at 183.

[FN191]. See id. at 179.

[FN192]. See id. at 184.

[FN193]. See Steelworkers' Summary Judgment Brief, supra note *6,* at 22- 26; Steelworkers' Facts, supra note 38, at P 58.

[FN194]. See Steelworkers' Facts, supra note 38, at P 58 ('USWA Vice- President for Administration Richard Davis assumed and exercised full responsibility for all aspects of the direction of the campaign. '); Steelworkers' Summary Judgment Brief, supra note *6,* at 7 ('The Bayou Steel corporate campaign was USWA's campaign. The USWA and only the USWA managed, controlled, supervised and directed all aspects of the campaign. '); Id. at 21 ('The corporate campaign was USWA's campaign. USWA alone managed, directed and controlled the campaign.'); Id. at 25 (Richard Davis 'operated and managed all aspects of the USWA's corporate campaign that is at issue in this case.').

[FN195]. See Steelworkers' Summary Judgment Brief, supra note 6, at 57, 60-61.

[FN196]. See supra notes 110-141 and accompanying text.

[FN197]. See e.g., New Jersey v. Roth, 673 [redacted] 285, 288 (N.J.Super. 1996) (affirming blackmail conviction where pro se real-estate dealer claimed he was merely 'playing [economic] hardball' by threatening to file motion to set aside sheriffs sale on technical grounds) (bracketed text in original); State v. Harrington, 260 A.2d 692 (Vt. 1969) (veiled threat to make accusations of tax evasion and customs violations, as well as adultery, unless victim agreed to a divorce settlement is a crime); Connecticut v. Bassett, 200 A.2d 473 (Conn. 1964) (blackmailer convicted, who entered proprietor's store on a Sunday, threatened to accuse proprietor of violating Sunday closing laws unless money was paid); State v. McInnes, 153 *So.* 2d 854 (Fla.Dist.Ct.App. 1963) (threat to expose tax evasion unless paid money sufficient to charge crime of extortion); Commonwealth v. Keenan, 184 A.2d 793 (Pa. Super. Ct. 1962) (affirming conviction based on threat, inter alia, to disclose damaging information to the I.R.S. unless paid money). See also, United States v. Coyle, 63 F.3d 1239, 1250 (3rd Cir. 1995) ('The blackmail statute thus reaches those who would evade their responsibility to inform the authorities about a violation of the law by exchanging the promise to forebear from giving such information for some benefit.').

[FN198]. See Professional Real Estate Investors v. Columbia Pictures, 508 U.S. 49, 56 (1993) ('Those who petition the government for redress are generally immune from antitrust liability.' (citing Eastern R.R. Presidents Conference v. Noerr Motor Freight, 365 U.S. 127 (1961)). See also Noerr, 365 U.S. at 144 (extending protection to petitioning of administrative agencies and courts); USS - POSCO Indus. v. Contra Costa County. Bldg. & Constr., 31 F.3d 800, 810 (9th Cir. 1994) (extending protection to legislative lobbying). The Noerr-Pennington doctrine began as a rule of statutory construction, it is

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now well-understood to embody the First Amendment's freedom to seek redress. See Landmarks Holding Corp. v. Bermant, 664 F.2d 891, 895 (2d Cir. 1981).

[FN199]. See City of Columbia v. Omni Outdoor Adver., 499 U.S. 365, 380 (1991); California Motor Transport Co. v. Trucking Unlimited, 404 U.S. 508, 513 (1972) ('Misrepresentations, condoned in the political arena, are not immunized when used in the adjudicatory process.'); Noerr, 365 U.S. at 144 (finding the Sherman Act was not violated where '[n]o one denies that the railroads were making a genuine effort to influence legislation and law enforcement practices.').

[FN200]. Omni Outdoor, 499 U.S. at 382.

[FN201]. Id. at 380 (emphasis in original) ('A classic example is the filing of frivolous objections to the license application of a competitor, with no expectation of achieving denial of the license but simply in order to impose expense and delay.').

[FN202]. Columbia Pictures, 508 U.S. at 58 (citing Allied Tube & Conduit Corp. v. Indian Head, Inc., 486 U.S. 492, *500* n.4 (1988).

[FN203]. *See* United States v. Otter Tail Power Co., 360 F.Supp. 451 (1973) (finding exception to Noerr-Pennington immunity based on litigation timed and designed for anti-competitive purpose), aff'd, 417 U.S. 901 (1974) (subsequently cited with approval in Columbia Pictures, 508 U.S. at 58); Trucking Unlimited v. California Motor Transp. Co., 432 F.2d. 755 (9th Cir. 1970) (alleged 'information campaign' involving a multiplicity of administrative and legal actions was not entitled to immunity under Noerr- Pennington), aff'd, California Motor, 404 U.S. 508 (1972).

[FN204]. Otter Tail Power Co. v. United States, 410 U.S. 366, 380 (1973); cf. USS-POSCO Indus. v. Contra Costa County. Bldg. & Constr., 31 F.3d 800, 811 (9th Cir. 1994) (reconciling the Supreme Court's treatment of immunity where a single piece of litigation is challenged, as in Columbia Pictures, versus cases involving a 'whole series of legal proceedings,' as in California Motor).

[FN205]. See California Motor, 404 U.S. at 512-13 ('Misrepresentations, condoned in the political arena, are not immunized when used in the adjudicatory process.' Examples given by the court included: perjury of witnesses, fraud in obtaining patent, conspiracy with licensing authority, bribery of public purchasing agent); Litton Sys., Inc. v. American Tel. & Tel. Co., 700 F.2d *785* (2d Cir. 1983) (finding exception to Noerr-Pennington immunity where administrative processes were used to cause expense and delay); Landmarks Holding Corp. v. Bermant, 664 F.2d 891, 894- 96 (2d Cir. 1981) (finding abuse of judicial and administrative processes and holding that attempt to delay construction of competitor's shopping mall through orchestrated series of court and administrative actions not protected under Noerr-Pennington).

[FN206]. See e.g., Columbia Pictures, 508 U.S. at 73 (Stevens, J., concurring) ('Repetitive filings, some of which are successful and some unsuccessful, may support an inference that the process is being misused. '); Landmarks Holding *Corp.*, 664 F.2d at 894, 896 (where orchestrated plan to initiate proceedings sought to cause expense and delay, fact that some proceedings resulted in relief did not protect the plan under Noerr- Pennington).

[FN207]. See Litton Systems, 700 F.2d at 807 (in finding that Noerr- Pennington did not immunize an unlawful tariff plan, the court reasoned, 'The decision to impose and maintain the interface tariff was made in the AT&T boardroom, not at the FCC.').

[FN208]. See e.g., Columbia Pictures, 508 U.S. at 49; Manego v. Orleans Bd. of Trade, 598 F.Supp. 231, 238 (D. Mass 1984) ('Subsequent developments have held that this exception also applies to a single suit filed for an improper purpose, such as generating publicity unfavorable to a competitor.' (citing Energy Conservation v. Heliodyne, 698 F.2d 386 (9th Cir. 1982)).

[FN209]. See Columbia Pictures, 508 U.S. at 60-61. Defendants' misrepresent this test as a strict rule of universal application, see Steelworkers' Summary Judgment Brief at 60-63, but it is not. See Columbia Pictures, 508 U.S. at 75 (Stevens, J., concurring) (observing that 'objectively reasonable suits may still break the law.').

[FN210]. See Columbia Pictures, 508 U.S. at 67-75. The Steelworkers' view of Noerr-Pennington, which asserts an unabashedly broad reading of Columbia Pictures, would lead to absurd results. For example, consider a patent application based on intentional fraud. By assumption the applicant has both an objectively reasonable prospect of success, and a bona fide subjective interest in success. Using this reasoning, this fraud would be immunized under the First Amendment. That,

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however, is not the law. See Walker Process Equip., Inc. v. Food Mach. & Chem. Corp., 382 U.S. 172 (1965) (a single instance of enforcing a fraudulently procured patent can violate the Sherman Act); Hydranautics v. Filmtec Corp., 70 F.3d 533 (9th Cir. 1995) (holding intentional fraud in securing a patent strips immunity from antitrust claims).

[FN211]. See, e.g., California Motor Transport Co. v. Trucking Unlimited, 404 U.S. 508, 510 (1972). California Motor concerned a threatened and executed 'information campaign' by a consortium of trucking companies to procedurally exploit, to the fullest extent possible, a variety of both administrative and judicial proceedings to create barriers to entry in the trucking markets. See generally Trucking Unlimited v. California Motor Transport Co., 432 F.2d. 755 (9th Cir. 1970), where the District Court had dismissed the case, holding Noerr's 'sham' exception inapplicable 'because plaintiffs did not allege that the presentations defendants made to the agencies and the courts were in themselves false, misleading, or lacking in evidentiary or legal support.' Id. at 762. On appeal the Ninth Circuit applied Noerr's exception, reversed, and remanded the case for trial. Id. In reversing the District Court, the Ninth Circuit erroneously held that Noerr's protections do not reach actions initiated before agencies and courts. Id. Nevertheless, the Supreme Court affirmed the Ninth Circuit's reversal of the District Court, stating '[a] pattern of baseless, repetitive claims may emerge which leads the factfinder to conclude that the administrative and judicial processes have been abused .... It is well settled that First Amendment protections are not immunized from regulation when they are used as an integral part of conduct which violates a valid statute.' California Motor, 404 US. at 513-14. Thus, the repetitive exploitation of administrative and judicial procedures was condemned. Subsequently, in Columbia Pictures, 508 U.S. at 58, the Supreme Court cited with approval its opinion in California Motor for the proposition that 'a pattern of baseless, repetitive claims' is not immune under Noerr. Justice Stevens's concurrence, id. at 75, is especially instructive, '[r]epetitive filings, some successful and some unsuccessful, may support an inference that the process is being violated.' See also Otter Tail Power Co. v. United States, 410 US. 366, 371 (characterizing procedural exploitation as 'the weapon of litigation.'); USS - POSCO Indus. v. Contra Costa County. Bldg. & Constr., 31 F.3d 800, 811 ('California Motor Transport thus recognized that the filing of a whole series of lawsuits and other legal actions without regard to the merits has far more serious implications than filing a single action, and can serve as a very effective restraint on trade.').

[FN212]. See Israel v. Baxter Lab., Inc., 466 F.2d 272, 278 (2d Cir. 1972) (a basic concern of the courts is the integrity of the regulatory process. 'No actions which impair the fair and impartial functioning of an administrative agency should be able to hide behind the cloak of an antitrust exemption.').

[FN213]. USS-POSCO, 31 F.3d at 810-11 (expressly reconciling the Supreme Court's Noerr-Pennington jurisprudence from California Motor Transport Co. and Real Estate Investors). The issue has also been posed in the converse: if defendants were enjoined from conspiring to submit false allegations to government agencies, would the former be deprived of any constitutional right to petition or participate in the governmental process? See Woods Exploration & Producing. Co. v. Aluminum Co. of America, 36 F.R.D. 107, 111-12 (S.D. Tex. 1963) (denying Noerr immunity where false mineral forecasts were filed with agency), reasoning approved on appeal, 438 F.2d 1286 (5th Cir. 1971) Reversing and remanding for an evidentiary trial, the court reasoned, '[f]or the political process to be effective there must be freedom of access, regardless of motive, to ensure the 'right of the people to inform their representatives in government of their desires with respect to the passage or enforcement of laws.' (quoting Noerr) ... Where these poiitical considerations are absent the Noerr doctrine is inapplicable .... We think that the doctrine should not be extended unless the factors upon which Noerr rested are present and require the same result.') (internal citations omitted). Id. at 1296-97.

[FN214]. Noerr, 365 U.S. at 139.

[FN215]. See generally Real Estate Investors, 508 U.S. at 67-75 (Stevens, J., concurring) (surveying and analyzing the law).

[FN216]. See United States v. Quinn, 514 F.2d 1250. 1268 (5th Cir. 1975) ('It may categorically be stated that extortionate speech has no more constitutional protection than that uttered by a robber while ordering his victim to hand over the money, which [has] no protection at all.').

[FN217]. See Litton Sys., Inc. v. American Tel. & Tel. Co., 700 F.2d 785, 807 (2nd Cir. 1983) (fact that defendants' unlawful plan to maintain telephone network monopoly was executed through filings with agencies did not create First Amendment protections). Indeed, it can be the case that invoking governmental processes is a form of blackmail to expose the victim to the authorities. See, e.g., State v. Harrington, 260 A.2d 692 (1969) (veiled threat to make accusations of tax evasion and customs violations, as well as adultery, unless victim agreed to a divorce settlement); State v. McInnes, 153 So. 2d 854 (Fla.Dist.Ct.App. 1963) (threat to expose tax evasion unless paid money); Commonwealth v. Keenan, 184 A.2d 793 (Pa.

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Super. Ct. 1962) (affirming conviction based on threat, inter alia, to disclose damaging information to the I.R.S. unless paid money).

[FN218]. USS-POSCO, 31 F.3d at 811

[FN219]. See Steelworkers' Summary Judgment Brief, supra note 6, at 55-60.

[FN220]. 458 U.S. 886 (1982).

[FN221]. Id. at 914-32. Julia Johnson testified about her goals in the boycott as follows:
There were some things I really wanted, and the things I wanted were the right to vote, the right to have a title--Mrs. or Mr. or whatever I am, and not uncle or aunt, boy or girl.,..And if I wanted a job--a qualified job, I wanted to have the opportunity to be hired. Not hired because I'm black or white, but just hired.
Id. at 922, n. 62.

[FN222]. See id. at 889-93.

[FN223]. Id. at 914.

[FN224]. See id.

[FN225]. See id. at 912 ('Through speech, assembly, and petition--rather than through *not* or revolution--petitioners sought to change a social order that had consistently treated them as second-class citizens.'). Thus, Claiborne stands for the proposition that the First Amendment applies with the greatest force where fundamental political rights are genuinely sought and alternative to speech is either 'riot or revolution.'

[FN226]. Federal Trade Comm'n v. Superior Court Trial Lawyers Ass'n, 493 U.S. 411 (1990) (Justice Stevens--who authored Claiborne --delivered the opinion of the Court. The Supreme Court was unanimous with respect to all matters pertinent to this case).

[FN227]. See id. at 412.

[FN228]. See id. at 424-25. ('But in the Noerr case the alleged restraint of trade was the intended consequence of public action; in this case the boycott was the means by which respondents sought to obtain favorable legislation .... In Noerr, the desired legislation would have created the restraint on the truckers' competition; in this case the emergency legislative response to the boycott put an end to the restraint.') (emphasis in original).

[FN229]. Id. at 426.

[FN230]. Id. at 427. 'Respondents contend that, just as the Claiborne Hardware boycott sought to secure constitutional rights to equality and freedom, the lawyers' boycott sought to vindicate the Sixth Amendment rights of indigent defendants.' Id. at 427 n.11 (This argument was rejected. Good intentions do not justify otherwise unlawful conduct within the meaning of the First Amendment.).

[FN231]. 485 U.S. 568 (1988). See Steelworkers' Summary Judgment Brief, supra note 6, at 56-59.

[FN232]. See De Bartolo, 485 U.S. at 570-71, 588. The Court did not reach the First Amendment questions that would be raised by a converse interpretation of labor laws.

[FN233]. 29 U.S.C. § 106 (1994).

[FN234]. See United Mine Workers v. Gibbs, 383 U.S. 715, 739 (1966) ('What is required is proof, either that the union approved the violence which occurred, or that it participated actively or by knowing tolerance in further acts which were in themselves actionable under state law or intentionally drew upon the previous violence for their force.').

[FN235]. See id. at 737.

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[FN236]. Cox v. Administrator United States Steel, 17 F.3d 1386, 1409 (1 1th Cir. 1994) ('In Yellow Bus Lines, Inc. v. Local Union 639, 883 F.2d 132, 136 (D.C.Cir.1989), rev'd in part on other grounds, 913 F.2d 948 (D.C.Cir.1990) (en banc), cert. denied, 501 U.S. 1222 (1991), a Union president received a letter from the president of a bus company which contained allegations that Union members had committed violent acts; there was no evidence 'to indicate that the union took action to investigate the allegations or to curb any excesses' of the strikers. The D.C. Circuit held that from the Union's 'apparent lack of concern with the violence brought to its attention, the jury plausibly could conclude that the [Union] 'knowingly tolerated' this state of affairs. No more is required to support a finding of ratification.' Id. The situation in this case is similar to that in Yellow Bus Lines, and we find the reasoning of that case to be persuasive .... From the Union's failure to act, a reasonable jury could conclude that the Union 'knowingly tolerated' the situation, and thereby ratified it.').

[FN237]. See id.

[FN238]. See infra, notes 245 and 250 and accompanying text.

[FN239]. NLRB v. Local 294, Int'l Bhd. Of Teamsters, 592 F.2d 921, 928 (6th Cir. 1979) (affirming and adopting Special Master's findings, citing NLRB v. Bulletin Co., 443 F.2d 863, 867 (3rd Cir. 1971)).

[FN240]. Id. at 929.

[FN241]. See Alremose Constr. Co. v. Building & Constr. Trade Council of Philadelphia, 751 F.2d 653, 655-56 (3rd Cir. 1985) ('[O]n a Rule 56 motion we may not draw inferences or make findings. Thus even on issues of union authorization, participation in, or ratification of acts complained of, our role is to determine only whether such inferences are, under the evidence, logically permissible.'). See also Kerry Coal Co. v. United Mine Workers of America, 488 F.Supp. 1080, 1085-86, n.1 (W.D. Pa. 1980)
The Special Interrogatories and Answers thereto were. in part, as follows;
14. Has Kerry Coal Company established by clear proof participation in or ratification of violent acts directed against the Kerry Coal Company with regard to its contractual or business relationships, which were a substantial factor in directly causing damage to the Kerry Coal Company, on the part of:
a. United Mine Workers of America (International) Yes
b. United Mine Workers of America District No. 5 Yes
aff'd, 637 F.2d 957 (3d Cir. 1980) ('The court instructed the jury that it must find by clear proof actual participation or actual authorization of violent acts .... Once the jury has been properly charged as to the governing standard of proof, our role in assessing the propriety of a judgment notwithstanding the verdict is no different in such a case than in any other. '); Celotex Corp. v. United Steelworkers of America, 388 F.Supp. 1132, 1138 (E.D. Pa. 1974) ('Based on the evidence outlined above and other evidence presented at trial, the jury concluded that the plaintiff established by strict proof that the acts or statements which gave rise to the unauthorized work stoppage were actually authorized or subsequently ratified by the defendants. '); Solar Fuel Co. v. United Mine Workers of America. 346 F.Supp. 789, 797 (W.D. Pa. 1972) ('They also claim that the defendant unions cannot be held responsible for unlawful acts of individual officers, members or agents except upon 'dear proof of actual participation in or actual authorization of such acts, or ratification of such acts after actual knowledge thereof.' 29 U.S.C. § 106, and that there was an absence of clear proof as required by this act to send the case to the jury. The court ... painstakingly explained to the jury that with respect to liability of the labor unions the jury must find clear proof of the 'direction, authorization, participation in or ratification of such acts by the defendant as they are above explained. The jury was Further told that they could consider the presence of the organizers on the picket lines, their participation and instructions to pickets, their repudiation or lack of repudiation of alleged misconduct and discipiinary action taken or not taken against individuals. Clear proof was properly defined as 'clear, unequivocal and convincing proof. It was differentiated from the requirement of proof beyond a reasonable doubt in criminal cases and it was explained to the jury that this standard of proof applied not only to the charges of violation of the antitrust laws but also to the claims under Pennsylvania Iaw for destruction of property .... It appears that these instructions were in strict conformity with the requirements of U.M.W. v. Gibbs, 383 U.S. 715, 86 S.Ct. 1130, 16 L.Ed.2d 218 (1966) and Ramsey v. U.M.W., 401 U.S. 302, 91 S.Ct. 658, 28 L.Ed.2d 64 (19711.').

[FN242]. See supra note 42 and accompanying text.

[FN243]. See Bayou Steel Corp. v. United States Steelworkers of America, Local 9121, 108 Lab. Arb. (BNA) 1153 (Aug. 20, 1997) (Baroni, Arb.).

[FN244]. See NLRB v. Teamsters, Chauffeurs, Helpers and Taxicab Drivers, Local No. 327, 592 F.2d 921,928.

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[FN245]. Id.

[FN246]. See id. at 929.

[FN247]. The cases discussed immediately, infra, are those cited by the Steelworkers' Summary Judgment Brief.

[FN248]. 330 U.S. 395 (1947).

[FN249]. Id. at 406-07 (for imputed liability to attach there must be clear proof that the members' conduct either was authorized or ratified).

[FN250]. 383 U.S. 715 (1966).

[FN251]. Id. at 739 (internal footnote omitted).

[FN252]. See id. at 741-42.

[FN253]. See supra note 243.

[FN254]. See supra note 246.

[FN255]. Gibbs, 383 U.S. at 739.

[FN256]. Id. at 737 n.28.

[FN257]. 527 F.2d 269 (8th Cir. 1975).

[FN258]. Id. at 275 ('During the progress of this lengthy strike there was, it is clear, reprehensible conduct on the part of some union adherents.').

[FN259]. See id. at 276-77 (holding that routine payments of strike benefits was not ratification of member violence).

[FN260]. 744 F.2d 521. (6th Cir. 1984).

[FN261]. 616 F.2d 919 (6th Cir 1980).

[FN262]. 18 U.S.C. § 1964 (c) states in pertinent part, 'Any person injured in his business or property by reason of a violation of Section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee, ...'

[FN263]. The Steelworkers, too, failed to broach any damages issues in their summaryjudgment papers.

[FN264]. See Northrup, Corporate Campaigns, supra note 49, at 350.

[FN265]. Legal defense costs are an important component of the costs intended to be imposed on a corporate campaign target. See id. See also La Botz, supra note 49, at 127.

[FN266]. Such a rule would be similar to Rule 11 of the Federal Rules of Civil Procedure, or the Noerr-Pennington analysis for stand-alone cases articulated in Professional Real Estate Investors v. Columbia Pictures, 508 U.S. 49 (1993).

[FN267]. Such a rule would be similar to the equitable defense of unclean hands.

[FN268]. See generally A. Mitchell Polinsky & Steven Shavell, Punitive Damages: An Economic Analysis, 111 Harv. L. Rev. 869 (1998) [hereinafter Polinsky & Shavell] (using economic tools to explore optimal damages theories); Richard A. Posner, Economic Analysis of Law 77-8 (1st ed. 1972); Dorsey D. Ellis, Jr., Fairness and Efficiency in the Law of Punitive Damages, 56 S. Cal. L. Rev. 1 (1982) (outlining legal theories behind imposing punitive damages); Robert D. Cooter, Punitive Damages for Deterrence: When and How Much?, 40 Ala. L. Rev. 1143 (1989); Darryl Biggar, A Model of Punitive

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Damages in Tort, 15 Int'l Rev. L. & Econ. 1 (1995) (suggesting a possible efficiency justification for the main features of the law of punitive damages); James Boyd & Daniel E. Ingberman, Noncompensatory Damages and Potential Insolvency, 23 J. Legal Stud. 895 (1994) (discussing the optimal level of damages under strict liability when bankruptcy of the firm is a possibility; Bruce Chapman & Michael Trebilcock, Punitive Damages: Divergence in Search of a Rationale, 40 Ala. L. Rev. 741 (1989); Robert D. Cooter, Economic Analysis of Punitive Damages, 56 S. Cal. L. Rev. 79 (1982) (using economics to analyze punitive damages); Richard Craswell, Damage Multipliers in Market Relationships, 25 J. Legal Stud. 463 (1996) (discussing the usage of damage multipliers in determining optimal sanctions); Andrew F. Daughety & Jennifer F. Reinganum, Everybody Out of the Pool: Products Liability, Punitive Damages, and Competition, 12 J.L. Econ. & Org. 410 (1997); David Friedman, An Economic Explanation of Punitive Damages, 40 Ala. L. Rev. 1125 (1989); Thomas C. Galligan, Jr., Augmented Awards: The Efficient Evolution of Punitive Damages, 51 La. L. Rev. 3 (1990) (proposing a system of extracompensatory damages based solely on deterrence); David D. Haddock, Fred S. McChesney & Menahem Spiegel, An Ordinary Economic Rationale for Extraordinary Legal Sanctions, 78 Cal. L. Rev. 1 (1990) (using a property rights analysis to determine optimal damages); Jason S. Johnston, Punitive Liability: A New Paradigm of Efficiency in Tort Law, 87 Colum. L. Rev. 1385 (1987) (discussing punitive liability as an alternative to more traditional notiions of negligence and strict liability); Marcel Kahan & Bruce Tuckman, Special Levies on Punitive Damages: Decoupling, Agency Problems, and Litigation Expenditures, 15 Int'l Rev. L. & Econ. 175 (1995) (analyzing the effects of levy statutes on litigation incentives and outcomes); William M. Landes & Richard A. Posner, An Economic Theory of Intentional Torts, I Int'l Rev. L. & Econ. 127 (1981); George L. Priest, Insurability and Punitive Damages, 40 Ala. L. Rev. 1009 (1989) (discussing issues relating to the insurability of punitive damages awards); George L. Priest, Punitive Damages and Enterprise Liability, 56 S. Cal. L. Rev. 123 (1982); Paul H. Rubin, and John E. Calfee & Mark F. Grady, BMW v Gore: Mitigating The Punitive Economics of Punitive Damages, 5 Sup. Ct. Econ. Rev. 179 (1997) (proposing the regulation of long-arm jurisdiction as a means of mitigating excessive punitive damages through the mechanics of federalism).

[FN269]. Deterrence and punishment are traditionally said to be the goals of punitive damages, See City of Newport v. Fact Concerts, Inc., 453 U.S. 247, 266-67 (1981) ('Punitive damages ... are ... intended to ... punish the tortfeasor whose wrongful action was intentional or malicious, and to deter him and others from similar extreme conduct.'); Gertz v. Robert Welch, Inc., 418 U.S. 323, 350 (1974) ('[Punitive damages] are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.')+

[FN270]. The theory of deterrence--the elaboration of the effect on rational actors of the possible imposition of sanctions for violations of law--was first articulated in detail in Jeremy Bentham, Principles of Penal Law, in 1 The Works of Jeremy Bentham 365, 365- 580 (John Bowring ed., 1952) (1838-43), and has been developed intensively in recent decades, stimulated largely by Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. Pol. Econ. 169 (1968). This literature is synthesized and surveyed in R.A. Can-Hill & N.H. Stem, Crime, the Police and Criminal Statistics: An Analysis of Official Statistics for England and Wales using Econometric Methods (1979); William A. Luksetich & Michael D. White, Crime and Public Policy (1982); David J. Pyle, The Economics of Crime and Law Enforcement (1983). Beginning with Guido Calabresi, The Costs of Accidents (1970), many writers have applied the general theory of deterrence to the subject of tort liability. For an integrated presentation of this literature, see William M. Landes & Richard A. Posner, The Economic Structure of Tort Law (1987), and Steven Shavell, Economic Analysis of Accident Law (1987).

[FN271]. See Polinsky & Shavell, supra note 268, at 887, and sources cited therein.

[FN272]. Id. at 877-88.

[FN273]. See, e.g., Kelco Disposal, Inc. v. Browning-Fems Industries of Vermont, Inc., 845 F.2d 404, 411 (2d Cir. 1988) (reasoning in an antitrust case, 'Where, as here, the prevailing party elects a remedy provided by state law [punitive damages], and thereby forgoes its treble damage award, it should forgo the entire remedy provided by federal law, including attorneys' fees.... Having turned its back on the federal remedy, Kelco must perforce lose the federal reward.'), aff'd, Browning-Ferris Indus. of Vermont, Inc. v. Kelco Disposal, Inc., 492 U.S. 257 (1989). See also, Jonathan Turley, The RICO Lottery and the Gains Multiplication Approach: an Alternative Measurement of Damages under Civil RICO, 33 Vill. L. Rev. 239, 243 (1988) [hereinafter Turley, The RICO Lottery] ('In developing civil RICO's damages provisions, Congress relied heavily on the antitrust penalties contained in Section 4 of the Clayton Act, particularly the latter's treble damages provision.') (Citing 113 Cong. Rec. 17,999 (1967) (statement of Sen. Hruska) (RICO takes readily from the antitrust laws); 115 Cong. Rec. 6,995 (1969) (statement of ABA, Antitrust Sec.) (same)).

[FN274]. See Polinsky & Shavell, supra note 268 at 889 (observing that the correct punitive damages multiplier is the

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reciprocal the probability of a claim being brought). Here the punitive damages multiplier is fixed at one.

[FN275]. See generally Polinsky & Shavell, supra note 268.

[FN276]. For example, Section 1 of the Sherman Act, 15 U.S.C. § I, condemns 'every contract, combination ... or conspiracy in restraint of trade. ' Despite the broad scope of this proscription, however, it is rudimentary antitrust jurisprudence that Congress did not intend to outlaw all contracts, even though all contracts restrain trade. See, e.g., Standard Oil Company of New Jersey v. United States, 221 U.S. 1, 88-89 (1911) (only contracts that are an unreasonable restraint of trade are condemned). Accordingly, the analogous RICO inquiry could be posed as whether Congress sought to exclude economically efficient (e.g., socially beneficial) racketeering.

[FN277]. Turley, The RICO Lottery, supra note 291 at 250 ('The primary purpose of civil RICO is prosecutorial, not compensatory.') (footnote omitted).

[FN278]. See Id. at 268 ('The social costs of racketeering defy computation. Moreover, even if they were capable of calculation, the malum in se community standard presupposes the absence of an efficient level of racketeering.') (footnote omitted).

[FN279]. See id. at 252 ('RICO guarantees potential litigants attorney's fees, liberal venue and service of process provisions, and the ability to join a large number of defendants in an apparent effort *to* maximize the number of cases as well as the amount of damages.') (citations omitted.).

[FN280]. See id. ('Quite to the contrary, RICO is first and foremost a penalty-maximizing statute and is largely unconcerned with who gets the damages so long as the violator's resources are duly depleted.').

[FN281]. Discipline usually is reviewed under the 'just cause' standard, which in practice allows arbitrators, NLRB, and courts to consider mitigating factors (such as an employee's length of service, prior work record, and whether the employer had a stated rule against the offensive conduct) in deciding whether to uphold challenged discipline. See, e.g., NLRB v. Mueller Brass Co., 509 F.2d 704 (5th Cir. 1975); NLRB v. Soft Water Laundry, Inc., 346 F.2d 930 (5th Cir. 1965). Bayou Steel negotiated a disciplinary review standard that disallowed such factors (save provocation), and which provided instead that if certain enumerated offenses (for instance violence, destruction of property, threats, or intimidation) were shown, discipline would be upheld.

[FN282]. See supra note 34, sources cited therein, and accompanying text.

[FN283]. See Forms LM-2 for United Steelworkers of America, International, and Local 9121 for the years 1993-1996 (the unions spent approximately one million dollars per year funding the strike and corporate campaign against Bayou Steel).

[FN284]. See generally Florida Steel Corp. v. NLRB, 587 F.2d 735, 739 (5th Cir. 1979) ('In 1973 the Union commenced organizing campaigns at the Company's steel mills in Charlotte, North Carolina, and Jacksonville, Indiantown, and Tampa, Florida. The Union campaign at the Tampa plant began in 1973. It resulted in a Board-conducted election on February 26, 1976. Although the Union lost that election by an overwhelming vote, it was subsequently set aside by the Board on October 14, 1976, because of objections filed by the Union, and a second election was ordered to be conducted at such time as is deemed appropriate by the Board's regional office.'); Florida Steel Corp. v. NLRB, 586 F.2d 436, 437 (5th Cir. 1978) ('The Union began an organization campaign at the Tampa plant in 1973.... Union elections were held simultaneously in the Traffic Division, the Mill Division, and the Rebar Division of the Tampa plant in February, 1976. The Union lost the elections by an overwhelming vote of from three to five to one. The Union filed objections and the Board set aside the elections and ordered new elections held.'). The Union, however, never won bargaining rights at these plants.

[FN285]. See, e.g., Nancy Kelly, USW chief points finger at LTV. (LTV-Trico venture questioned by United Steelworkers of America), Am. Metal Market, March 8, 1996, at 12 ('Frustrated by the plans of LTV-Trico Inc., Cleveland, to build a flatrolled steel mini-mill in Decatur, Ala., and manufacture product with nonunion labor, United Steelworkers union president George Becker used his time before the Congressional Steel Caucus yesterday to berate the company specifically and mini-mills in general.'); Marcus Gleisser, USW Protests Alabama LTV Plant, The Plain Dealer, August 6, 1995, at H5 ('LTV's position is Trico employees should have the right to decide on union representation and it would be illegal for LTV to force Trico to violate the right of their employees to choose whether they wish to be represented by a union.').

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[FN286]. For example, Ravenswood had 1700 employees whom the operating management had permanently replaced, while Bayou had only 300 employees and used only temporary replacements.

[FN287]. For accounts based up Steelworker claims, see Sandra Livingston, Up from the Ranks, New Steel Workers Chief Has Record of Successes, The Plain Dealer, March 1, 1994, at C1 ('The campaign was so successful that even Coca- Cola Co. and Miller Brewing Co. switched aluminum suppliers during the dispute. '); Charles Jarvis & Ron Lewis, RAC on Brink of 'Financial Ruin', Parkersburg News, May 5, 1992, 1992 WL 3152809 ('The union persuaded Anheuser-Busch, Miller Brewing and Stroh Brewery not to buy RAC aluminum sheet for cans. '). In fact, we believe that only Stroh, the smallest of the companies involved, actually did drop Ravenswood as a supplier, as recounted in supra note 59.

[FN288]. See Ken Ward, Jr., Aluminum Company Chief Praises Sale, Charlston Gazette, Apr. 13, 1994, 1994 WL 12839746 (Ravenswood's ousted chief executive, Emmett Boyle, 'had denied Rich was involved with the company, but later said otherwise in court documents'); Stephen Franklin, Steelworker's Victory an Ending Labor Likes, Chi. Trib, May 29, 1992, 1992 WL 4486498.

[FN289]. See Perry, Union Corporate Campaigns, supra note 48.

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TOOLS AND RESOURCES FOR FINANCIAL EXECUTIVES

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.

Alix Nyberg, CFO Magazine
September 08, 2003

Bill Teuber prickles a bit at the notion that the landmark Sarbanes-Oxley legislation has forced major reforms within EMC Corp. "I think about internal controls all the time; I didn't need the law to get me to think about them," says the CFO of the $5.4 billion information-storage giant. For the past decade, Hopkinton, Massachusetts-based EMC has carefully tracked its financial results with monthly closes and updated forecasts, says Teuber. In the same spirit, his regional controllers have been attesting to their compliance with EMC's procedures since mid-2001 — before Enron imploded. Teuber has also been thinking about financial transparency since being promoted to CFO in 1998, breaking down revenue streams by product classes rather than broad categories, and disclosing the quarterly earnings impact of stock options a5 early as July 2002.

Yet by the end of the year, EMC will have spent more than $1million and thousands of man-hours complying with two of the main statutes in the Sarbanes-Oxley **Act** of 2002 — Section 404, related to internal controls; and Section 302, mandating CEO and CFO certifications of quarterly financial statements. Teuber won't even speculate on the price tag for full compliance, except to say "it's not insignificant." Moreover, he doesn't expect that burden to lift, thanks to ongoing testing and disclosure requirements. "Even maintenance mode will require a sizable effort," he says.

Like Teuber, CFOs across America say they are spending more time and money trying to shoehorn existing practices into legally acceptable formats. Forty-eight percent of companies will spend at least $500,000 on Sarbanes-Oxley compliance, according to finance executives who participated in a recent CFO magazine survey. Unlike Teuber, however — who sees the increased internal-controls documentation as "a chance to get best-of-breed solutions in our sales offices across 50-plus countries" — other CFOs (nearly 40 percent) see the increased burden as having "very little" or "no effect" on their current processes. Moreover, only 30 percent believe the benefits uutweigh the costs.

In fact, many CFOs, such as Borland Software Corp.'s Ken Hahn, who expects to spend $3 million on compliance — including having some 25 percent of Borland's employees sign papers "saying they're not doing anything wrong" — see Sarbanes-Oxley as nothing more than "an efficiency tax." Stephen P Bishop, CFO of Berkshire Hathawayowned NetJets Inc., speaks for many when he says the "documenting and papering" of internal controls for Section 404 compliance will result in little "value-add." And €. Follin Smith, CFO of $4.7 billion Constellation Energy Group, goes so far as to say the law could eventually make the "fear of personal liability so great that managers are afraid to take risks on innovation."

Indeed, many finance executives believe that in seeking to curb the freewheeling ways of the likes of Enron, Tyco International, and WorldCom, Congress has committed some excesses of its own. Part of the problem, of course, was the haste with which the law was written. "If Congress had given the [Securities and Exchange Commission] more time to promulgate the regulations and the SEC had gtven companies more time to comply, costs would have been lower," says Goodwin Procter LLP partner Steve Poss. Instead, by rapidly legislating a whole set of processes, the law has become a windfall for auditors and lawyers and a time drain on overburdened finance departments. Moreover, the liability implications have "put people so on edge that they're looking over their shoulders all the time to see whether they're perceived as doing the right thing, not whether they are doing the right thing," says LCC International senior vice president **and** CFO Graham Perkins. "I don't think the legislators really understood all of the adverse consequences."

Perception Versus Reality

It's hard to know exactly what Congress expected, since it did not assess any costs when it passed the law. That's not unusuat, since "there's no formal process for Congress to calculate benefits or costs of legislation," says Thomas McCool, head of financial markets and community investment at the General Accounting Office. "Sometimes they try to get indications from various parties, but when it's something prospective like this, [costs] would be *very* hard *to* tell."

The SEC, though, is required to estimate the burdens associated with its information requests under the Paperwork Reduction Act of 1995, and so has offered some guesses at future costs in piecemeal fashion. Such guesstimates have been chronically low. For one thing, they are typically limited to disclosure activities, and don't attempt to quantify costs like software purchases, audit-fee increases, or management and staffing requirements. The agency also tends to lowball the number and costs of hours of external help involved. "Most professionals look at these estimates and laugh," says Poss.

Reg FD compliance, for example, was projected to add a maximum $49.5 million to total annual disclosure costs when the rule was passed in August 2000, but actually cost somewhere between $250 million and $450 million, according to a Securities Industry Association (SIA) study in May 2001. That divergence was in large part based on the SEC's assumption that hourly legal fees were $85 to $175, compared with the $450 to $550 the SIA reported.

The same mistakes plague Sarbanes-Oxley, says Poss. The agency's new assumption is that outside legal fees will run $300 per hour, a figure with which most CFO respondents concur. Poss argues that fees will run higher. "These are not quick consultations, and they're usually with senior partners," whose rates run from $400 to $700 per hour in most big cities, he says.

No doubt, the SEC's biggest miscalculation was its original estimate that Section 404 compliance would require an additional five hours' worth of work per annual and quarterly filing. The figures were too low "by at least a factor of 100" if not more, wrote Cary Klafter, director of corporate affairs for Intel's legal department, in a November letter to the SEC. "We can only hope that the Commission's burden estimates are not used for any substantive governmental purpose, since they are completely incorrect."

While the SEC typically receives few comments on such estimates, this one raised the ire of so many companies that the agency was forced to recalculate — ending up instead with an average 383-hour workload per company, for a total annual price tag of $91,000, not including additional auditors' fees. "We recognize the magnitude of the cost burdens and we are making several accommodations to address commenters' concerns and to ease compliance," the agency said in its final rules on Section 404, released June 5.

Those accommodations included changing the requirement to test internal controls from a quarterly to an annual activity (unless they are materially changed) and extending the Compliance deadline from September 30, 2003, to fiscal years ending on or after June 15, 2004, for accelerated filers; all others will have a compliance deadline of April 15, 2005. The detay "was an effort to hetp reduce the burden in general, and help make sure it was done right," says SEC commissioner Cynthia A. Glassman. "We did not want a system where [companies] were going to have to redo things."

Just doing it the first time, however, will not be a picnic. While the year extension has prevented a lot of what SPSS CFO Edward Hamburg calls "unnecessary thrashing and spending," the rules make little accommodation for companies of different sizes and growth stages. And even the revised cost estimates are considered "low" or "very low" by more than 80 percent of survey respondents. That irks those who believe the SEC should be held to the same standard as the firms it regulates. "In Corporate America, if you make a bad prediction of what cost of sales or revenues are going to be in a future period, you're likely to get grilled by the SEC about why you thought it was reasonable," says Poss. "It would be interesting to see the same standard applied to regulators."

The Usual Beneficiaries

The yearlong respite reduces the need for outside help, and hence the cost. However, tt won't change the fact that two constituencies — auditors and lawyers — stand to reap great gains as firms plow ahead. And given the uncertainty over what will get a pass from the SEC, the final tab is a moving target.

EMC has hired Deloitte & Touche to help sift its balance sheet and income statement into 30 processes (like sales and stock-option granting) and 250 subprocesses (like order taking, shipping, and billing), document them, test them, and package them into a central database for future audtt purposes. But EMC's external auditor, PricewaterhouseCoopers, is also "part and parcel of the process," according to Teuber, giving informal approval to the firm's compliance strategy and fielding audit-committee questions on how well EMC is doing on compliance compared with other firms. (Companies can't use their external auditors to help them prepare the controls, but can consult with them on compliance strategies.)

Teuber says it's helpful to have two of the Big Four audit firms on the project. "It's all virgin territory," he says, "so you wouldn't want to do this in a vacuum." But those firms will be the ones collecting the bulk of EMC's $1 million compliance payments for 2003, excluding the final attestation fee.

Many of the Section 404 projects, such as documentation, are one-time efforts. But Sarbanes-Oxley is also guaranteeing audit firms a future income stream by requiring them to attest to the soundness of management assessment of internal controls once a year starting with 10-Ks filed on or after June 15, 2004. The final annual tab for that exercise is uncertain. The Public Company Accounting Oversight Board has yet to issue standards regarding how many controls must be tested, in what manner, and according to what criteria, so audit firms appear to be taking their time estimating the fees for attesting to internal controls. But so far, according to a Financial Executives International survey, CFOs expect to see audit fees increase 35 percent on average, and up to 100 percent at some companies.

What exactly audit firms will do to justify such increases is also cause for consternation. At Digene Corp., a Gaithersburg, Maryland, biotech firm, for example, president and CFO Charles M. Fleischman has watched his audit bill with Ernst & Young

and other compliance-related fees increase by 72 percent for 2003. **He is** currently negotiating fees for 2004, which coutd jump by another 70 percent. And while he insists he has a good relationship with his auditor, Fleischman just wants "to understand what the scope of the work is — and how that matches up against the bill." *So,* before he authorizes payment for 2004, he is working with his audit committee and E&Y to determine exactly "what they are doing and where they are going to draw the line between assuring quality in financial reporting and just adding costs."

Legal costs are also on the rise, although CFOs say they are not generally **as** onerous as audit fees. Magma Design Automation Inc. CFO Greg Walker expects to spend an incremental $200,000 to $300,000 for legal work in the next 12 to 18 months, including efforts to monitor compliance, set up a whistle-blower program, and train employees. That's on top of an additional $750,000 in audit and consulting fees. On average, legal fees nearly doubled, to $404,000, between 2002 and 2003, according to an April survey by law firm Foley & Lardner.

Ranking tow on the list of costs is software. Forty percent of finance executives say compliance will not affect their IT budgets, while another 25 percent say it will involve minimal IT costs, according to a **CFO** IT survey. "Tools are often bundled with consulting fees; I don't think [software is] an integral part of the solution," says Kim Roll-Wallace, vice president of consulting for The Johnsson Group Inc. EMC, in fact, uses Excel, "We've found it works quite well in this regard," says chief accounting officer Mark Link, largely because "everyone already knows how to use it."

Multiple Price Tags

Then there are the indirect costs. The requirement to disclose off-balance-sheet structures more clearly has encouraged some companies to bring these structures on the balance sheet and others to collapse them entirely. Financial experts have become hot properties now that companies are required to disclose if they have one on their board. Restrictions on nonaudit work that a company's auditor can perform has left CFOs scrambling for new tax consultants. Meanwhile, the whistle-blower provision has sparked untold numbers of costly internal investigations.

Of course, there's also an opportunity cost associated with compliance activities. In fact, 33 percent of respondents say they've delayed or canceled projects as a result of Sarbanes-Oxley. Internal staff development is the most common casuatty. Moreover, executives say the focus on compliance has also left them frazzled, with less time to mull strategic decisions, as compliance efforts absorb more than 10 percent *of* a CFO's time in roughly **4** out of 10 companies.

One example of the strain: LCC's Perkins says he has made more lengthy and complicated trips, partly to spearhead compliance efforts across operations at more than 10 locations in six countries. "Instead of being a business partner **and** doing all the positive things you'd like to do, you're doing the negative things, like triple-checking a filing," says Perkins. In fact, he says he might have thought twice about taking his job at the $100 million wireless-services firm last January if he had known how much compliance-related work it would involve. "I did not anticipate when I jorned this company that I **would** become a surrogate for the **SEC,"** he says.

And this is just the beginning. About 35 percent of survey respondents expect annual compliance efforts to absorb at least $500,000 of their revenues and more than 10 percent of their time going forward, thanks in large part to Section 404's mandate *for* ongoing controls testing and auditor attestation. That's not counting, of course, the price of changing auditors every five years, as Sarbanes-Oxley mandates.

No one should look for additional relief from the SEC. Glassman says she believes changes could be a possibility "if we start hearing that companies are spendtng a lot of money to comply but there are no apparent benefits, or if we hear there are more efficient ways to accomplish the same objectives." However, there are no formal efforts under way within the government to test cost assumptions, and she says such a study would be hard to design. "It's a very difficult equation. The costs are explicit. There's also some distraction from running the business. But the benefits are very intangible."

No Guarantees

Indeed, survey respondents are about evenly split on whether going through the compliance process has yielded internal benefits, such as more-efficient processes or more respect for the finance department. "It's a constant struggle to try to get benefit out of **404** work," says consultant Roll-Wallace. "In any given company, about 50 percent is work that puts in best practices and the other 50 percent is a dog-and-pony show, putting everything into a neat package for the auditors."

There may be some external benefits, however, says Magma's Walker. The legislation has sped up his time frame for reporting improvements at the $75 million company, he says, but to good effect. "I probably do better **deals** with customers — the earlier you can detect issues, the better you can structure a contract," he says. And there may be spillover effects, says Borland's Hahn, who is hoping to leverage his new director of financial governance as a "process-improvement specialist."

As for the SEC's larger goal of improving investor confidence, though, there's little agreement on how that will be achieved. On one hand, "you're more confident that senior people are taking extra care to derive the best possible information," says

Robert D. Spremulli, a TIAA-CREF senior analyst. But it's hard to see the direct effects of those sentiments, given the multivariate nature of the market. Indeed, major indices showed varying degrees of improvement on Sarbanes-Oxley's one-year anniversary, with the Nasdaq composite index closing up 30 percent from its year-earlier level, but the New York Stock Exchange, the S&P 500, and the Dow Jones Industrial Average up by only 8, 8, and 6 percent, respectively.

And many still question whether Sarbanes-Oxley is an effective inoculation against future financial frauds. "Just having a good control environment doesn't guarantee that people will act ethically," says Deloitte & Touche enterprisewide risk-service partner Stephen Curry. Enron's trading operations, he points out, were cited as a model for enterprisewide risk management in former Andersen partner James DeLoach's 2000 book on the topic. Those close to the company agree. "What allowed Enron to melt down was its culture, and I don't think Sarbanes-Oxley would have changed that," says Sterling Chemical Inc. controller John Beaver, whose Houston office is across the street from Enron's headquarters.

Even companies touched by scandal are skeptical of Sarbanes-Oxley's healing powers — at any price. Tyco, for example, is spending north of $5 million to comply with the act and generally clean up its image by developing new editions of its controllership guide and ethics manual. Still, "that's not to say that we can document routines and controls and be assured that nothing improper will happen," says corporate-governance head Eric Pillmore. "What we hope is that by doing this, we detect problems earlier."

Across the Board

With the Sarbanes-Oxley act of 2002 raising expectations and liabilities for directors, it's no surprise that board-related costs are rising for most public companies — albeit slowly. To date, only about 14 percent of companies have seen those costs jump by more than 50 percent, according to the CFO survey, while 17 percent have not seen any hikes yet.

Those numbers are likely to increase as more companies confront higher directors' and officers' insurance premiums. Many are also in the process of adding new directors to comply with independence requirements and sweetening the pots for current ones. At its annual meeting in August, for example, Computer Associates International Inc. was seeking shareholder approval to boost the value of its annual directors' compensation from about $95,000 last year to $150,000 this year, and reversing its longtime policy of stock-only payments to allow directors to take up to half of that fee in cash.

"Board members, audit-committee members in particular, have been given a whole host of new duties," says CA corporate-governance head and corporate secretary Robert Lamm. (Audit committees, for example, must now oversee the auditors, preapprove any nonaudit services they provide, and decide how to classify nonaudit services in annual filings.) The fee increases "represent the time involved in additional documentation, for better or worse, and the checking of additional boxes."

A Silver Lining for Some

At this point, many companies are still performing low-tech risk-mapping processes to gauge the impact of Sarbanes-Oxley. But the technology sector has high hopes that soon that will give way to a need for new tools. In fact, First Albany technology strategy analyst Gerard Hallaren expects spending on compliance-related technology to grow by $8 billion to $12 billion in the next year. "We've seen a modest push from Sarbanes-Oxley so far, but I think the real spending will kick in at the end of this year," he says.

Content and document management tools, along with analytics, are likely to be among the first beneficiaries of the law, predicts Hallaren, since "auditors are going to have a hard time auditing lots of individual spreadsheets" in the Excel formats that many companies now use. Data-storage companies are likely to be next in line, as analytical and data-management systems become more voluminous.

EMC Corp., which recently debuted the "compliance edition" of its Centera product, is one of the companies waiting for the windfall. The product codes information with a unique identifier, and can automatically delete documents at the end of their required retention period. "It's more accidental offense than planned," says CFO Bill Teuber, "but any number of regulations out there...require more information to be stored, and clearly our products help in that regard."

Tough Act to Follow

In August, *CFO* Magazine E-mailed a questionnaire on Sarbanes-Oxley compliance to senior financial executives drawn randomly

from our circulation list. We received 220 responses; 139 from executives at publicly traded companies. The results below represent a combination of both public and private company responses. Note: Numbers may not add up to 100%, due to rounding.

1) Who is responsible for Sarbanes-Oxley compiiance at your company?

CFO	55%
Controller	30%
Assistant Controller	2%
Treasurer	1%
Other	12%

2) Are you tracking the costs to your company of implementing Sarbanes-Oxley?

Yes	44%
No	56%

2a) If not, when do you expect to do so?

Within 3 months	13%
Within 6 months	16%
Within 12 months	16%
More than 1 year	7%
Never	48%

3) What do you estimate to be the total costs to your company to implement all portions of Sarbanes-Oxley requirements in the first year (including external audit, legal, and consulting fees; new hires; and software purchases, but not board-related costs)?

Less than $500,000	52%
$500,000 to $999,000	23%
$1 million to $2.9 miltion	16%
$3 million to $5 million	6%
More than $5 miltion	3%

4) What do you expect annual compliance costs to be going forward (including external audit, legal, and consulting fees; new hires; and software purchases, but not board-related costs)'

Less than $500,000	65%
$500,000 to $999,000	22%
$1 million to $2.9 million	7%
$3 million to $5 million	3%
More than $5 million	3%

5) What percentage of your time has been spent on Sarbanes-Oxley compliance, on average, per month, over the past year?

None	14%
1% to 10%	51%
11% to 20%	20%

21% to 35%	9%
36% to 50%	3%
More than 50%	3%

6) Going forward, how much time **do** you **expect** to spend on Sarbanes-Oxley compliance monthly?

None	10%
1% to 10%	56%
11% to 20%	**24%**
21% to 35%	6%
36% to 50%	0%
More than 50%	3%

7) Have projects or initiatives been delayed or canceled as a result of Sarbanes-Oxley compliance?

Yes	33%
No	54%
Not sure	13%

7a) If yes, please check all that apply.

Internal staff dvlpmnt.	24%
Technology purchases	14%
Other capital expenditures	9%
M&A activity	6%
Other	9%

8) How much have internal processes changed in response to compliance-related efforts at your company?

Very much	6%
Some	56%
Very little	28%
Not at all	10%

9) Has going through the Sarbanes-Oxley compliance process yielded any internal benefits for your company?

Yes	49%
No	52%

9a) If yes, please check all that apply.

More efficiencies in reporting processes	23%
More accurate numbers	10%
Cost savings	3%
Other	22%

10) Overall, **do** you think the benefits of compliance outweigh the costs?

Yes	30%
No	70%

11) How much have total costs to retain directors (including salaries and directors' and officers' insurance) increased over last year?

None	28%
1% to 10%	20%
11% to 25%	27%
26% to 50%	15%
51% to 100%	9%
More than 100%	1%

Not Adding Up

How realistic are the following cost assumptions made **by** the SEC? Note: Numbers may not add up to 100%, due to rounding.

1) External legal and audit fees run an average of $300 per hour.

Very low	3%
low	24%
Accurate	56%
High	16%
Very high	1%

2) Internal professional staff costs are $125 per hour.

Very low	2%
Low	13%
Accurate	47%
High	33%
Very high	5%

3) Complying with Reg G (reconciling pro forma to reported earnings) can **be** accomplished by an in-house Junior accountant in about 30 minutes per filing, at a cost of $13 including overhead.

Very low	50%
Low	39%
Accurate	11%
High	0%
Very high	0%

4) Disclosure associated with off-balance sheet arrangements costs $10,000, including in-house staff time and outside professional fees.

Very low	15%
Low	45%
Accurate	33%
High	5%
Very high	2%

5) Additional disclosure associated with nonaudit fees and

changes in practices to promote auditor independence takes about two hours, half a page of a proxy and/or 10-K, and costs about $418 per filing, including internal and external staff fees.

Very low	23%
Low	53%
Accurate	23%
High	2%
Very high	0%

6) The average annual cost of implementing Section 404 is around $91,000 per company.

Very low	23%
Low	53%
Accurate	13%
High	6%
Very high	0%

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Corporate Governance Highlights

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Proposed Proxy Access Rule Leaves Proponents Uncertain About Preparations for 2004 Proxy Season

BIG QUESTION IS WHICH TRIGGER TO ATTEMPT. Now that interested parties have had a chance to dissect the SEC's complex proposal to allow shareholders to nominate their own candidates to the board, shareholder proponents are wondering how they should proceed with plans for prosy season 2004.

Under the scenario presented by the SEC's rule, shareholder proposals on prosy access—one of the triggers that could allow shareholder nominees onto the company's prosy ballot—would have to be submitted to companies in accordance with the 14a-8 shareholder proposal rules. This means that the proposals would be subject to 14a-8 submission deadlines and could be challenged by companies under the no-action provisions. Most of the submission deadlines fall in November and December because a majority of companies hold their annual meetings in the spring (14a-8 requires that proposals be received by companies not less than 120 calendar days before the anniversary of the date that their previous annual meeting proxy statement was released to shareholders). This leaves proponents scrambling to draft triggering proposals without much definitive guidance from the SEC. Also, companies are likely to be more eager to go the extra mile to seek no-action relief from the SEC to **keep** these potential triggers out of their prosy statements.

Richard Ferlauto, director of pension investment policy at the American Federation of State, County and Municipal Employees, says that SEC staff told him that the proposed prosy access rule does not overturn the decision last year that allowed ***Citigroup*** to omit a binding prosy access proposal submitted by AFSCME. That proposal would have permitted a shareholder or group of shareholders owning at least 3 percent of Citigroup's shares to include a director nominee on the company's prosy card. Citigroup argued that the proposal related to a board election. In its ruling allowing omission of the proposal under 14a-(i)8, SEC staff said, "It appears that the proposal, rather than establishing procedures for nomination or qualification generally, would establish a procedure that may result in contested elections of directors." (See *Highlights* March 7, 2003.) AFSCME appealed the decision to the full commission, but the SEC decided to review the whole issue of proxy access instead of reviewing the staff decision. Ferlauto told IRRC that the SEC staff recently indicated to him that all potentially triggering shareholder proposals on proxy access that are submitted for the 2004 proxy season should reference the SEC's proposed 14a-11 rule. However, the exact proposal test that the SEC is looking for remains unclear, so Ferlauto predicts that many activists will concentrate their efforts on the other triggering mechanism proposed in the rules that is more clear cut—"vote-no" campaigns. This trigger requires that at least one of a company's nominees for the board receive "withhold" votes from more than 35 percent of the votes cast at the annual meeting.

Once shareholders actually activate either one of the proposed triggers, they still would have to overcome some formidable obstacles before seeing their director nominees appear on a proxy ballot. For example, even after a successful triggering event, a company may decide that it is not required to include a nominee from a shareholder in its proxy statement if it determines *any* of the following:

- The shareholder nomination procedure in proposed rule 14a-11 is not applicabie to the company.
- The nominating shareholder has not complied with the requirements of the procedure.
- The nominee does not meet the requirements of the procedure.
- Any representation required to be included in the notice to the company is false in any material respect.
- The company has received more nominees than it is required to include by proposed rule 14a-1I. and the nominating shareholder is not entitled to have its nominee inciuded in that situation.

If the company determines to exclude a nominee on any of the above grounds, it would have to send out **a** notice to the nominating shareholder no later than 30 calendar days before the release of its proxy statement. In this notice the company would have to include *all* of the following information:

- a description of the determination made by the company's board, including an affirmative statement of its determination not to include that specific nominee;
- a discussion of the specific requirement or requirements of proposed rule 14a-11 that the company's board of directors has determined permit the company not to include that specific nominee; and
- a discussion of the specific basis for the belief of the company's board that the company is permitted to not include that specific nominee.

When asked about these provisions in the proposed rule. Ferlauto said they have not yet been the subject of much debate. "Right now, the triggers are so onerous that it is difficult to get to this point. so we haven't directed our attention to these other parts of the proposal yet." he explained.

STATE TREASURERS TELL SEC CHAIR THEY WANT MORE SAY IN DEBATE OVER PROPOSED RULE. In related news, a group of state treasurers and pension fund managers met on October 29 with SEC Chairman William Donaldson to tell him that they cannot accept the proposed prosy access rules as they stand, and to urge him to include their input in the rulemaking process. The group of state leaders is expected to draft a version of what it would like to see in the proposed rule within the next ueek or two. "There will be a public fund version of the proposed rule and probably a Business Roundtable version and then there will be a negotiating session," predicted Rich Ferlauto of AFSCME. He noted that the group talked to Donaldson about having a one-year, instead of a two-year, trigger in the rule. and the SEC chairman said the length of the trigger is still subject to discussion. Ferlauto also said he believes a final rule will be put in place before the end of the year.

Dissident Group Uses Written Consent in Attempt to Unseat eXegenics' Directors

AS STOCK PRICE FALLS, NASDAQ CONSIDERS DELISTING. The Meyers Group has launched a campaign to try to persuade ***eXegenics*** shareholders to act by written consent to remove all four of the company's current directors and elect the Meyers Group's five nominees. Two of the company's four directors are considered independent under IRRC's definition of independence. The deadline for shareholders to give their consent is November 5. Ira J. Gelb and Irwin C. Gerson. both considered by IRRC to be independent, resigned as directors of the company in May. just a month after being re-elected. In their letters of resignation they cited shareholder dissatisfaction with the way the board and senior management were managing the company.

The Meyers Group. which owns approximately 12.9 percent of the company's outstanding common stock and approximately 3.9 percent of the company's outstanding preferred stock, is dissatisfied with eXegenics' financial results, particularly the company's lack of revenue, its depleting cash, and the continual decline of the company's stock price. The dissident group also accuses the company of being unable to develop marketable products and of failing to complete business combinations with other companies.

The company contends that the Meyers Group has neither disclosed a specific plan for the company nor revealed how its nominees will attempt to increase the value of shareholders' investments. The company specifically accuses

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Wednesday, December 17, 2003

A Seat at the Corporate Governance Table

By Burton Rothberg and Ned Regan

While most everyone who looks at mutual funds is moving from scandal to scandal, another upheaval is in progress in the fund business, one that **may** have profound effects on American corporate governance. Last January, ignoring the opposition from the mutual funds, the **SEC** ruled that the funds must develop and disclose policies for voting management and shareholder resolutions appearing on corporate proxy statements. Starting next year, they will also have to disclose their actual votes. This puts the funds, which hold over **15%** of U.S. stocks, squarely at the corporate governance table.

Until now, mutual funds, like other institutional investors, have not invested a lot of energy in improving corporate governance. There are a few examples of active governance in the institutional community (Calpers and TIAA-CREF come quickly *to* mind), but, while many voted their proxies, the attitude has been to not make waves. This was even true of most index funds, and the horde of closet indexers who effectively do the same thing. They invest in a specific portfolio, often holding the same **stocks** for decades on end. If a corporation is shutting off a potential takeover with a poison pill or if a cabal of top management **is** looting the company with bloated options, the only viable alternative is to vote against management and to provide oversight to restrain or overturn these policies.

The Center for Financial Integrity at Baruch College has collected and tabulated the proxy voting policy statements of the largest fund groups -- Fidelity, Vanguard and others -- mostly from the SEC's Edgar database (www.SEC.gov) but also from the funds' Web sites. They control the vast majority of fund shares and **have** developed similar positions on key policy issues. We expect this will have an immediate effect on the behavior of corporate boards.

The funds' fiduciary obligation **is** to increase shareholder value, and an open market for corporate control is one way to achieve that goal. ***So*** **virtually** all of the funds strongly oppose anti-takeover defenses. The near unanimity on this issue makes it clear that there is a large block of institutional money that will be actively voting to tear these defenses down. Shareholder resolutions on these issues already have met with some success. It seems likely that corporate barriers to M&A activity will continue to fall, and there will **be** more takeovers **of,** and board turnover at, undervalued but asset-rich companies.

The funds are also strongly against types of executive compensation chat they consider to be unfair. Among **these** are stock options with below-market exercise prices and the practice of lowering the exercise price of existing options after the company's stock falls. They are also taking a harder look at the dilutive effects of option packages, particularly those that dilute equity over

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10%. About half the funds report opposition to golden parachute severance agreements.

On the other hand, the funds will give management broad leeway on the actual running of the company. They vigorously avoid shareholder proposals with social, environmental or political agendas. They do not want -- and in some cases it is prohibited -- to get involved in day-to-day management, such as operational issues and capital structure issues, or even choice of auditors. But now that they are at the table, they can be expected to sharpen their monitoring of corporate board practices. Many may follow Vanguard's policy of withholding votes for re-electing board members whose positions the fund opposes.

The SEC rule included a directive that the funds disclose how they deal with conflicts of interest, e.g., when a fund may be opposing management in a company in which the fund also does investment banking or pension management. In most cases, this was not felt to be an issue since the fund would be obliged to follow their policies to vote in the economic interest of their shareholders. However, in these cases where the guidelines are contravened, the decision would be made by a committee of more senior personnel and, of course, would be a matter of public record.

Finally, the statements point to the pervasive influence of Institutional Shareholders Services, Inc. (ISS). ISS is a leading proxy-voting consultant and has its own set of voting guidelines, which virtually all the funds use as a reference. Some went so far as to strictly adhere to the ISS guidelines. The new disclosures will likely bring the role of ISS more into the public debate.

The important point is that the funds now have public policies on how they will use proxy-voting procedure to protect their investors' interests. Since voting records will become public knowledge next July, they know that they will be judged on how they implement these procedures.

Will this mean a rash of proposals opposing poison pills and stock-option policies? Will corporate boards and management discuss this with the funds ahead of time, bringing forth only policies they know will be accepted? Either way, the mutual funds are now major players in the governance of American corporations.

Mr. Rothberg is assistant professor of accounting at, and Mr. Regan the president of, Baruch College.

---- INDEX REFERENCES ----

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Monday, April 21, 2003

SEC Receives Record Requests to Bar Shareholder Proposals From Proxies

Howard Stock

A record number of companies have asked the Securities and Exchange Commission to intervene this proxy season by allowing them to exclude certain shareholder proposals from their proxy statements.

SEC Deputy Director of Corporation Finance Martin Dunn said the agency has received 480 no-action requests so far, adding that the number could increase by as many as 60 or more before the year is through.

Last year, the agency received a total of 460 no-action requests. A no-action request is a letter sent by companies to the SEC objecting to a shareholder proposal on procedural or substantive grounds. The SEC then decides whether or not the objection has merit, and if the proposal is in or out.

SEC Commissioner Paul Atkins said at a recent Council of Institutional Investors conference that an "inordinate amount of resources", both public and private, are devoted to this process each year, and called for reform in the system.

"I'd 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," he said.

Going Through the Motions

Raising these objections are a drain on company resources as well, David Porter, a partner at Cleveland, Ohio-based law firm Jones Day said.

"To object to a proposal will cost a minimum of $30,000, and it can easily escalate well above that, depending on the amount of research, the extent of the negotiations with the proponent and any number of other factors," he said, adding that a poorly crafted proposal from a smaller shareholder with little experience in writing them can cost more than one put forth by an institutional investor.

Yet despite the costs, Porter anticipates seeing the number of no-action requests continuing to rise in conjunction with the number of proposals.

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"More individual shareholders will come up with proposals, and as long as corporate governance remains front-page news, there will be more people out there who are going to go beyond the usual," he said.

However, Porter added, since many of the proposals written by individuals are not done correctly, they are open to objection, and quite often do not appear on the proxy statements.

Dunn said that the increase is in large part due to the focus on corporate governance, and noted that a lot of the proposals currently in question are related to governance issues such as splitting the chairman and CEO's role or requiring shareholder approval for a poison-pill provision.

Even Split

However, he cautioned against drawing any general conclusions as to the positions companies are taking on these issues more broadly.

"The vast majority of these proposals are specifically tailored to companies, and companies are only dealing with what is being put in front of them. They are not coming out and making a broader statement about shareholder proposals in general," he said.

The ratio of decisions coming down on either the company or the proponent side has remained steady at about 50/50, Dunn said, adding that the SEC staff does not favor any issues in either direction.

"Every letter we deal with, we deal with the exact proposal and the exact argument. I can't generalize and say this subject always goes in or this subject always goes out," he said.

While the SEC may not take an official stance, institutions often do, and executive pay has emerged as the favorite this year, Investor Responsibility Research Center Director of Social Issue Services Meg Voorhees said.

The IRRC has counted 995 proposals that have been filed to date, compared with 802 in 2002, and roughly one-third of those have addressed executive compensation.

In keeping with these statistics, Teachers Insurance and Annuity Association/College Retirement Equities Fund (TIAA/CREF) spokesman Patrick Connor said that the institution's goal this proxy season was to bring executive compensation into better alignment with the interests of

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shareholders. TIAA/CREF has filed 10 proposals so far, two of which are likely to go to vote at Siebel Systems Inc. and SBC Communications Inc.

Board Cooperative

However, Connor said that on a percentage basis, TIAA/CREF saw a decrease in the number of no-action requests this year over last.

"In 2002, our proposal was that shareholders should have the right to approve stock option plans, and every single company asked for a no-action letter," he said.

This year's proposal appears stronger, he said, adding that they may have been a little ahead of the curve last year.

"Perhaps our proposal did not appear so sweeping this year," Connor said.

Notably, although the SEC initially backed the companies on the option-plan proposal in 2002, the staff ultimately reversed that opinion, and the proposal ended up or, a number of ballots, Connor said.

The SEC can be difficult to read, and may uphold a shareholder resolution that the company is confident it will drop, based on individual facts and circumstances, Porter said.

"You can never say what the position actually will be, because it changes, depending on specific circumstances," he said.

Oftentimes, issues that have historically been viewed as "ordinary business," which means they are part of day-to-day operations and are therefore not subject to shareholder approval, become recognized as part of the social and political dialogue, and can no longer be considered ordinary, he said.

Porter added that while executive pay has traditionally fallen under ordinary business, the abuses of the system that have recently come to light could soon change that.

Talk Is Cheap

Under these circumstances, it is generally in the company's best interest to work with proponents to keep the proposal from coming under public scrutiny, and most companies realize this, Connor said.

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"By and large, companies would prefer to talk rather than have a proxy battle. We have always had pretty good dialogue with most companies. A proxy vote is the last resort," he said.

Connor said that while recent scandals have not led to any radical change in how companies are responding to shareholder proposals, some companies may be more open to discussion in the interest of corporate ethics.

Yet while most companies may take the time to listen to TIAA/CREF, which has $261 billion in assets under management, smaller shareholders may have a harder time. A holder with 1,000 shares is simply not worth the time and manpower it would take to negotiate. And companies are well within their rights, Porter said.

"Think about the U.S. government and the number of aids each legislator has to respond to constituents. If you impose that on a corporation, it wouldn't make any money. The primary concern of a corporation is not to respond to shareholder concerns; it is to make money," he said.

Given this corporate prerogative, many companies see shareholder proposals as relatively benign, and they recognize that it may be cheaper to simply live with the proposal on the ballot, Porter said.

However, it is primarily a matter of company culture, and there will always be those who protect their proxy statements with a territorial zeal, regardless of cost, he said.

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BYLINE: John Waggoner

BODY

The nation's largest pension system, Teachers Insurance and Annuity Association–College Retirement Education Fund (TIAA–CREF), has taken activist investing to a new level.

TIAA, the insurance unit of the **pension fund,** ousted the **board** of directors of Furr's/Bishop's, a restaurant chain. Based on preliminary results from the sharehoider meeting Thursday, this will be the first time a **pension fund** has unseated a **board** of directors and replaced it with its own.

TIAA owns 17.7% of Furr's stock after Furr's/Bishop's defaulted on debt issued to **TIAA** in 1996, according to Bloomberg News. The stock, which closed Thursday at $1 13/16, had been as high as S33 3/4 in July 1993. The company reorganized after the 1996 default.

"The action was the result of long–standing dissatisfaction with management," says Tom Pinto, spokesman for **TIAA.** "We **saw** a clearly troubled management with a lack of direction and a lack of a strategic plan, and excessive executive compensation."

The seven–member **board** nominated by **TIAA** won 80% of the vote. "We look for this new **board** of directors to lead Furr's/Bishop's in a positive, constructive way that will enhance the company's long–term prospects," says Sharon Manewitz, managing director of TIAA's securities division.

Furr's/Bishop's is based in **Lubbock.** Texas. and runs 100 restaurants in Midwest and western states under the Fun's or Bishop's names.

Most **pension funds** and mutual funds prcfcr not to Interfere with a company's affairs, But a few big **pension funds,** most notably CALPERS, the California state **pension fund,** have become more willing to tell companies how to shore **up** their business.

TIAA says its action **with** Furr's/Bishop's isn't pan of a larger strategy to **unseat** corporate **boards.** "It's only when companies don't make satisfactory changes that **we** go to shareholder resolutions," Pinto says.

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1998 R. Marlin Smith Student Writing Competition Award Winner

*97 WHY LOCAL ECONOMIC DEVELOPMENT INCENTIVES DON'T CREATE JOBS: THE ROLE OF CORPORATE GOVERNANCE

Rachel Weber [FNa1]

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1. Introduction

THE PRACTICE OF ECONOMIC DEVELOPMENT PLANNING rests on the assumption that municipal governments have a modicum of control over the local economy. Through tax increment financing, abatements, exemptions and deductions, grants for infrastructure, and low-interest loans, local officials believe they can attract and retain private investment, thereby increasing jobs and tax revenues. In stark contrast to this position, numerous academic studies conducted have demonstrated that most state and local economic development incentives are not effective means of improving the economic and fiscal well- being of the municipality. [FN1] Supporting their assertions with survey data, multivariate regression, and sophisticated econometric models of local economies, they have found that incentives rate particularly poorly as mechanisms for job creation, especially for full-time jobs paying above minimum wage.

*98 Although scholars are convinced that incentives do not work, practitioners continue to rely on them. [FN2] It is possible that the use of incentives persists because scholars, on the whole, have not offered persuasive reasoning for why economic development incentives are not effective. With the exception of Wolkoff (1985) and Dewar (1998), little attention has been given to the question. [FN3] Incentives may cover too small a percentage of operating and relocation costs to influence firm behavior. Or the mobility of capital and the fragmented system of American municipal governance may contribute to cities' inability to control economic development outcomes.

These financial and political explanations for the failure of incentives are actually part of the same argument. After all, the inability of the public sector to substantially modify a company's cost structure contributes to its weak bargaining leverage. Both explanations, however, treat "the firm" like a black box that responds to changes in prices (e.g., the cost of relocating) in an entirely calculated and rational way. If the price is right, the logic goes, local officials can pour money (i.e., grants, tax savings) into the box to produce jobs. Both explanations ignore the complex internal workings of the corporate enterprise and the competition for capital that takes place there. [FN4]

In response, this article develops a third approach to explain the failure of economic development incentives: a legal-institutional approach. This approach in no way supersedes the other two; rather it supports and enriches the other financial and political understandings of the problem. The legal-institutional approach asserts that the real engine of job and revenue growth is the business entity and that, ultimately, the individual investment strategy of each business determines whether or not it will relocate, expand or contract, create jobs, or produce additional tax revenues. Although every business is unique and responds to pressures within its own product market, all businesses develop their investment strategies in the context of national regulations, institutionalized practices for raising capital, and legal doctrines *99 that set parameters for what is acceptable corporate behavior. [FN5] Relying on insights from economic sociology, geography, and the "law and

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economics" literature, this article sets the conceptual terrain for understanding the environment in which investment decisions are made. From there it is possible to discuss the distributional decisions and patterns of relationships within businesses in order to better understand the influence financial incentives can and cannot have on the public benefits commonly associated with "economic development," particularly job growth.

After briefly reviewing the economic development literature on public subsidies and job creation, this article introduces the concept of "corporate governance" in legal theory and doctrine. Corporate governance describes the relations between actors in publicly traded corporations, especially the rights and obligations of the board of directors, managers, and shareholders. No single authoritative source for corporate governance "rules" exists; it is a body of law and custom culled from case law, legal texts (e.g., corporate charters and bylaws), and boardroom practices. [FN6] These basic ground rules--some legal, some customary--influence the allocation of rights and responsibilities within the corporation. In the third section, this article discusses how American financial market institutions reinforce corporate governance rules, placing pressure on management to privilege short-term returns over investments in labor and training. In the last section, this article discusses potential avenues of reform that can assist planners and municipal attorneys in holding subsidized firms to their economic development promises.

II. The Failure of Economic Development Subsidies

American cities have been subsidizing private firms in the name of job creation since the country's inception. Despite the rhetoric of free markets and laissez-faire, municipal governments made cash donations and bought stock in local companies, invested in privately owned manufacturing facilities. and used bonds and other financial inducements to attract business. [FN7] The competition for economic development during the early 1800s was ruthless as regions vied with one another for trade routes to growing inland areas. Those municipalities that could not *100 borrow or raise taxes enough to attract railroads, canals, and manufacturing facilities (like Park City, Jacksonville, and Galena, Illinois--towns that lost out to Chicago as the primary Midwestern railroad hub) faded into obscurity. [FN8] Major cities like New York and Chicago did not just provide the governmental backdrop for economic activity; they were intensely entrepreneurial, using their charters and their property to control and foster commercial life within their borders. [FN9]

Over the past two decades, American cities have experienced a wave of economic development activity that resembles the municipal entrepreneurship of the nineteenth century. As manufacturing jobs were lost to global competition and technological trends increased the relative mobility of capital, cities came under increased pressure to attract and hold onto large employers. In the 1980s, cities and urban counties established or greatly expanded their economic development offices. [FN10] Some cities created new quasi-public industrial authorities to raise funds and circumvent state-imposed debt limits. The number and kind of public financing instruments proliferated and their use intensified. [FN11] No comprehensive compendium of urban economic development programs exists, but it is safe to say that every major city offers incentives to prospective and existing businesses. [FN12] Private businesses--relocating, expanding, and new--regularly receive incentive packages consisting of direct grants for infrastructure and training, tax abatements, market assistance, and low-interest loans.

Tax expenditures, which are foregone revenues or uncollected taxes, are the most popular tool for business recruitment and retention. These include different forms of tax abatements, exemptions and reductions, such as corporate income or excise tax exemptions, property tax abatements, and investment tax credits for the purchase of new equipment. They are considered tax "expenditures" for budgeting purposes because *101 they are indirect spending programs administered through the tax system as opposed to spending directly through appropriations. Cities also offer direct grants for infrastructure and training as well as loan guarantees and low-interest loan programs by floating tax-exempt revenue bonds. With these diverse instruments of municipal finance, cities selectively mitigate the costs of doing business in their locales and, in doing so, increase the returns to individual firms.

Such blatant forms of public assistance have been upheld by the courts as fulfilling valid "public purposes" because of the indirect economic and fiscal benefits associated with incentives. [FN13] When companies locate or expand within their jurisdictions, cities expect to reap the benefits of positive externalities, such as lower unemployment, increased property values, and tax revenues. Nonpecuniary public benefits. such as an enhanced image and higher quality of life, are also expected. If tax incentives can attract new businesses, the logic goes, they should increase the net number of jobs in a particular city--unless employees shift from other firms in the same area (what are known as "substitution effects"). Other things being equal, lower rates of taxation and subsidized inputs should raise the expected return on investment in a particular city and thus make it a more attractive site. Deals that attract or retain large companies--even if financial incentives were not a motivating factor--are announced with great fanfare as politicians rush to take credit for reviving the local economy. City

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agencies often advertise the number of jobs created or retained "because of the subsidy."

Whether or not state and local financial incentives actually fulfill municipal expectations has been the subject of voluminous literature. [FN14] This literature is comprised primarily of empirical studies that evaluate the impact of economic development policies on new business attraction,*102 which is distinct from, but related to, the question of whether incentives create jobs in existing firms. These studies have cast doubt on the efficacy of financial incentives in enhancing tax revenues and creating jobs. Even a cursory review of the scores of studies conducted in the past two decades reveals that there is no conclusive evidence to suggest a significant relationship between tax expenditures and the locational behavior of firms. Using both surveys and econometric models of regional economies to forecast changes in employment, scholars have found little if any correlation between local tax policies and business attraction. Academic opinion has shifted somewhat in recent years (with some agreeing that incentives may make a difference when a firm has chosen a metropolitan region but is deciding between several sites), but there is still no consensus that cutting taxes and offering financial inducements leads to job and revenue growth.

The scholarship on the relationship between inducements and existing firms is similarly inconclusive, with several authors arguing that firms which receive subsidies do not necessarily create new jobs or retain existing ones. [FN15] In surveys, recipient firms often claim that subsidies were instrumental in their decisions to retain or add jobs. But, few firms will turn down a gift when offered, and most will say that the subsidy had a clear effect on retention or expansion decisions. [FN16] Firms whose behavior is influenced by subsidies are extremely difficult to distinguish from those who would gladly present a case that subsidies mattered in their expansion or retention decisions--even when they did riot. The "gifthorse" theory of economic development is substantiated by research that traces the behavior of recipient firms. Many subsidized firms do not meet their stated job growth projections, and some even leave the city or reduce their workforces shortly after receiving public assistance.

Anecdotal evidence confirms the belief that financial incentives are no guarantee of job creation. In some high profile cases, subsidized firms engaged in mass downsizing and closed plants. [FN17] In 1984, for example, the charter township of Ypsilanti, Michigan, gave General *103 Motors approximately $1.3 billion in tax abatements with the understanding that the company would maintain its Willow Run plant there for twelve years. After seven years, General Motors announced that it was moving the plant to Arlington, Texas, after Arlington offered substantial inducements. Over 4,000 jobs were lost at the Willow Run plant, and 10,000jobs were lost in related local industries. [FNI8]

Poking holes in each other's research design, scholars of incentives have raised as many methodological problems as they have solved. They point, first and foremost, to the lack of reliable data for tracking subsidies and measuring outcomes. Many cities do not maintain records of tax expenditures and avoid monitoring the performance of subsidized firms. Critics claim that they wish to avoid the painful recognition of how small a fraction of the advertised job creation benefits are actually net jobs derived from program expenditures. [FN19] Former New York State Comptroller Ed Regan noted that "the very people entrusted to oversee fiscal affairs of state and local governments-- treasurers, auditors, comptrollers--as well as those responsible for formulating public policy--governors, mayors, county executives, legislators— have no idea of the extent of such tax benefits, at least in most jurisdictions." [FN20] Few studies account for the opportunity costs incurred when direct grants or tax expenditures are "spent" on attracting or retaining business (as opposed to other related programs or private investment in the same activities). [FN21] In measuring outcomes, researchers frequently count all jobs created at subsidized firms as evidence of program benefits when some or all of these jobs might have been added without the incentive. [FN22] These problems of attribution plague most evaluations of incentive programs.

*104 Scholars of economic development offer two sets of reasons for why financial incentives fail to fulfill their intended purpose. The first kinds of explanations are financial in nature. Local taxes and the other factor costs that a municipality can influence (i.e., land write-downs) comprise too small a percentage of a firm's operating costs and profits to affect business expansion and location decisions. [FN23] Abating property taxes or providing a low-interest loan makes a minimal dent on the bottom line, which is not enough to influence a company's business strategy. The ultimate value of the financial incentive to the recipient firm is also offset by the other tax benefits that no longer apply once they are abated. [FN24] Firms, for example, can deduct local taxes before computing federal income taxes. Property tax abatements may be treated as revenue for tax purposes and would be directly taxed, thereby reducing the benefit of such assistance. [FN25]

The other explanatory framework focuses on the inability of local officials to successfully administer incentive programs given the politics of economic development. Policymakers admit that job and revenue creation projections are more symbolic than substantive, used to sway popular opinion about corporate welfare, and offer protection from accusations that cities give

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away too much for too little. [FN26] When the promised public returns do not materialize, local officials are not surprised. Rather than actually create jobs, incentives merely signal that local government is responsive to the needs of the private sector. They are a politically palatable, though often ineffective, way of """doing something" in the face of an imminent plant closure or relocation.

My own work offers a nuanced alternative to these blanket explanations for the failure of incentives. Arguably, subsidized businesses are under no obligation to spend their cost savings from financial incentives on hiring or retaining workers and face stronger, competing claims to corporate resources freed up by incentives. Once a subsidy enters the firm's accounting stream, it is absorbed into the general operating *105 budget and is beholden to management's own distributional calculus and decision-making autonomy. Perhaps senior executives would rather return higher dividends to the company's shareholders or purchase new labor-saving equipment instead of creating or retaining jobs. Subsidies substitute directly for items that would otherwise have to be paid for with the firm's own resources, but the capital freed up by the subsidy must compete with other uses. Labor market stimuli will be dampened considerably if the cost savings from subsidies are appropriated by other uses and groups outside the geographic area in which the business is located.

If we want to know why subsidies do not create jobs, we need to "pierce the corporate veil" and explore how investment decisions are made within the firm. Although ultimately these decisions are based on the idiosyncrasies of individual firms, managers, and product markets, it is possible to make some important generalizations about the American system of corporate governance in which investments are made. Legal-institutional factors influence who has first priority to the surplus revenues generated by subsidies and what managers are legally obligated to do with this surplus. In the following section, this article explores how, within publicly traded corporations, corporate governance rules privilege shareholders in the investment decisions that can ultimately create or destroy jobs.

III. Shareholder Primacy in a Nexus of Contracts

Peering into the "black box" of the firm, one finds a cacophony of competing claims for corporate resources among employees, shareholders, directors, managers, and creditors. Who among the various participants in the corporate enterprise owns and controls what, and who makes which decisions? What are corporate directors obligated to do and to whom are they obligated? Who has responsibility for, and legitimate claims against, the revenues and assets of a corporation? How does management prioritize the claims of different stakeholders with potentially conflicting interests? The answers to these questions comprise a subfield of business, economics, and law called "corporate governance." Corporate governance is key to understanding urban economic development because it provides incentives and disincentives for stakeholders to engage in wealth-creating activities at the local level. [FN27]

*106 Corporate governance rules are not static; they are the result of historical processes and political struggles. Nevertheless, every era has its dominant paradigm, a model that is both popular with academics and operationalized by the legal, managerial, and financial professions. Since the late 1970s, the dominant model of enterprise governance in corporate law has been the "nexus of contracts" or "contractarian" paradigm. [FN28] This paradigm is an outgrowth of some basic assumptions from contract and property law and rests on the idea that a corporation is simply the amalgam or "nexus" of different contracting relations among individual input owners. Chief Justice Marshall set the stage for this model in 1819 when he called the corporation """an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence." [FN29] In this paradigm, the corporation is disposable, instrumental only in facilitating the contracting interactions of different corporate actors. Scholarly adherents believe that corporations are nothing but contracts resulting from the willful and voluntary interaction of actors who trade rights and obligations among themselves, taking into account their respective skills and abilities as well as the corporation's needs. [FN30] The contractarian firm is comprised both of transactions that take place within an internal system of hierarchical governance (i.e., a firm) as well as those that take place across a market interface. Contracts may be formal and discrete or implied and informal, but parties' respective rights and responsibilities are always defined by the twin themes of commerce: consent and ownership.

*107 The nexus of contracts model of the corporation flows from this assumption of freely contracting input owners and private asset ownership. Management raises funds to acquire physical capital and finance operations by contracting with creditors (for debt) and shareholders (for equity). The proceeds of the corporation's activities are divided among its employees, suppliers, and creditors based on contracts that are assumed to be clear, set in advance, and drafted on terms independent of the success of the enterprise as a whole. [FN31] In other words, wages and loan payments are fixed liabilities; they are negotiated in advance of performance and are not contingent on whether or not the firm is thriving or performing

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poorly. Only shareholders contract for a variable share of net proceeds, after all previously contracted for obligations have been paid to the firm's employees, suppliers, and creditors. Because payments to shareholders are paid last and because these payments vary depending on the profitability of the business, shareholders are said to have a "residual" claim on the corporation's profits. [FN32]

Shareholders' *status* as "residual claimants" is perhaps the most significant organizing principle of the publicly traded corporation. Shareholders are thought to have the most at stake **in** management's ability to generate profits because they subject themselves to the **risk** that they will earn no return on their investments. [FN33] Their status as residual claimants entitles shareholders to act as the principals of the **firm** who then **""hire"** agents--the corporation's directors and senior officers--to act on their behalf. Contractarian scholars insist that this relationship is both embodied in explicit contracts (e.g., those found in corporate bylaws and charters) and also arises out **of** expectations and tacit agreements, or implicit "contracts." [FN34] Shareholders, creditors, and others enter into these contracts when they invest in the corporation, whether or not they individually negotiate contract terms. Under the contractual theory of the corporation, state corporation statutes—like the Uniform Partnership Act **and** the Uniform Commercial Code--enforce corporate contracts, reduce the costs of private contracting by creating standard corporate forms into which parties can opt, and provide central notice to potential creditors that the firm has adopted limited liability. [FN35]

108** Because shareholders bear the residual **risk** of corporate activity, management is expected to devote its energies ***to advancing shareholders' interests. The nexus of contracts model of governance is guided **by** the notion that the corporation should be structured in the best interests of its shareholder-principals. [FN36] Management fulfills this mission by attempting to maximize shareholders' return **on** investment. In other words, first priority to the company's profits is the reward for residual risk-taking.

Although shareholders are residual claimants, they are a dispersed and often disorganized lot. Effective control **of** corporate property lies in the hands of a few managers instead of the multitude **of** individual investors. [FN37] Given this separation **of** ownership and control and the decentralization of owners, shareholders experience great difficulties monitoring managers to **make** sure they are using the shareholders' assets to generate profits. Management has access to relevant information about cost structures and future strategies to which the shareholders are not privy. Likewise, managers have few means **of** intuiting shareholders' preferences. Thus, the separation of ownership from control creates wide "information asymmetries" between these two groups. [FN38] Managers need discretion to respond to contingency and the authority to take advantage **of** investment opportunities, and yet shareholders must prevent officer abuse, shirking, and opportunism. Although shareholders bear the residual risk ***as*** principals, they cannot devise contractual restrictions to fully control their agents because shareholders are incapable of predicting and resolving the various contingencies that **arise** in a long-term relationship. In the language of ***109** organization theory, the separation of ownership from control creates serious "principal-agent problems" that corporate law seeks to rectify. [FN39]

Because principals cannot effectively monitor or evaluate the agent's efforts and because a shortage of information hinders the agent's ability to draw conclusions about the principals' preferences, a special type of arrangement is required to govern transactions between shareholders and management. Corporate law provides a standardized provision that directors owe shareholders fiduciary duties to maximize the value of shareholders' assets. Managers are able to act as **de** facto owners **in** exchange for their vows to uphold their fiduciary duties to shareholders. [FN40]

Fiduciary duties are legal-institutional mechanisms for ensuring corporate accountability **to** shareholders; they include the duties of loyalty, care, and concern, i.e., obligations that the agent work for the "exclusive benefit" and in the best interest of the principal. [FN41] **Courts have** applied this term to relationships as diverse as guardian-ward, attorney-client, **and** manager- stockholder. Fiduciary relations rely expressly on trust, **a** variety **of** which may extend beyond the written terms of the actual contract, Fiduciary duties are viewed differently than contracts; they are imbued with a distinctly moral **and** ethical character and applied judiciously by judges to express the highest standard of accountability. [FN42]

Compared with shareholders, the other constituencies involved in the corporate enterprise are **of** less concern to corporate law because they do not own property in the corporation **and** are not believed to have risked as much **as** shareholders. [FN43] Local governments, employees, suppliers, and creditors may be considered informal "stakeholders" in that they have a direct interest in the survival of the organization and make **risky** investments that are specialized to the enterprise. [FN44] Management, ***110** however, does not **owe** them fiduciary duties and **is** not supposed to further their interests at the expense of the "true" owners. Within this paradigm, managers are only accountable to those stakeholders whose assets they are "borrowing:" shareholders.

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Explicit contracts and regulatory statutes, rather than fiduciary duties, determine management's obligations to nonshareholder constituencies. [FN45] For example, managers are legally obligated to adhere to individual redevelopment agreements with municipal governments and to the National Labor Relations Act as it pertains to the company's employees. Beyond these contractual and legislative obligations, corporate law vests managers with the authority to act in their own or in shareholders' interests. Managers may allocate investment capital, select production techniques, or initiate layoffs in any way they see fit, unless explicit contracts or regulations prohibit specific behavior. If there is no express private agreement to the contrary, managers do not owe nonshareholder constituencies any duties of loyalty, care, or concern beyond those articulated in their contracts. [FN46]

Cities often agree to provide tax abatements to businesses in return for job creation but do not write contracts that specify the expectation of these jobs. Judges interpreting the situation within the nexus of contracts paradigm assume that cities are willing to take on the risk that businesses will not create jobs if they choose not to write such provisions into their individual contract. For example, when the Triangle Corporation decided to reduce production after the City of Duluth issued $10 million in Industrial Revenue Bonds to finance land acquisition and modernization of the tool company, the city sued. The court found that "while the parties discussed a restriction which would have required Triangle to guarantee certain employment levels at [the company] ... the parties' final agreements did not contain specific employment levels." [FN47] Similarly, the court denied the City of Yonkers, New York, any relief when Otis Elevator shut its plant in 1982 after accepting a federal subsidy in the early 1970s. The court commented that Yonkers had failed to "exact in return for ... funding a commitment from Otis to operate its plant for any period of time." [FN48] Cities weaken their prospects for damages when they rely on implicit contracts or leave contract language open-ended and ambiguous. The only *111 way the cities can protect themselves against the possibility of such harm, as I will explain in the last section, is to specify their expectations in contracts enforceable by law.

The contractarian approach holds that management is not accountable to nontraditional stakeholders beyond the terms of their contracts, and views any judicial or legislative attempts to protect these stakeholders as anathema. [FN49] By this logic, public intervention is not to be used to improve social welfare or redistribute assets because in order to do *so* the public sector would have to overrule the private contracts to which parties have already given their express consent, According to this model, public intervention should not substitute for private ordering.

IV. Enabling Institutions

The nexus of contracts paradigm has an ideological naturalness, partly because it affirms the liberal current underlying much of our law and political theory; it resonates with deeply held convictions about the freedom of contract, the importance of consent, the value of private property, and the integrity of the person against outside interference. In this model, explicit contracts specify rights and duties between two parties that are fixed by their own voluntary and actual agreement. Because obligations stem only from individuals' explicit promises, not from any paternalistic belief in distributive justice, enforcement of contracts is therefore consonant with individual freedom.

The predominance and power of this model, however. is not only based on the """strength" of its ideas, but on the degree to which such ideas are institutionalized. In other words. fiduciary duties are perceived as strong deterrents against managerial opportunism not simply because they reflect strongly held beliefs about discretion and freedom, but because they are enforced through prevailing institutional arrangements. The nexus of contracts paradigm reflects and reinforces the way that large, publicly traded corporations raise capital in the United States: namely, through a reliance on dispersed shareholders, powerful institutional investors, and competitive capital markets that establish stock prices. [FN50] Whereas firms in other countries depend on debt and relations with banks to finance their operations. the American system--as a result *112 of important political and legal machinations in the early half of this century--is based on equity and relations with shareholders. The institutional context privileges the interests of shareholders, as management's dependency on them creates room for their control. Thus, management privileges the interests of shareholders not only because they have legal obligations to do so, but because shareholders have come to wield a substantial amount of power and can enforce management's obligations to them.

In the late 1970s and early 1980s, financial deregulation. overvalued dollars, and foreign competition drastically changed the environment in which American firms operated Manufacturing companies were unable to achieve desired sales and revenue growth and began borrowing directly from financial markets as banks raised their borrowing rates. This period also saw the rise to power of institutional investors, particularly pension and mutual funds, and insurance companies. The specific purpose of these funds *is* to generate high yields for their multiple and dispersed members by giving them access to money managers who can buy and sell large blocks of stock. The percentage of equity in United States corporations held by institutional

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investors skyrocketed during the 1980s: in 1950, institutional investors owned 8 percent of the equity in American firms, but by 1988, this level had reached 45 percent. [FN51] Institutional investors, or at least their representatives, now exert an unprecedented amount of power over management.

Shareholders are able to challenge the power of corporate management to set the firm's strategic agenda through a variety of control and enforcement mechanisms. Shareholders can enforce managements' fiduciary duties through the threat of derivative suits in which a single shareholder can challenge a breach on behalf of the "corporation." [FN52] Fiduciary duties are also enforced by voting rights, which enable shareholders to elect and remove directors. In companies where they hold large blocks of stock, institutional shareholders have been able to directly influence the actions of management. Public pension funds and "cowboy" investors like Warren Buffet and T. Boone Pickens initiated *113 rebellions in the 1980s, as they bullied management at underperforming companies. Money managers pressed management to restructure and deliver more value, and if they were still not satisfied with the company's performance, they would sponsor resolutions to change governance structures. Managers were compelled to increase price/earnings ratios and provide higher dividends to shareholders. This pressure paid off the share of after-tax profits distributed as dividends grew from 40 percent in the 1960s to 85 percent in the early 1990s. [FN53] In essence, shareholders fully utilized their powers of voice to ensure that rents, which companies may have previously shared with their employees and possibly local governments, were appropriated by shareholders. [FN54]

Shareholder groups periodically urge management to adopt incentives that will align their respective interests: namely, rewarding managers with stock options and bringing on outside directors who have fewer attachments to the corporation and more sympathy for investors. Compensation systems that link managerial rewards to stock price (as opposed to total sales or revenue) have become increasingly popular: whereas in 1982, 37 percent of senior management's compensation was based on stock incentives (and annual bonuses), in 1993, 54 percent of their compensation derived from variable measures. [FN55] Stock grants or options make management's goals more consonant with those of shareholders by further riveting managers' attention to fluctuations in stock price. Shareholders also support bringing more outside directors onto boards in hopes that they will be less beholden to management. At the end of 1993, 86 percent of manufacturing companies and 91 percent of financial companies had a majority of outside directors. [FN56]

In addition to exercising "voice" to influence management, shareholders have another powerful and more commonly used control tool at their disposal: exit. [FN57] If shareholders are not pleased with management's performance, they will "vote with their feet," sell their stock, and force share values down. Institutional investors engage in shortterm *114 trading practices, sometimes holding shares for just days or weeks. [FN58] Turnover rates for stock in the early 1990s were the highest since the speculative 1920s and 1930s; shares were held, on average, for just 1.9 years in 1985, compared with an average rate of seven years in 1960. [FN59] Transient and diversified, shareholders have little interest in working with management on a day-to-day basis to transform an underperforming company into a more profitable enterprise. Expressing dissatisfaction through exit is easy and costless. and the threat of or actual exit can spur managers to attend to the short-term interests of investors.

Managers interpret signals from external capital markets and the actions of shareholders to infer the preferences of the market. Although information asymmetries keep dispersed shareholders from directly communicating their true preferences to managers (they rely on fund managers or their ability to exit), managers of publicly traded corporations allow short-term share appreciation to drive their strategy. [FN60] Internal capital budgeting takes place "by the numbers," with management second guessing how the market will respond to their investment decisions. Managers intent on demonstrating to shareholders that they are performing will foster those aspects of firm performance that can be readily monitored by shareholders, such as sales levels, at the expense of those investments that will affect the balance sheet or income statement only after many years. like increasing production. [FN61] Corporations have institutionalized the obsession with shareholder value by developing new systems of control over lower levels and different divisions of their organizations. Internal performance measures now form the basis of strategic decisions made within operating units; each unit is its own individual profit center where decisions about plant expansion or industrial location are evaluated against their effect on the bottom line. [FN62]

In contrast, constitutional and statutory restrictions prohibit cities and other parties with long-term interests in firms from owning shares of the companies they finance. Municipalities may not engage in such business activity unless it "falls properly under the heading of 'public *115 utility' and is not for profit." [FN63] Banks are subject to the Glass-Steagall Act of 1933, which prohibits them from owning and dealing in corporate securities. As such, these stakeholders are unable to use the power of ownership *to* exert influence over corporate investment decisions.

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As management has become increasingly beholden to shareholders, these other stakeholders have lost status within the firm. Local governments once exercised economic powers similar to private corporations, but changes in legal doctrine and financial institutions rendered them powerless over investment decision making. [FN64] Private corporations are not subject to local government control; rather, the decision-malung autonomy of business is the cornerstone of the "free market" system--and for many good reasons. However, municipal governments are dependent on something they cannot control: the willingness of business to invest in their cities, plants, and workforce. Because capital is mobile but cities are not, municipal governments must cajole firms with financial incentives with the hape of altering private behavior.

Cities fight an uphill battle given the fact that many publicly-owned businesses are not likely to invest in job creation, retraining, and all of the other investments associated with local economic development when they are under the pressure from shareholders to produce short-term increases in stock prices. To create jobs, firms must allocate revenues toward salaries, wages, benefits, and training based on projections of future production needs. In order to show their dispersed shareholders that they are doing a good job, however, managers are more likely to concentrate on measurable, tangible quantities--such as quarterly earnings--in the short-term and neglect variables that are important to the longevity of the firm but whose impact on income statements may be difficult to observe--such as investments in labor. Decisions to increase production or reinvest in the company and its workforce must contend with pressures from shareholders, who might interpret such investments as damaging financial performance in the short run.

V, Extending the Paradigm

If financial incentives are to have the intended effect of increasing or retaining employment, the role of the public sector within the corporale *116 governance of employers must be strengthened. Rather than set out to change the dominant contractarian model, this article suggests that economic development planners and attorneys work within this paradigm of corporate governance to strengthen the relationship between economic development subsidies and job creation. The nexus of contracts paradigm is predicated on the sanctity of the contract and protections for residual risk bearing. By offering financial subsidies to footloose private firms, cities are taking nsbs and making investments in firm-specific assets. Thus, cities take on some of the qualities of shareholders, and in doing so. deserve some form of protection against future harms, particularly the harm that subsidized firms will not use their cost savings to create jobs. Cities must draft stronger contracts with provisions that protect their interests if they are to influence the investment decisions of the private firms they subsidize. Through explicit contracts, cities can make subsidies conditional on employment projections, hold subsidized companies to their promises and protect public claims on the use of subsidies within the firm.[FN65]

Explicit, detailed contracts are the cornerstone of "smart growth" economic development strategies. Rather than halt the practice of subsidizing business, cities need to become astute negotiators in bargaining for the social benefits they seek from subsidized firms. [FN66] Cities must try to raise the standards of public accountability by raising the cost of a firm's failing to deliver on its promises. Contracts, state statutes, and city ordinances can be written to reflect the quid pro quo nature of subsidies through specific, legally enforceable provisions and binding performance requirements.

Contractual provisions can tie the subsidy to job creation and retention objectives. [FN67] Cities may require that subsidized firms maintain employment at a certain level or may provide a certain amount of subsidy for every job created. If employment drops below the threshold level or if fewer jobs are created than expected. the amount of the subsidy is similarly reduced. Obligations may extend over a specific time penod, *117 normally for the duration of the loan or subsidy. Some cities have specified the wage rates (often expressed as a percentage of the federal minimum wage) and benefits. These provisions are traditionally used in high-impact. high-profile subsidy agreements, such as Mercedes-Benz in Alabama, but could be extended to all subsidy deals.

Failure to meet specified job levels can be regarded as a breach of the firm's contractual duties and can trigger a host of remedies. [FN68] Nonperformance provisions generally fall into five categories:
(1) Recisions: canceling a subsidy agreement if job and revenue projections are not met;
(2) Clawbacks: recovering all or part of subsidy costs if performance goals are not met;
(3) Penalties: adding charges (e.g., the interest accrued on the public's investment) for non-performance or relocation;
(4) Recalibrations: adjusting of subsidy to reflect changing business conditions; and
(5) Debarment: excluding firm from future contracts with city government in the event of non-performance. [FN69]

Specifying remedies and damages in the contract can create an inducement for the recipient firm to try to provide the promised benefits. Proactive and preemptive strategies that specify the terms of the exchange ex ante, before public funds

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change hands, protect the city's claim on the use of subsidies before these cost savings are redirected toward general operating expenses or dividends to shareholders. Experience shows that post facto attempts to impose conditions and enforce implicit understandings are not as likely to succeed. [FN70]

Using contracts to obtain more influence within the firm should not substitute for legislative or regulatory remedies. [FN71] Contracts, after all, are not law but agreements enforceable by law. In the absence of legislation, corporations can use their bargaining leverage to dilute the terms of individual subsidy agreements and give themselves maximum flexibility. Likewise, government officials may be reluctant to impose obligations or enforcement provisions on the corporations on whom *118 they depend. Thus, state enabling legislation and city ordinances should be crafted to strengthen the leverage of cities in their negotiations with firms. Legislation can both require that economic development agencies draft individual contracts and also provide guidelines for drafting these contracts. Courts tend to be deferential to legislatures, and, moreover, legislation is uniform and establishes a known standard. The best municipal strategies, therefore, rely on both state statutory frameworks and city ordinances that make inducements conditional on contracts embodying certain standard provisions. City councils, such as those in Burlington, Vermont, New Haven, Connecticut, and Austin, Texas, have passed ordinances that require contracts and provide guidelines to recapture abated taxes if the recipient company reneges on its commitments. [FN72]

Accountability mechanisms are a critical part of the bargaining process between governments and businesses, but they must be enforced and used in conjunction with sound local economic development strategies. The mere existence of accountability provisions in contracts or legislation does not ensure that the city enforces them. Accountability is enforced through the city's ability to (1) write legally binding, complete contracts with subsidized firms; (2) judge the outcome of its assistance; and (3) collect damages or opt out of relationships with agents who breach their contracts. [FN73] Fear that cities will be stigmatized as "business unfriendly" and the inability draw causal links between subsidies and job creation often prevent these three conditions from being met. Rather than burden them with additional requirements and defeat the original "economic development" intentions of subsidies, cities regularly try to accommodate firms as best they can.

Legal provisions alone will not stimulate a depressed local economy. The move toward accountability must be accompanied by a shift from reactive tax reductions and giveaways to proactive spending programs whose benefits accrue to the city even if a subsidized firm decides to leave the particular locale. Local officials acknowledge that tax expenditures are rather blunt and ineffective financial instruments to encourage job creation. Subsidizing place- bound infrastructure, training and educational facilities, and collaborative networks of firms would create broader, localized benefits that do not depend on cajoling and catering to individual firms. [FN74]

*119 VI. Conclusion

Publicly held corporations are structured to serve the interests of their shareholders, not cities. Municipal governments, therefore, cannot expect corporations to possess an internal commitment to job creation and local attachment. Legal doctrine and financial market pressures, as I have explained, constrain corporations, compelling management to forego long-term investments in favor of quick-fix increases in share prices. Shareholders have legally recognized rights to residual corporate profits, and managers have legally recognized obligations to distribute that surplus to them. Management's fiduciary obligations to shareholders are codified in and protected by corporate charters and bylaws.

American corporations are not likely to highly value their ability to respond to other public interests, unless the public sector and other affected parties (e.g., organized labor, taxpayers) put pressure on them and enter the realm of corporate governance by way of explicit contracts. The public sector gains a modicum of bargaining leverage over corporations in contributing financial resources to firms. It can use its financial largesse to require more control over investment and encourage job creation and retention. Reform efforts must focus on inserting opportunities for public governance into the contracts the city writes and the regulations it drafts. These legally binding agreements can specify attendant responsibilities and formalize a firm's reciprocal responsibilities.

Businesses may complain about this infringement of their freedom, sacrosanct as it is in our liberal market economy. On the other hand, the businesses themselves may prefer legally binding agreements to informal handshakes and "free" subsidies. Most businesses are accustomed to business arrangements governed by contracts and partnership agreements. They provide each party with a deeper sense of security about the future, decreasing uncertainty and the prospects for arbitrary behavior on the part of the city. Since cities contribute to the financial well-being of subsidized firms and must bear the risk that they will "take the money and run," entering into a formal contract would create a more balanced and equitable symmetry of obligation.

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[FN1]. For reviews of this extensive literature, see TIMOTHY BARTIK, WHO BENEFITS FROM STATE AND LOCAL ECONOMIC DEVELOPMENT POLICIES? (1991) and ROGER WILSON, STATE BUSINESS INCENTIVES AND ECONOMIC GROWTH: ARE THEY EFFECTIVE? A REVIEW OF THE LITERATURE (1989).

[FN2]. See Harold Wolman, Local Economic Development Policy: What Explains the Divergence Between Policy Analysis and Political Behavior?, 10 J. URB. AFF. 19-28 (1988).

[FN3]. Michael J. Wolkoff, Chasing a Dream: The Use of Tax Abatements to Spur Urban Economic Development, 22 URB. STUD. 305-315 (1985); Margaret E. Dewar, Why State and Local Economic Development Programs Cause *So* Little Economic Development, *12* ECON. DEV. Q. 68 (1998).

[FN4]. The fact that "the firm" has been undertheorized in the economic development literature is not surprising given that the field of urban planning derives from a concern with state power and municipal administration.

[FN5]. Susan Christopherson, Market Rules and Territorial Outcomes: The Case of the United States, 17 INT'L J. URB. & REGIONAL RES. 274,277 (1993).

[FN6]. ROBERT CLARK, CORPORATE LAW 17-19 (1986).

[FN7]. ALBERTA M. SBRAGIA, DEBT WISH: ENTREPRENEURIAL CITIES, U.S. FEDERALISM AND ECONOMIC DEVELOPMENT 44-61 (1996).

[FN8]. Id. at 47-50.

[FN9]. See HENDRIK HARTOG, PUBLIC PROPERTY AND PRIVATE POWER: THE CORPORATION OF THE CITY OF NEW YORK IN AMERICAN LAW 1730-1870 (1983); ROBIN L. EINHORN, PROPERTY RULES: POLITICAL ECONOMY IN CHICAGO 1833-1872 (1991).

[FN10]. PETER K. EISINGER, THE RISE OF THE ENTREPRENEURIAL STATE: STATE AND LOCAL ECONOMIC DEVELOPMENT POLICY IN THE UNITED STATES 15-21 (1988).

[FN11]. A survey of 203 tax and finance executives conducted by KPMG-Peat Marwick (1995) found that 73% perceived that incentives were more freely available in 1995 than they had been in 1990; 79% of the respondents reported that their firms were currently collecting location incentives. David Cay Johnston, Boom Seen in State and Local Tax Aid to Business, N.Y. TIMES, Sept. 21, 1995, at D4 (citing BUSINESS INCENTIVES AND TAX CREDITS: A BOON FOR BUSINESS OR CORPORATE WELFARE? (1995)).

[FN12]. State programs are better documented. The National Association of State Development Agencies (NASDA) publishes a biennial SURVEY OF STATE ECONOMIC DEVELOPMENT EXPENDITURES.

[FN13]. See, e.g., Common Cause v. State, 455 A.2d 1 (Me. 1983), in which a bond issue to rebuild a dry dock for and retain the Bath Iron Works in state was declared a valid use of tax revenues.

[FN14]. BARTIK, supra note 1; WILSON, supra note 1; Wolkoff, supra note 3; Robert W. Wassmer, Can Local Incentives Alter a Metropolitan City's Economic Development'?. 31 URB. STUD. 1251 (1994); Paul Foley, Local Economic Policy and Job Creation: A Review of Evaluation Studies, 29 URB. STUD. 557 (1992); K. G. Willis, Estimating the Benefits of Job Creation from Local Investment Subsidies. 22 URB. STUD. 163 (1985); Rodney A. Erickson & Michael Wasylenko, Firm Relocation and Site Selection in Suburban Municipalities. 8 J. URB. ECON. 69 (1980); Thomas F. Luce, Jr., Local Taxes, Public Services, and the Intrarnetropolitan Location of Firms and Households, 22 Pub. Fin. Q. 139 (1994); Wiiliam Schweke et al., Bidding for Business: Are Cities and States Selling Themselves Short? (1994); Robert Lynch, Do State and Local Tax Incentives Work? Economic Policy Institute (1996).

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[FN16]. TIMOTHY BARTIK & RICHARD BINGHAM, CAN ECONOMIC DEVELOPMENT PROGRAMS BE EVALUATED? (Upjohn Institute Working Paper 6-12, 1995).

[FN17]. GREG LEROY ET AL., NO MORE CANDY STORE: STATES AND CITIES MAKING JOB SUBSIDIES ACCOUNTABLE (1994); LOUISIANA COALITION FOR TAX JUSTICE, THE GREAT LOUISIANA TAX GIVEAWAY: A DECADE OF CORPORATE WELFARE (1989).

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[FN21]. M. E. Dewar & B. Hagenlocker, Getting to the Bottom Line on Low- Interest Loans to Business: An Evaluation of the Small Cities Economic Development Programme in Minnesota, 30 REGIONAL STUD. 41 (1996).

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[FN25]. Some studies, however, have found that there is a large enough difference between rates of return in cities and states with different subsidy packages to affect location and expansion decisions. Bartik & Bingham, supra note 16, at 14-15; see also PETER FISHER & ALAN PETERS, INDUSTRIAL INCENTIVES; COMPETITION AMONG AMERICAN STATES AND CITIES (1998).

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[FN27]. Such an approach is in keeping with that of the legal realists and institutional economists working during the first half of this century who argued that economic phenomena could not be understood without an adequate theory of organizations and legal institutions. Underlying even the simplest economic transaction, they asserted, is a complex structure of property rights, contracts, and social relationships. See. e.g., Robert L. Hale, Coercion and Distribution in a Supposedly Non-Coercive State, 38 POLI. SCI. Q. 470 (1923); Moms R. Cohen. Property and Sovereignty, 13 Cornell L. Rev. 8 (1927); John Commons, The Legal Foundations of Capitalism (1957); Joseph W. Singer, Legal Realism Now, 76 Cal. L. Rev. 465 (1988).

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[FN29]. Dartmouth College v. Woodward, 17 U.S. 518, 636 (1819).

[FN30]. Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J. LAW & ECON. 425 (1993); Michael Jensen & William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976); Henry Butler, The Contractual Theory of the Corporation, 11 Geo. Mason L. Rev. 99 (1989); Oliver E. Williamson, The Economic Institutions of Capitalism (1985), and Markets and Hierarchies, Analysis and Antitrust Implications: A Study in the Economics of Internal Organization (1975).

[FN31]. MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 20-25 (1995).

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[FN34]. See Henry Butler, The Contractual Theory of the Corporation, 11 GEO. MASON L. REV. 99 (1989).

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[FN36]. Adherents of the shareholder primacy argument point to Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919), in which the Dodge brothers sued Ford Motor Co.. asserting that Henry Ford had chosen to forego dividend payments in order to lower the price of his cars and expand the business. The Michigan Supreme Court agreed stating that:
[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself. to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.
Id. at 684.

[FN37]. ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[FN38]. Richard Zeckhauser & John Pound. *Are* Large Shareholders Effective Monitors'?, in ASYMMETRIC INFORMATION, CORPORATE FINANCE AND INVESTMENT (R. Glenn Hubbard ed., 1990).

[FN39]. Robert Clark, Agency Costs Versus Fiduciary Duties, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (John Pratt & Richard Zeckhauser eds., 1985).

[FN40]. See Eugene Fama & Michael Jensen, The Separation of Ownership and Control, 26 J. LAW & ECON. 301 (1983).

[FN41]. See Deborah A. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 DUKE L. J. 879 (1988).

[FN42]. Clark, supra note 39, at 71-79, argues that fiduciary law is stricter than any form of contract law in four respects: a fiduciary's affirmative duty to disclose, its open-ended duty to act. its closed-in rights of positional advantage, and the distinctively moral rhetoric in which these duties are couched.

[FN43]. in keeping with the notion that the assets of the firm are the property of shareholders, some refer to this contractarian model as the """property conception of the firm." BLAIR, supra note 31, at 210. See Charland v. Norge Div., Borg-Warner Corp., 407 F.2d 1062, 1065 (6th Cir. 1969). cert denied, 395 U.S. 927 (1969) (employer's decision to relocate did not infnnge on employee's rights, since employee had no property interest in his job).

[FN44]. BLAIR, supra note 31, at 239

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[FN47]. In **re** Indenture of Trust, 437 N.W.2d 430,435 (Minn. Ct. App. 1989).

[FN48]. City **of** Yonkers v. Otis Elevator ***Co.***, 649 **F.** Supp. 716,719 (S.D.N.Y. 1986).

[FN49]. Macey, **supra** note **33,** at 180. For an **opposing** view, see Joseph **W.** Singer, The Reliance Interest in Property, 40 STAN. L. REV. **611,618 (1988).**

[FN50]. See generally JOHN **ZYSMAN,** GOVERNMENT, **MARKETS,** AND GROWTH: FINANCIAL **SYSTEMS** AND THE POLITICS OF **INDUSTRIAL** CHANGE (1983); MARK ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

[FN51]. John **C.** Coffee, Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 COLUM. **L.** REV. 1277, 1291 (1991) (citing Carolyn Kay Brancato, The Pivotal Role **of** Institutional Investors in Capital **Markets,** in INSTTTUTIONAL INVESTING: CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY **3,** 17-19 (Arnold W. Sametz ed., 1991). Among some of the largest corporations the percentage of institutional ownership **is** extremely high, for example: General Motors Corp. (82%), Mobil Corp. (74%), Citicorp (70%), Amoco (86%), **and** Eli Lilly & Co. (71%). Id. at 291 (citing Carolyn Kay Brancato, The Momentum of the Big Investor, DIRECTORS & BOARDS **38** (Winter 1990)).

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[FN55]. **JAY** LORSCH & ELIZABETH MACIVER. CORPORATE GOVERNANCE **AND** INVESTMENT TIME HORIZONS (1991). ***See*** Michael ***C.*** Jensen & Kevin J. Murphy, Performance Pay and Top- Management Incentives, 98 J. POL. ECON. **225** (1990).

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[FN57]. See generally ALBERT **O.** HIRSCHMAN. EXIT, VOICE, AND LOYALTY: **RESPONSES** TO DECLINE IN FIRMS. ORGANIZATIONS, AND STATES **21-29** (1970).

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[FN62]. Appelbaum & Berg, supra note **54,** at 210-211

[FN63]. FRANK I. MICHELMAN & TERRANCE SANDALOW, MATERIALS ON GOVERNMENT IN URBAN AREAS 103 **(1970).** See also **A.** Michael Froomkin, Reinventing the Government Corporation, 1995 **U.** ILL. L. REV. 543 (1995).

[FN64]. See generally Gerald E. Frug, The **City** as a Legal Concept, 93 HARV. L. REV. 1059 (1980).

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[FN70]. See Charter Township of Ypsilanti v. General Motors Corp., No. 92-43075-CK, 1993 WL 132385 (Mich. Cir. Ct. Feb. 9, 1993), rev'd, 506 N.W.2d 556 (1993), and United Steelworkers of America v. United States Steel, 631 F.2d 1264, 1280 (6th Cir. 1980).

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[FN72]. For a state-by-state *summary* of accountability provisions, see GRASSROOTS POLICY PROJECT, PUBLIC SUBSIDIES, PUBLIC ACCOUNTABILITY (1998).

[FN73]. Ziance, supra note 66, at 40.

[FN74]. Directing municipal strategies in this direction. however, is very difficult given that private firms demand the kinds of narrow assistance (tax abatements, land write-downs) that substitute for their own costs of doing business. If an incentive does not drop straight to the firm's bottom line. it may not have any influence.

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34

AMERICAN JURISPRUDENCE

SECOND EDITION

A MODERN COMPREHENSIVE TEXT STATEMENT
OF AMERICAN LAW

STATE AND FEDERAL

COMPLETELY REVISED AND REWRITTEN
IN THE LIGHT OF MODERN AUTHORITIES AND DEVELOPMENTS
BY THE EDITORIAL STAFF OF THE PUBLISHERS

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Observation: The fact that an issuing corporation cannot vote pledged shares held in its own name[47] should not bar a pledgor of the corporation's shares from voting by proxy.[48]

§ 1068. Effect of status of debt secured

While the mere maturity of a debt secured by a pledge of stock does not authorize the pledgee to vote the stock,[49] yet where the pledgee proceeds to perfect title to the stock, he thereby obtains the voting power.[50]

H. PROXY VOTING [§§ 1069–1111]

Research References

Model Business Corporation Act § 33

ALR Quick Indexes, Corporate Stock and Stockholders: Corporations: Proxies; Voting

Federal Quick Index, Corporate Stock and Stockholders: Corporations: Proxies

LEXIS Index to Annotations, Corporations: Proxies

6, 6A Am Jur Legal Forms 2d, Corporations §§ 74:980, 74:982, 74:984, 74:1595-74:1601, 74:1603-74:1605

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1. IN GENERAL [§§ 1069–1075]

§ 1069. Generally; definitions

A proxy to vote shares of stock is an authority given by the holder of the stock who has the right to vote it to another to exercise his voting rights.[51] Traditionally viewed, a proxy creates an agency relationship governed by agency law.[52] The term "proxy" is also used in the sense of proxy holder—that is, the person to whom such authority has been given.[53]

§ 1070. Checklist for drafting a proxy

The following matters should be considered in drafting a proxy:[54]

- Eligibility of proxy holder to act as proxy under state statutes.
- Requisites of proxy.
  - —compliance with statutory requirements.
  - —date proxy given.
  - —signature of person giving proxy.
  - —acknowledgment or attestation of proxy, if necessary.

Curlew Creamery Co., 16 Wash 2d 476, 134 P2d 66.

47. § 1039.

48. Goldfield Corp. v General Host Corp., 29 NY2d 264, 327 NYS2d 330, 277 NE2d 387.

49. Goldfield Corp. v General Host Corp., 29 NY2d 264, 327 NYS2d 330, 277 NE2d 387.

50. J. H. Wentworth Co. v French, 176 Mass 442, 57 NE 789; Haskell v Read, 68 Neb 107, 93 NW 997, reh den 68 Neb 115, 96 NW 1007.

Annotation: 68 ALR3d 680 § 9.

51. Commissioner of Banks v Cosmopolitan Trust Co., 253 Mass 205, 148 NE 609, 41 ALR 658; Manson v Curtis, 223 NY 313, 119 NE 559; Tums v Hestonville, M. & F. P. R. Co., 149 Pa 70, 24 A 88.

52. Abbey Properties Co. v Presidential Ins. Co. (Fla App D2) 119 So 2d 74; Auto West, Inc. v Baggs (Utah) 678 P2d 286.

A proxy creates an agency with a power to vote. Swann v Martin, 302 Ky 381, 194 SW2d 855.

53. §§ 1073 et seq.

54. *Practice Aids.*—Forms of proxies. 6A AM JUR LEGAL FORMS 2d, CORPORATIONS §§ 74:1595 et seq.

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HIGHLIGHTS

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Aranow & Einhorn on Proxy Contests for Corporate Control, Third Edition

by Randall S. Thomas and Catherine T. Dixon

Aranow & Einhorn on Proxy Contests for Corporate Control is a comprehensive and exhaustive analysis of federal and state regulations affecting corporate voting contests. Proxy voting contests have undergone radical change in recent years and this treatise provides practical coverage of the critical issues surrounding contested elections of boards of directors and shareholder proposals. This Third Edition of the attorney's "bible" for handling such contests brings the time-honored treatise up to date with the latest analysis to meet the unique demands of today's requirements in this highly regulated field. The book takes a step-by-step approach through the considerations and legal intricacies of successfully initiating — or defending against — a proxy contest.

Coverage is provided for such crucial topics as:

- Federal antifraud rules
- Proxy contest defensive tactics

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§ 21.01 NECESSARY EXPENSES OF MANAGEMENT AND INSURGENTS

Management's and insurgents' expenses in a proxy contest will depend on a number of factors, including the size of the corporation, the number of stockholders, the nature and intensity of the campaign, and the issues presented. Over time, these costs have escalated as contests have become more and more elaborate.

In almost ail cases, at the conclusion of the contest, each side had aggregate expenses considerably greater than originally contemplated. The reason is apparent: the cost of one side's campaign will depend on, to a large extent, the size of opposition's campaign. Each move will call for a countermove, and expenses spiral upward. Participants, in the heat of battle and with much at stake, are not likely to become economy-minded. Nevertheless, at the beginning of the contest, federal law requires management and insurgents to estimate their expenses.[1] In most cases, the insurgents will be the first party to do this because they must initially determine whether to undertake a control contest.

As discussed in Chapter 2, the insurgents (and later the management) will need to organize a team of experts to plan the campaign and to estimate expenses. This team will usually include a lawyer, an accountant, a public relations expert, and a proxy solicitor. The insurgents' immediate retention of these experts will require negotiations over their fees. In most cases, the insurgents make preliminary fee arrangements with their experts subject to subsequent developments in the campaign waged and the services ultimately rendered. Once each side has organized its team of experts and tentatively planned its campaign, it can attempt to estimate its expenses.

Management has a considerable advantage over the insurgents with respect to payment for proxy contest expenses, for it has the corporate treasury to pay for virtually all of its expenses in trying to elect its candidates to the board of directors. By contrast, the insurgents must defray their own expenses, subject to the conditions that they will probably be reimbursed by the corporation if they win the contest and the cumpany's new board and stockholders vote to approve payment.[2]

While every contest will raise different issues concerning the expenses that are likely to be incurred by the participants, both management and the insurgents should include cost estimates for the following items:

1. The legal fees and costs incurred by the insurgents to obtain the corporation's stocklist and, in certain situations, to examine its books and records;
2. The fees and expenses required for preparing and filing all materials required by the SEC. including Schedule 14A and, in appropriate circumstances, Schedule 13D;

---

[1] An estimate of each group's total expenditures in connection with the solicitation must be made in the proxy statement. *See* Item 4(b)(4) of Schedule 14A.

[2] See discussion in § 21.04

3. The cost of preparing, printing, and mailing the original proxy mailings and subsequent communications to stockholders. The insurgents may send out several such communications, although the insurgents may choose to target mailings to the larger stockholders of the company to reduce their costs;
4. The expenses and fees paid to nominate brokers and banks, or their agent ADP, for forwarding the proxy solicitation materials to the beneficial owners and obtaining their instructions on how to vote;[3]
5. The fees of accountants, investment bankers, and financial analysts for preparing, handling, and analyzing financial statements and preparing statistical comparisons for use in the insurgents' proxy materials and elsewhere;
6. The fees and expenses of public relations experts and professional proxy solicitors for the multitude of tasks that they will handle over the course of the contest;
7. The travel, telephone, and (perhaps) entertainment expenses incurred in the solicitation of proxies from important stockholders;
8. The expenses of hiring personnel to receive, tabulate, examine, and retain all proxies until the meeting. This task will frequently be undertaken by the professional proxy solicitors, as discussed in Chapter 13;
9. The costs of having representatives present at the actual count of proxies and the voting at the stockholders' meeting;
10. The legal fees for a variety of other services, including any premeeting litigation (*e.g.*, preliminary injunction proceedings to stop the meeting); the examination of proxies to determine their legal validity; the conduct of the stockholders' meetings; challenges to the opposition's proxies or resisting challenges by the opposition; and legal proceedings after the meeting attacking the result of the meeting.

All of these expenses are usually necessary to conducting an adequate campaign. The staggering cost of launching a full-blown proxy contest for control makes it imperative to consider each side's ability to defray these expenses. Exhibit 21-1 lists the actual proxy contest expenses for various companies. The following sections examine management's right to use corporate funds,[4] and the insurgents' conditional right to be reimbursed from corporate funds.[5]

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[3] See § 15.05.
[4] *See* § 21.03.
[5] *See* § 21.04.

EXHIBIT 21-1. Proxy Contest (and Related) Expenses

Company Name	Management Costs $	Dissident Costs $
Allegheny Int'l[6]	6,000,000	
Amdura[7]	6,783,000	
American Sav. Bank[8]	1,500,000	
Apple Bancorp[9]	5,000,000	
American General[13]	25,000,000	
Builders Transport[14]	12,900,000	See mgmt. exp.
California Jockey Club & Bay Meadows[15]	479,000	
Centel[16]	4,100,000	
Cleveland Cliffs[17]	1,200,000	
Comdata[18]	1,400,000	
Consolidated Oil & Gas[19]	177,000	
Counsellors Tandem[20]	699,372	
Crazy Eddie[21]		1,550,000
Crown Resources[22]		389,000

[6] Related to administration of its Chapter 11 bankruptcy proceedings and the recent proxy contest. See Form 10-Q (June *26, 1988).*

[7] Charges for Funding executive continuity agreements and proxy costs. ***See*** Form 10-Q (Sept. 30,1989).

[8] Special charges related to proxy issues at **two** stockholder meetings, evaluation **and** revision of business strategy, and changes to Board of Directors and senior management. *See* Annual Repon to Stockholders (Dec. 31, 1989).

[9] **Proxy** contest and related matters See Form 10-K (Dec. 31, 1990).

[10] Proxy contest, litigation, and settlement expense. **See** Annual Repon to Stockholders(Dec. 31, 1991).

[11] Proxy contest and solicitation. ***See*** Annual Report to Stockholders (June 30, 1989).

[12] Settlement that ended all litigation and terminated ***proxy*** fight. ***See*** **Form** 10-Q (March **31,** 1991).

[13] Proxy contest and sale process. See Annual Report to Stockholders (1991).

[14] Restructuring, reorganization, and proxy costs **(proxy** costs of both slates of directors) See Annual Report to Stockholders (Dec 31, 1990).

[15] Proxy contest expense increases the general administrative **expenses** by $479,000. Annual Report to Stockholders (Dec. 31, 1991)

[16] Result of proxy fight cost allocations and slightly higher maintenance cost for distribution plant and for Jeffrey Center. See Annual Report to Stockholders (Dec. 31, 1988).

[17] Proxy contest expenses *See* Annual Report to Stockholders (Dec. 13, 1987).

[18] Proxy contest solicitation expenses ***See*** Form 10-K (June 30, 1987).

[19] Proxy contest and related civil action. Additional expenses were incurred subsequently. See Form 10-Q (Aug. 31, 1988)

[20] **Proxy** costs *See* Annual Report to Stockholders (Dec. 31, 1990).

[21] Potential write-off of proxy reimbursement when Crazy Eddie can pay. Entertainment Marketing, Annual Repon to Stockholders (Jan 31, *1989).*

[22] Crown Resources settled claims for proxy solicitation costs of Gold Capital Corp. See Form 10-K (Dec. 31, 1989)

Company Name	Management Costs $	Dissident Costs $
CNW[23]	2,355,000	
CTS[24]	3,743,000	
Cypress Fund[25]	423,406	
Del Webb[26]	1,000,000	
Desoto, Inc.	3,303,000 [27]	985,000[28]
Farah[29]	350,000	
Gillette[30]	9,000,000	
Grow Group[31]	600,000	
Healthco	3,651,000[32]	2,200,00033
Heico Corp.[34]	2, 100,000	
Hollywood Park Operating Co.[35]	6,755,000	
Income Opp. Realty Trust[36]	1,900,000	
Int'l. Banknote[37]	2,318,000	
Kinark[38]	1, 128,000	
Kollmorgen[39]	7,000,000	
Lockheed[40]	20,000,000	
MATRIX[41]	300,000	

[23] Proxy contest expense. *See* Form 10-Q (June 30, 1989).

[24] Special expenses related to DCA litigation, proxy contest and sale of company. *See* Form 10-Q (June 28, 1987).

[25] Proxy solicitation expenses. *See* Annual Report to Stockholders (Sept. 30, 1990).

[26] Proxy contest expenses. *See* Annual Repon to Stockholders (June 30, 1991).

[27] Legal fees related to proxy contest and also paid expenses incurred by dissident, Sutton. *See* Form 10-K (Dec. 31, 1991).

[28] Sutton Holding Corp., dissident, proxy expenses. *See* Dcsoto, Form 10-K (Dec. 31, 1992).

[29] Proxy contest expenses. *See* Fonn 10-K (Oct. 31, 1990).

[30] Proxy expenses. See Form 10-Q (June 30, 1989).

[31] Special proxy solicitation. *See* Annual Report to Stockholders (June 30, 1991).

[32] Costs for outside advisers, legal counsel, proxy solicitation fees and expenses, printing and mailing expenses, and other cost and expenses related to proxy contest. See Annual Report to Stockholders (Dec. 29, 1990)

[33] Healthco reimburses Gemini, dissident, for its actual out-of-pocket expenses and solicitation of proxy contest. See Healthco. Annual Report to Stockholders (Dec. 29, 1990).

[34] Proxy cost, related litigation, and provision for the restructuring of the aviation operations. See Annual Report to Stockholders (Oct 31, 1990).

[35] Accrued proxy expenses *See* Annual Repon to Stockholders (Dec 31, 1991)

[36] Legal fees and proxy costs. *See* Annual Repon: to Stockholders (Dec. 31, 1989)

[37] Proxy solicitation fees *See* Form 10-K (Dec. 31, 1989)

[38] The most significant factor increasing the administrative cost was a proxy contest for election of three directors, also legal fees, proxy solicitation. *See* Form 10-K (Dec 31, 1990)

[39] Includes legal, accounting and financial advisory fees, as well as printing and other proxy costs in connection with proxy contest. See Form 10-K (Dec 31, 1990).

[40] Costs related to stockholder proxy contests in 1990 *See* Annual Report to Stockholders (Dec. 29, 1991).

[41] Proxy contest costs in 1988 *See* Form 10-K (July 31, 1988)

Company Name	Management Costs $	Dissident Costs $
Media General	2,300,000 [42]	1,200,000[43]
National Heritage[44]	1,300,000	
National Intergroup	7,900,000 [45]	4,200,000[46]
Oak Industries[47]	1,861,000	
Payfone[48]	170,000	
Pic N Save[49]	15,500,000	
Regal[51]	1,600,000	
R.P Sherer Corp.[52]	3,600,000	
Schafer[53]	786,229	
Sun[54]	1,100,000	
Synalloy[55]	250,000	
XTRA[56]	5,294,000	

[42] Proxy contest expense. Annual Report to Stockholders (1989).

[43] Proxy contest expense of dissident, Giant Group LTD. Giant Group Annual Report to Stockholders (Dec. 31, 1988).

[44] Legal expenses of proxy contest *See* Form 10-K (June 30, 1990).

[45] Proxy cost, environmental provisions, costs associated with company purchase operation of corporation. Annual Report to Stockholders (March 31, 1992)

[46] Corporation paid largest stockholder partial reimbursement in connection with proxy solicitation and contest. *See supra* note 35

[47] Proxy contest expense *See* Form 10-K (Dec 31, *1990)*

[48] Expense in *connection* with resisting claims of dissident, including related proxy contest and legal expenses *See* Form 10-K (June 30, 1987)

[49] Proxy expenses *See* Form 10-K (Feb 2, 1992)

[50] $1,700,000 increase in corporation expenses primarily due to added costs of proxy contest, strike related cost, and expenditures to evaluate diversification opportunities. *See* Annual Report to Stockholders (Ccc 31, 1989)

[51] Due to litigation cost, professional services, settlement payments, and reimbursement of proxy expenses. *See* Form 10-K (Dec 31, 1987)

[52] Legal costs. investment banking and other fees, relating to a proxy contest. *See* Annual Report to Stockholden (March 31, 1991)

[53] Proxy contest and related expenses Annual Report to Stockholders (Dec. 31, 1989).

[54] Settlement of proxy contest and related legal and investment banking fees. See Annual Report to Stockholders (Dec. 31, 1990)

[55] Proxy contest expenses *See* Form 10-K (Dec. 29, 1990)

[56] Proxy contest expenses and related costs, including solicitation, litigation cost, and investment bankers. See Form 10-Q (June 30, 1990)

[57] Proxy solicitation expenses related to contested election of directors. See Form 10K (Dec. 31, 1989).

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B

Black's Law Dictionary"

Seventh Edition

Bryan A. Garner
Editor in Chief

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until the baron uprising in 1263 under Simon de Montfort.

proviso (prə-vI-zoh). **1.** A limitation, condition, or stipulation upon whose compliance a legal or formal document's validity or application may depend. **2.** In drafting, a provision that begins with the words *provided that* and supplies a condition, exception, or addition.

provisor. 1. *Hist.* A provider of *care* or sustenance. **2.** *Eccles. law.* A person nominated by the Pope to be the next incumbent of a benefice that is not yet vacant.

provocation, *n.* Something (such as words or actions) that arouses anger or animosity in another, causing that person to respond in the heat of passion. ● "Adequate" provocation can reduce a murder charge to voluntary manslaughter. — **provoke,** *vb.* — **provocative,** *adj.* See MANSLAUGHTER.

provost marshal. *Military law.* A staff officer who supervises a command's military police and advises the commander.

proxenete (prok-sə-nee-tə). [Latin] *Roman & civil law.* **1.** A person who negotiates or arranges the terms of a contract between parties; a broker. **2.** A person who negotiates marriages; a matchmaker. — Also termed *proxeneta.*

proximate (prok-sə-mit), *adj.* **1.** Immediately before or after. **2.** Very near or close in time.

proximate cause. *See* CAUSE (1).

proximate consequence. A result following an unbroken sequence from some (esp. negligent) event.

proximate damages. See DAMAGES.

proximity. The quality or state of being near in time, place, order, or relation.

proxy, n. **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.

proxy contest. A struggle between two corporate factions to obtain the votes of uncommitted shareholders. ● A proxy contest usu. occurs when a group of dissident shareholders mounts a battle against the corporation's managers. — Also termed *proxy fight.*

proxy marriage. See MARRIAGE (2).

proxy solicitation. A request that a corporate shareholder authorize another person to cast the shareholder's vote at a corporate meeting.

proxy statement. An informational document that accompanies a proxy solicitation and explains a proposed action (such as a merger) by the corporation.

PRP. *abbr.* Potentially responsible party.

prudent, *adj.* Circumspect or judicious in one's dealings; cautious. — **prudence,** *n.*

prudent-investor rule. *Trusts.* The principle that a fiduciary must invest in only those securities or portfolios of securities that a reasonable person would buy. — *Also* termed *prudent-person rule.*

prudent person. See REASONABLE PERSON.

prurient (pruur-ee-ənt), *adj.* Characterized by or arousing inordinate or unusual sexual desire <films appealing to prurient interests>. — **prurience,** n. See OBSCENITY.

p.s. *abbr.* (*usu. cap.*) **1.** Public statute, *See* PUBLIC LAW (2). **2.** Postscript.

pseudo-foreign-corporation statute. A state law regulating foreign corporations that either derive a specified high percentage of their income from that state or have a high percentage of their stuck owned by people living in that state.

pseudograph (soo-də-graf). A false writing; a forgery.

pseudo-guarantee treaty. See *guaranty treaty* under TREATY.

pseudonym (sood-ə-nim), *n.* A fictitious name or identity. — **pseudonymous** (soo-don-ə-mas), *adj.* — **pseudonymity** (sood-ə-nim-ə-tee), *n.*

PSI. *abbr.* PRESENTENCE INVESTIGATION REPORT.

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FLETCHER CYCLOPEDIA

OF THE LAW OF

PRIVATE CORPORATIONS

WILLIAM MEADE FLETCHER

2003 REVISED VOLUME

By JENNIFER L. BERGER, J.D.,
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measured was deemed to be materially misleading.[8] However, in another case, two &rectors' reasons for not endorsing a merger transaction recommended by a majority of the board and a family relationship involving a proposed consulting agreement were not required to be disclosed in a proxy statement.[9] The materiality of a misrepresentation in a proxy solicitation is a mixed question of law and fact, involving the application of a legal standard to a particular set of facts.[10] The issue of the materiality of misrepresentations made in a proxy solicitation may be resolved as a matter of law on summary judgment if the established misrepresentations are so obviously important to an investor that reasonable minds cannot differ on the question of materiality.[11]

§ *2052.80* Proxy contests.

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.[1]

In many publicly owned companies, the stock may be so widely scattered among the outside shareholders that an outside group may be tempted to undertake a creeping acquisition of control by the quiet purchase of stock, especially where the stock ownership of management is small.[2] When an insurgent group has bypassed management and made a general offer to shareholders for the purchase of a sufficient number of shares to obtain working control,[3] an effortto protect the incumbent management and other sharehold-

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[8] **Del.** In re Staples, Inc. S'holders Litig., 792 A2d **934** (Del Ch 2001).

[9] **Del.** Newman v. Warren, 684 A2d 1239 (Del Ch 1996).

[10] **Alas.** Meidinger v. Koniag, **Inc.**, 31 P3d 77 (Alaska 2001).

[11] **Alas.** Meidinger v. Koniag, Inc., **31** P3d 77 (Alaska 2001).

[Section 2052.80]

[1] **U.S. A** proxy contest has become a part of the corporate wav of life; and the economic life of a corporation in all its fullness is the **backdrop** against which corporate expenses incurred in a proxy contest must be analyzed in determining whether they are "ordinary and necessary" for tax purposes. Locke Mfg. Co. **v.** United States, **237** F **Supp** 80.

Del. Unitrin, Inc. **v.** Amer. Gen. Corp., 651 A2d 1361 (Del 1995) (stockholders are presumed to act in their own best economic interests when they vote in **proxy** contests).

[2] See Sufficiency, Under § 14 of Securities Exchange **Act** of 1934 (USC 15 § 78n) and Implementing Regulations of Proxy or Information Statement Incident to Merger of Corporation, 4 ALR Fed 1021.

[3] See Machtinger, Proxy Fight Expenditures **of** Insurgent Shareholders, 19 Case W Res L Rev 212.

ers by a dissident security-holders' group struggling for corporate control comes within the protective design and intent of Section 14 (a) of the Securities Exchange Act of 1934 (Exchange Act).[4]

The Securities and Exchange Commission (SEC) rules require dissidents as well as management to adhere to the standard of conduct contemplated by Section 14(a) that any solicitation for proxies or authorizations or consents to a particular course of conduct affecting corporate action should be conducted under the rules of full, fair and complete disclosure, and devoid of any materially false and misleading statements.[5]

The problems involved in proxy contests have resulted in an extension of Securities and Exchange Commission proxy regulations in contested as well as uncontested proxy solicitations.[6] In the case of a proxy contest not involving the election of directors, Rule 14a-12 determines when solicitations may be made prior to furnishing the required proxy statement.[7]

Schedule 14A sets forth the filing and disclosure rules applicable to proxy solicitations in connection with the election of directors. Under Schedule 14A, the proxy statement must contain a description of the rights of appraisal or similar rights of dissenters with respect to any matter that is to be acted on at the meeting for which the proxy is being given,[8] and must state whether or not the proxy is irrevocable. If the right to revoke the proxy is limited, or subject to compliance with any formal procedure, the proxy statement must briefly describe the limitation or procedure.[9]

If solicitations are made which are not subject to regulation, i.e., solicitations in which the solicitator is not taking a position, then:

1. If the solicitation is made by management, that fact must be indicated. In addition, the proxy must indicate the name of any director who has informed management in writing that he intends to oppose any action intended to be taken by management.

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[4] U.S. Greater Iowa Corp. v. McLendon, 378 F2d 783.

Federal regulation of proxies under Section 14(a), *see* § 2252.10 et seq.

[5] U.S. Rosenblatt v. Northwest Airlines, Inc., 435 F2d 1121; Greater Iowa Corp. v. McLendon, 378 F2d 783; General Time Corp. v. Talley Industries, Inc., 403 F2d 159.

[6] U.S. Ainslie v. Sandquist, 270 F Supp 382.

[7] Rule 14a-12, 17 CFR § 240.14a-2.

[8] SEC Schedule 14A Item 3, 17 CFR § 240.14a-101.

[9] SEC Schedule 14A Item 2, 17 CFR § 24.14a-101.

2. If the solicitation is made by one other than management of the corporation, that **fact** must be disclosed along with the name of the persons for whom the solicitation is undertaken
3. If the solicitation is to be taken other than by use of the mails, details concerning the method of solicitation must be **described.**
4. **The** name **of** the person bearing the cost of the solicitation must be disclosed.[10]

For solicitation involving a **proxy** contest, the following information must be disclosed:

1. **A** statement showing by whom the solicitation is made together with a description of the methods to be utilized in the solicitation.
2. Identification of employees, if any, to **be** used in connection with the solicitation, together with the manner and nature of their employment.
3. Where an outside proxy soliciting firm is engaged, details of the contractual relationship between the firm and the solicitator should be identified together with the anticipated cost of the planned solicitation and the approximate number of employees to be engaged in the program.
4. An estimation of the total amount to **be** spent in the program.
5. Identification of the parties responsible for the cost of the solicitation. If the cost is to be borne other than by the company, the **proxy** statement must indicate whether reimbursement will be sought from the company. If the cost is to **be** sought from the company, the **proxy** statement should disclose whether management anticipates submitting that issue to the shareholders.[11]

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[10] SEC Schedule 14A Item 3(a); 17 CFR § 240.14a–101.

[11] **The** instructions provided by the Commission indicate that costs and **expenses** within the meaning of the requirement that costs and expenses **be** disclosed includes fees for attorneys, accountants, public relations, financial advisers, **proxy** solicitors, advertising, printing, transportation, litigation and other costs incidental to the solicitations, except that the issuer **may** exclude that amount normally expended for solicitations in the absence of **a contest** as well as costs represented by salaries and wages of regular employees and officers provided a statement to that effect is included in the **proxy** statement. SEC Schedule **14A** Item **4;** 17 CFR § 240.14a–101.

Whether or not there is **a proxy** contest, the proxy statement must describe any substantial interest, direct or indirect, of all officers and directors who **are** security holders.[12]

In cases where solicitations **are** made on behalf' of insurgents or other persons who do not comprise management, the proxy must contain the following:

I. information concerning nominees for election as directors and their associates;
II. a statement of the number of shares outstanding of each class;
III. the **record** date;[13]
IV. a statement as to the cumulative rights of shareholders;[14]
V. information concerning voting securities and their principal shareholders;[15]
VI. where the meeting is to elect directors, the following information must **be** furnished concerning the directors:

   A. name, term of office, positions or offices held by the nominee
   B. principal occupation together with principal positions held within the five-year period immediately preceding the prosy
   C. prior service as a director[16]
   D. the shareholdings of directors
   E. the shareholdings of directors and associated management required by Regulation S–K[17]

VII. details concerning reimbursement and remuneration of **executive** officers and directors;
VIII. details as to pensions, annuities and profit-sharing benefits accrued to individual officers and directors during the year;[18]
IX. a description of all remuneration payments proposed to be made in the future, directly or indirectly, to the issuer or any of its subsidiaries pursuant to an existing plan or arrangement;[19]

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[12] This rule is applicable only to solicitations on behalf of manage**ment.** See SEC Schedule 14A Item 5; 17 CFR § 240.14a–101.

[13] Record date, ***see*** § 2033 et **seq.**

[14] SEC Schedule **14A** Item ***6.***

Cumulative voting, see § 2048 et seq.

[15] SEC Schedule **14A** Item 6; 17 CFR § 240.14a–101.

[16] **17** CFR §§ 229.401, 240.14a–101.

[17] SEC Schedule **14A** Item **7;** 17 CFR § 240.14a–101.

[18] SEC Schedule **14A** Item 8; **17** CFR § 240.14a–101.

[19] Instructions to this item indicate that this information need not be included as to payment **to** be made for or benefits to **be** received

X. detailed information with respect to options granted to officers and directors, including details of the option price and a statement of whether the option price is less than 100 percent of the value of the stock at the time the option was granted;

XI. information reflecting the indebtedness of officers and directors to the corporation;

XII. details of transactions between the company and its officers and directors;

XIII. details of transactions in which officers or directors had a material interest;[20]

XIV. if auditors are to be selected at the meeting, indication of any interest which the auditors have in the business;

XV. if the meeting is to consider modification in the bonus, profit sharing pension retirement, or other Compensation plans, a description of the material features of the plan as well as the interest of officers and directors in the plan must be included;[21]

XVI. details of any proposed option or warrant arrangements;[22]

XVII. explanation and justification of any authorization of additional shares or modification of any class of securities, together with detailed financial statements;[23]

XVIII. details of proposed mergers, consolidations, acquisitions and similar matters together with detailed financial statements;[24]

XIX. description of any property to be acquired or disposed of, together with details of the transaction;[25]

XX. details concerning statement of accounts;[26]

XXI. details of proposed amendments to corporate charter, bylaws or other basic corporation documents.[27]

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from group life health or accident insurance. SEC Schedule 14A Item 10; 17 CFR § 240.14a–101.

[20] SEC Schedule 14A Items 8, 10; 17 CFR §§ 229.402, 240.14a–101.

[21] SEC Schedule 14A Item 12; 17 CFR § 240.14a–101.

[22] SEC Schedule 14A Item 12; 17 CFR § 240.14a–101.

[23] SEC Schedule 14A Item 12–13. *See* also Item 15; 17 CFR § 240.14a–101.

[24] SEC Schedule 14A Item 14. See also Item 14; 17 CFR § 240.14a–101.

[25] SEC Schedule 14A Item 15; 17 CFR § 240.14a–101.

[26] SEC Schedule 14A Item 16; 17 CFR § 240.14a–101.

[27] SEC Schedule 14A Item 19; 17 CFR § 240.14a–101.

SEC Rule 14a–7 provides that management must provide shareholders considering a **proxy** contest with the following information:

1. A statement of the approximate number of holders of record of any class of securities.
2. An estimate of the number of copies of **proxy** material required to be sent to banks and others holding shares as custodians.
3. *An* estimate of the cost of mailing **proxy** statements or other communications.

The SEC rules provide that management must mail the proxy materials of opposing security holders or, **at** its option, provide a reasonably current list of shareholder names and addresses together with a list of the **brokers,** bankers and other individuals holding shares for beneficial owners along with a reasonable estimate of the number of such beneficial owners.[28] If management is to mail the material, it is obliged to do so with reasonable promptness after the **receipt** of the material and the payment of **the** postage.[29] It has been held that the obligation of management to mail opposing **proxy** material does not preempt the right of opposing security holders under state law to inspect and copy the shareholders' list for the purpose of soliciting proxies.[30] The rules also require that in its **proxy** statement, management shall include a proposal and a statement in support of the proposal that a shareholder intends to present for action at the meeting.[31] However, management **may** omit such a

[28] 17 CFR § 240.14a–7.

U.S. Rosenblatt v. Northwest Airlines, Inc., **435** F2d 1121; Greater Iowa Corp. v. McLendon, 378 F2d 783; Studebaker Corp. v. Gittlin, 360 F2d 692; Wood, Walker & Co. v. Evans, 300 F Supp 171.

[29] 17 CFR § 240.14a–7(a).

[30] **U.S.** Wood, Walker & Co. v. Evans, 300 F Supp 171 (granting opposing shareholders' request for mandatory injunction to inspect and copy shareholders' list under Colorado law as not preempted by Rule 14a–7).

Colo. Wood, Walker & Co. **v.** Evans, **300** F Supp 171.

Right to inspect and copy shareholders' list under state law for purpose of proxy solicitations. see § **2223.20.**

[31] Under 17 CFR § 240.14a–8, each proponent may submit only one proposal and an accompanying supporting statement, however allowance is made for opportunity to reduce proposal items to one **acceptable** proposal.

U.S. Roosevelt **v.** E.I. Du Pont de Nemours & Co., 958 F2d 416 **(CA** DC 19921 (recognizing implied right of action pursuant to Rule 14a–8 to enforce registrant's Obligation to include shareholder's proposal in proxy materials); New **York** City Employees' Retirement Sys. v. Brunswick Corp., 789 F Supp **144** (SD NY 1992).

proposal if it is not a proper subject for shareholder action under the laws of the issuer's domicile, or if it appears that the proposal is submitted for enforcing a personal claim or redressing a personal grievance, or for the purpose of promoting economic, political, racial, religious, or social causes, or if the proposal has been submitted previously and failed to receive much support, or if it requests management to take actions on matters which relate to the conduct of ordinary business operations.[32] A proposal relating to capital expenditures may be sufficiently important to be outside the "ordinary business operations" exemption.[33] Nonetheless, such a proposal must target a particular capital expenditure.[34] A proposal that would require shareholder approval of all capital expenditures once a specified threshold is reached has been found to fall within the meaning of the "ordinary business operations" exemption.[35] The primary issue under Proxy Rule 14a–8 is whether the proposed shareholder resolution should be included in management's proxy statements,[36] and the burden of proof is on management to show that the particular proposal is not a proper one for such inclusion,[37] If the proposal need not be disclosed because it qualifies for an exemption under Rule 14a–8, then the failure to disclose the fact that the proposal will be presented at the next shareholders' meeting cannot render the proxy materials misleading under Rule 14a–9.[38]

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[32] 17 CFR § 240.14a–8.

U.S. Securities & Exchange Commission v. Medical Committee for Human Rights. 404 US 403, 30 L Ed 2d 560, 92 S Ct 577, vacating as moot 432 F2d 659; Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F2d 416 (CA DC 1992) (shareholder's proposals in connection with ending production of CFCs falling within exceptions relating to ordinary business operations); Rosenblatt v. Northwest Airlines, Inc., 435 F2d 1121; New York City Employees' Retirement Sys. v. Brunswick Corp., 789 F Supp 144 (SD NY 1992)(proposal for study to compare health care plans of subsidiaries operating in other countries seeking to force corporation to form national policy); Brooks v. Standard Oil Co., 308 F Supp 810 (proposed shareholder resolution held not proper subject and hence properly omitted by management).

[33] U.S. Grimes v. Ohio Edison, Co., 992 F2d 455 (CA2 1993).

[34] U.S. Grimes v. Ohio Edison, Co., 992 F2d 455 (CA2 1993).

[35] U.S. Grimes v. Ohio Edison, Co., 992 F2d 455 (CA2 1993).

[36] See 17 CFR § 240.14a-8.

U.S. Securities & Exchange Commission v. Medical Committee for Human Rights, 404 US 403, 30 L Ed 2d 560, 92 S Ct 577 (dissenting opinion by Justice Douglas).

[37] See Comment, Proxy Rule 14a–8: Omission of shareholder proposals, 84 Harv L Rev 700.

[38] U.S. Grimes v. Ohio Edison, Co., 992 F2d 455 (CA2 1993).

"no action" letter by the SEC on the matter has been held to be subject to direct judicial review,[39] as being a more appropriate remedy than a private action against the corporation.[40] Whether a court has jurisdiction to review "no action" letters in connection with shareholder proposals management indicates it intends to omit is questionable. The SEC itself has acknowledged that no–action letters have no binding effect on the parties addressed in the letters.[41] The Second Circuit Court of Appeals has held that a shareholder who believes that management improperly omitted a proposal from proxy materials must seek a judicial determination of the propriety of such actions.[42] Another decision has recognized an implied private right of action pursuant to Rule 14a–8 to enforce a registrant's obligation to include a shareholder's proposal in proxy materials mailed out in advance of an annual meeting.[43]

The Pennsylvania Control Shares Act has been construed to apply to the acquisition of voting power by revocable proxy unless the proxy falls under the safe harbor provision.[44]

Federal regulation of proxies under Rule 14a–9, see § 2052.30.

[39] U.S. Decision of court of appeals that it had jurisdiction to review SEC's determination not to oppose company's refusal of shareholder's request to include in its proxy statement a proposal to amend certificate of incorporation to prohibit sale of napalm without being given reasonable assurance that it would not be used against human beings. would be vacated as moot controversy where company subsequently acquiesced and included the proposal but less than 3 percent of all voting shareholders supported it at annual meeting, as result of which under Rule 14a–8(c)(4)(i), the company could exclude such proposal from its proxy materials for next three-year period. Securities & Exchange Commission v. Medical Committee for Human Rights, 404 US 403.30 L Ed 2d 560, 92 S Ct 577, vacating 139 US App DC 226,432 F2d 659.

[40] See Schwartz, The public-interest proxy contest: Reflections on campaign GM, 69 Mich L Rev 419; Note, The SEC and "no action" decisions under Proxy Rule 14a–8: The case for direct judicial review, 84 Harv L Rev 835.

[41] U.S. Amalgamated Clothing & Textile Workers Union v. S.E.C., 15 F3d 254 (CA2 1994) (discussing SEC's statement of informal procedure for rendering advice on shareholder proposals).

[42] U.S. Amalgamated Clothing & Textile Workers Union v. S.E.C., 15 F3d 254 (CA2 1994) (no-action letters not binding on district courts).

[43] U.S. Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F2d 416 (CA DC 1992).

[44] U.S. Because plaintiffs proxyholders received discretionary authority from the proxy cards, the safe harbor does not apply and, therefore, the judge of elections cor-

Directors who issue **proxy** statements regarding upcoming shareholder action owe the shareholders a duty of full disclosure grounded **in** their fiduciary duty to the corporation.[45]

§ 2052.90 Who must bear the expense?

It is well-settled that a corporation may, through its board of directors, expend reasonable sums in a contested election of directors in the solicitation of proxies where the expenditures **are** in the interest of intelligent exercise of judgment by its shareholders,[1] Thus, in a contest over policy as distinguished from a purely **personal** power contest, the corporate directors have the right to make reasonable and proper expenditures from the corporate treasury for the purpose of persuading the shareholders of the correctness of their position and soliciting their support for policies which the directors believe in good faith are in the best interests of the corporation.[2] In other words, the incumbent board of directors of a

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rectly concluded that the Control Shares Act required the sterilization **of** the proxies. Committee for New Management of Guaranty Bancshares Corp. v. Dimeling. **772** F Supp **230** (ED Pa 1991) (construing Pennsylvania law).

Pa. Committee for New Management of Guaranty Bancshares Corp. v. Dimeling, 772 F Supp 230 (ED Pa 1991).

Control share acquisition statutes generally, see §§ 2029.10, **2841.20.**

[45] **Del.** Where directors disclosed partial history leading **up** to proposed merger. but left out **background** information which would **make** disclosure not misleading, the directors breached their duty of candor. Arnold v. Society for Savings Cancorp., Inc.. 650 A2d 1270 (Del 1994).

Directors' disclosure duties *generally*, see § **837.70.**

[Section 2052.90]

[1] **U.S.** Levin v. Metro-Goldwyn-Mayer, Inc., 264 F **Supp 797;** Locke Mfg. Co. v. United States, **237** F Supp 80 (applying Connecticut **law>;** Selma-Dindings Plantations, Ltd. v. Durham, **216** F Supp **104,** affd **337** F2d **949;** Hand v. Missouri-Kansas Pipe Line Co., **54** F Supp 649 (applying Delaware law).

Conn. Locke Mfg. Co. v. United States, 237 F Supp 80.

Del. Kors **v.** Carey, 39 Del Ch **47,** 158 A2d **136.**

Hand v. Missouri-Kansas Pipe Line Co., **54** F Supp **649,** following Hall v. Trans-Lux Daylight Picture Screen *Corp.*, 20 Del Ch 78, 171 A 226.

Mo. Streett v. Laclede-Christy *Co.,* 409 SW2d 691 (Mo).

N.Y. Begleiter v. Moreland, **33** Misc 2d 118, 225 NYS2d **577;** In re Zickl, 73 NYS2d 181 (Misc).

[2] **U.S.** Palumbo **v.** Deposit Bank, 758 F2d 113 (CA3), citing this treatise; Levin v. Metro-Goldwyn-Mayer, Inc., **264** F Supp 797.

N.Y. Rosenfeld v. Fairchild Engine & Airplane Corp., 309 NY 168, 128 NE2d 291; Grodetsky **v.**

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HIGHLIGHTS

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A Practical Guide to SEC Proxy and Compensation Rules, Third Edition

by ***Amy*** *L. Goodman and John F. Olson*

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- Proposed changes to NYSE and NASDAQ corporate governance listing standards;
- Discussion of recent proxy contests; and
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CHAPTER 11

THE SHAREHOLDER COMMUNICATIONS PROXY RULES AND THEIR PRACTICAL EFFECT ON SHAREHOLDER ACTIVISM AND PROXY CONTESTS

by Steven A. Rosenblum

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§ 11.1 INTRODUCTION

The shareholder communications proxy rules adopted by the SEC in 1992 have played a major role in altering the balance of power between corporate management and institutional shareholders. In the context of increasingly concentrated institutional share ownership and a greater focus on corporate governance issues, the shareholder communications rules have given institutions and activists a powerful set of weapons with which to bring pressure to bear on boards and management. The rules give shareholders wide freedom in communicating among themselves privately, as well as expressing their views publicly, on any matter brought to a shareholder vote. This, in turn, gives institutional activists a much greater ability to wage an effective proxy campaign on any given issue, outside the framework and without the time and expense of a formal proxy solicitation.

Corporate management has had little choice but to recognize the increased power of the institutional shareholders and the need to be responsive to their concerns. Discussions and negotiations between management and shareholders have often replaced the confrontational atmosphere of the 1980s. But these discussions and negotiations carry the implicit threat of more direct institutional shareholder action if the institutions are not satisfied with management's response. And, in a number of instances where managers have been unwilling or unable to respond adequately to institutional shareholder concerns, boards of directors have responded to shareholder pressure by replacing incumbent management with new managers.

The shareholder communications rules have also had an impact on conventional proxy contests. With the increase in hostile takeover activity the past few years, the number of proxy contests has risen. The shareholder communications rules have permitted a range of activities by the proxy contests' participants, including testing the waters with large institutional shareholders and running strongly worded, hard-hitting proxy campaigns.

The corporate governance crisis created in the past year by Enron, WorldCom and others, and the political and regulatory responses embodied in the Sarbanes-Oxley Act of 2002 and the proposed NYSE and NASDAQ corporate governance rules, will almost certainly have a profound impact on the governance relationship of shareholders and managers in the future. Shareholders can expect an even greater and more accessible flow of information about the corporations in which they invest, and greater governmental and regulatory support for calling managers to task. Managers can expect even greater scrutiny of and accountability for their actions. And boards of directors will have to monitor management more tightly and will face added shareholder pressure. Moreover, additional changes are likely, such as SEC Chairman Pitt's call to eliminate the SEC rule that allows a corporation to omit shareholder proposals relating to the corporation's ordinary business conduct. All of these factors will combine to continue the shift in corporate governance power to shareholders and institutional activists.

The next section of this chapter provides an overview of the shareholder communications rules and their impact. as well as the potential impact of the recent corporate governance reforms and proposals. Section 1 1.3 sets forth examples of the effect of the rules on proxy contests and shareholder activism, and the effects that may be expected from recent reforms. Section 1 1.4 explores corporate responses to the rules and new reforms and sets forth recommendations for the future.

§ 11.2 THE SHAREHOLDER COMMUNICATIONS PROXY RULES AND THEIR EFFECTS

[1] Private Proxy Solicitations

The most significant of the shareholder communications rules effectively permits a wide array of private proxy solicitations. Previously, any solicitation directed to more than ten persons required a proxy statement and mandated public disclosure. Now, the proxy rules allow solicitation of an unlimited number of shareholders, with no proxy statement or public disclosure, so long as the person making the solicitation does not ask for a proxy and does not have a special interest in the subject matter of the solicitation.[1]

If the private solicitation is made by a person who holds more than $5 million of the company's stock, any written solicitation material must be filed with the SEC within three days of its use.[2] Otherwise, nu filing or disclosure is required at all. Persons who solicit their own proxy card, or who have a special interest in the matter to be voted on, continue to be subject to the full proxy statement and disclosure requirements. Others ineligible for the no disclosure rule include (i) the issuer; (ii) officers, directors or affiliates of the issuer or of any other ineligible person; (iii) director nominees; (iv) any person soliciting in opposition to a merger or similar transaction who is affiliated with a competing alternative transaction; (v) any Schedule 13D filer who has disclosed a possible control intent; and (vi) anyone who is paid to solicit by an ineligible person.[3]

The rule on private solicitations permits private discussions among a company's major shareholders, and private lobbying of major shareholders, all out of the view of the public and the company itself. No notice or filing with respect to oral communications among shareholders who do not solicit their own proxy card (and are not otherwise ineligible) need ever be made. Written material need be filed only by persons who hold more than $5 million of the company's stock (and even then need not be filed if it is published or broadcast). Given the size

1. Rule 14a-2(b)(1).
2. Rule 14a-6(g).
3. Rule 14a-2(b)(1).

of institutional holdings (over half of all equity securities in the United States),[4] for many companies these rules give institutional holders the power, if they so desire, to decide in private the outcome (or at least a substantial portion of the vote on) any given matter presented for shareholder vote.

As outlined in the next section, this rule has enhanced the influence of institutional shareholder activists. While its effect has been demonstrated in the context of proxy contests, the most important impact has been on the leverage it gives institutional activists to negotiate with a company short of any formal action. Institutional shareholders are regularly able to gain direct access to corporate managements and even boards of directors to discuss their dissatisfaction with corporate policies or personnel. The range of more formal measures favored by activists—such as bringing a Rule 14a-8 shareholder proposal, withholding authority from a company's slate of director nominees as a vote of no confidence,

[Next page is 11-5.]

4. As of the third quarter of 1999, institutions held approximately 58 percent of the 1,000 largest corporations in the United States, though this represented a slight decline from 60 percent in 1997. From 1987 to 1997, institutional ownership of the largest 1,000 U.S. corporations had increased from 47 percent to 60 percent. See *Reversal of Fortune: Institutional Ownership is Declining*, Investor Relations Business, May 1, 2000.

seeking the election of one or two institutional representatives to the board or seeking the appointment of a shareholder advisory committee—still remains as a backdrop to reinforce the institutional investors' power. The ability of institutions to communicate among themselves in private, without being deemed to be engaged in a solicitation, gives such measures an increased likelihood of success. Together with the sheer size of institutional holdings, the increased ability of institutional shareholders to act collectively has changed the dynamics of the interaction between a company and its major shareholders, giving the shareholders more access and more power to influence the company's direction.

[2] Announcement of Voting Decisions

The shareholder communications rules provide that a shareholder's public announcement of how the shareholder intends to vote on any matter (and the reasons for such vote) does not constitute a proxy solicitation.[5] Prior to 1992, doubt as to whether such an announcement could be considered a solicitation had deterred some shareholders from publicly announcing their voting decisions.

As discussed in the next section, this rule enables shareholder activists to apply public pressure on targeted companies. The announcement of a voting decision such as the withholding of authority for a company's board slate, combined with a public critique of company policy or performance, can be a very powerful weapon for the shareholder activist (particularly given the ability of the activist to lobby other shareholders in private to take the same position). Just the threat of such an announcement may also be a powerful weapon.

[3] Dissident Nominees

The shareholder communications rules allow a dissident's proxy card to "round out'' a less than full slate of dissident nominees by granting authority to vote for the incumbents' nominees (other than those incumbent nominees whom the dissident would replace), subject to the right of the incumbents to state that they will not serve if the dissidents are elected? For example, if a dissident sought to elect two directors to a board of ten, the dissident's proxy card could grant a proxy to vote for Mr. Brown and Ms. Green (the two dissident nominees), and for all of the incumbents' nominees other than Mr. Smith and Ms. Jones (the two incumbents sought to be replaced). Under the old ''bona fide nominee" rule, each nominee on a proxy card had to consent to being so nominated, which meant, in effect, that a dissident's proxy card could not confer authority to vote for any incumbents.

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5. Rule 14a-1(1)(2)(iv).
6. Rule 14a-4(d).

While this provision was hailed by shareholder activists as removing a major impediment to gaining minority representation on a company's board. initially it was largely ignored. The potential use of this provision resurfaced in late 1995, when Kirk Kerkorian proposed to seek to elect a nominee to the Chrysler board to replace one of the incumbent slate. Since then, dissidents have taken advantage of the ability to nominate a partial slate on a number of occasions.

[4] Preliminary Filings

The proxy rules now require preliminary filing and SEC review of proxy materials only for the basic proxy statement and proxy card. All other proxy materials, including letters to shareholders, newspaper advertisements and other supplemental materials, need not be filed in advance of their use and are not subject to prior SEC review.[7] As discussed in the next section, many of the proxy contests waged since adoption of these provisions have been particularly aggressive compared to proxy contests in previous years. The other major effect of the absence of prior review is to permit both sides of the contest to respond more rapidly to each other in the midst of the fight.

[5] Public Availability of Filings

Most proxy materials that are still required to be filed in preliminary form are available to the public upon filing, rather than remaining confidential until definitive materials are filed.[8] Only proxy materials to be used in connection with business combinations (other than going private transactions and partnership roll-ups) are now eligible for confidential treatment while in preliminary form.[9] And even this exception was largely undercut by proxy rule amendments adopted by the SEC in 1999, which permit confidential treatment only if the company confines itself to very limited public statements with respect to the business combination.[10] Because virtually any company announcing a business combination will want to explain the transaction publicly, the practical effect of the SEC's 1999 amendment is to eliminate the 1992 exception that permitted confidential treatment for preliminary proxies relating to business combinations.

[6] Commencement of Solicitations

Under the SEC's 1999 amendments, even a party that is required to file a proxy statement may commence a proxy solicitation before filing.[11] In order to

7. Rule 14a-6(a)-(c).
8. Rule 14a-6(e)(1).
9. Rule 14a-6(e)(2).
10. Rule 14a-6(e)(2)(ii).
11. Rule 14a-12.

take advantage of this rule, the party making the solicitation: (i) must file any written material used for the solicitation with the SEC no later than its first use; (ii) must include a legend advising shareholders to read the proxy statement when it becomes available and providing Shareholders with information about the participants in the solicitation or advising shareholders where they can find that information; and (iii) may not furnish a form of proxy until shareholders receive the final proxy statement. Previously, the proxy solicitation could not commence until the preliminary proxy statement was filed. The 1999 amendments further increase the speed with which a solicitation can be started. This rule has particular importance in the context of business combinations, where it has now become routine for company management to conduct extensive presentations and follow-up discussions with major shareholders following announcement of a transaction, but before filing a proxy statement. Amendments adopted concurrently in 1999 under the Securities Act of 1933 ("Securities Act") work in tandem with the proxy rules to permit this activity even in the context of a stock for stock transaction, without violating Securities Act rules relating to the registration of stock offerings.[12]

[7] Elimination of Schedule 14B

The adoption of the shareholder communications rules eliminated Schedule 14B, a form which was previously required to be filed to provide certain information about participants in election contests.[13] Elimination of the Schedule 14B works together with the ability to commence a solicitation before filing a preliminary proxy statement to increase the speed with which an election contest may be started.

[8] Unbundling of Related Proposals

The proxy rules no longer permit a company to present a group of related matters as a single proposal for shareholder action. Instead, the proxy card requires separate boxes to give shareholders the opportunity to vote on each matter separately. Each related matter may, however, be conditioned on passage of the others.[14]

This provision is largely an outgrowth of the SEC's unhappiness with the bundling of matters such as antitakeover charter provisions with an economic transaction such as a spinoff. However, the unbundling requirement may result in shareholder confusion in circumstances where matters that are truly interrelated, and mutually conditional, are presented for separate votes.

12. See Rule 165 under the Securities Act.
13. Rule 14a-11.
14. Rule 14a-4(a)(3) and (b)(1).

[9] Shareholder Lists

The shareholder communications rules require a company to provide a requesting shareholder with a shareholders list only for solicitations involving a roll-up or going-private transaction. In the case of all other solicitations, the company may mail a dissident's materials in lieu of turning over a shareholder list.[15] Rule 14a-7 provides that any shareholder is entitled to request a shareholder list or have the company mail soliciting materials for the shareholder. The company is required to respond to the request within five business days of receipt.

The SEC reaffirmed its commitment to enforcing this rule in a 1993 release.[16] Noting that there is no exception to a company's obligations under Rule 14a-7 based on a deficient request, the release states that "a failure to meet the requirement for a timely response to a Rule 14a-7 request is excusable only if the issuer informs the holder within the five business day period of any deficiencies in the request and what additional information is required to perfect a request"[17] The release also states that any "comprehensible request" for a shareholder list or for a mailing triggers the Rule 14a-7 requirements, even if the request references state law rather than the federal proxy rules, unless it expressly disclaims reliance on Rule 14a-7.[18] The release notes that Rule 14a-7 is intended "to provide shareholders a meaningful means to exercise their rights to communicate with other shareholders" and should not be conditioned on the requesting shareholder being aware of technical distinctions or of "the particular requirements of Rule 14a-7."[19]

[10] Published or Broadcast Solicitations

The shareholder communications rules allow solicitations by means of broadcast or publication without the delivery of a proxy statement, so long as a definitive proxy statement is on file with the SEC and no form of proxy is provided with the solicitation.[20] This allows broad-based solicitations without the expense of mailing proxy materials to all shareholders.

[11] Disclosure of Voting Results

The proxy rules mandate detailed disclosure of voting results in a company's Form 10-K and 10-Q.[21] All matters presented for a vote during the reporting

15. Rule 14a-7.
16. *Compensation Disclosure; Securityholder Lisr and Mailing Requests,* Exchange Act Release No. 34-32723 (Aug. 6, 1993).
17. *Id.* at 37.
18. *Id.*
19. *Id.* at 36-37.
20. Rule 14a-3(f).
21. Item 4(c) of Forms 10-K and 10-Q.

period must be disclosed, including disclosure of withheld votes and abstentions. This rule increases the effectiveness of a withheld vote or an abstention as a protest vote.

The rules also require disclosure in the proxy statement of the effect of abstentions in tabulating the vote on any given matter in accordance with state law and the company's charter and bylaws." This is designed to inform the shareholder whether an abstention will in essence be counted as a negative vote or a non-vote.

[12] Corporate Governance Reforms of 2002

The spectacular collapse of Enron in 2001, followed by fraud scandals and the collapse of other major companies, including WorldCom, in 2002 has led to a perceived corporate governance crisis. While one can debate whether these events reflect a pervasive problem, or more isolated instances of wrongdoing, the perceived crisis generated a rapid political and regulatory response. The Sarbanes-Oxley Act was signed into law on July 30, 2002, and both the NYSE and NASDAQ approved revised corporate governance proposals. The SEC continues to work on rulemaking to implement the Sarbanes-Oxley Act, as well as additional proposals. Much has and will be written about these developments, which are far beyond the scope of this chapter. This section, and the rest of this chapter, will reference just a few of the provisions of these reforms that are likely to interact with the shareholder communications rules and further facilitate shareholder involvement in corporate governance.

[a] Stock Exchange Proposals

The thrust of a number of the pending NYSE governance rule proposals is to require disclosure of corporate governance practices and enhance channels of communication with shareholders. The underlying premise appears to be that this will increase the ability of institutional investors to police corporate practices, and that corporations will be more likely to adhere to good practices for fear of censure from shareholders.

Perhaps the most significant provision in this respect is no?in the proposed rules themselves, but in the commentary to proposed Rule 303A(3). The substance of Rule 303A(3) requires non-management directors of a company to meet at regularly scheduled executive sessions without management. This is designed to allow the independent directors a regular opportunity to discuss issues affecting the company among themselves. The last sentence of the commentary to Rule 303A(3), however, imposes an additional requirement, stating: "In order that interested parties may be able to make their concerns known to the non-manage-

22. Item 21 of Schedule 14A.

ment directors. a company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group." This somewhat extraordinary requirement will open a direct line of communication between institutional shareholders and outside directors, bypassing management.

Institutional shareholders have already taken note of this provision in the commentary to Rule 303A(3). Meredith Miller, assistant treasurer for policy with the state of Connecticut's retirement and trust funds, says that pension fund investors are "currently sorting out how best to institutionalize a process to bring issues to corporate boards" under this provision?' As described in the next section of this chapter, institutional activists have already been very successful in using the shareholder communications rules, and the power those rules gives them, to negotiate privately with companies for desired changes. The requirement of a direct line of communication to outside directors is virtually certain to increase the frequency and effectiveness of these private negotiations.

A number of other proposed NYSE rules require more detailed disclosure of various corporate governance practices. With this disclosure, institutional investors will be able to monitor corporate activities to an even greater degree, and companies will have to define their corporate governance practices with an even greater eye to how those practices will be received by shareholders. For example, proposed Rule 303A(2) requires a company's board to make an affirmative determination as to each director's independence, and to disclose the basis for this determination or the categorical standards by which a determination of independence is made. This will give shareholders the information they need to take issue with the board's determination should they believe the board is being too lax in its standards of independence. At the same time, it should also push boards to be rigorous in their standards of independence, given that the board will have to be able to defend its determinations to shareholders.

Similarly, proposed Rule 303A(9) requires companies to adopt and disclose corporate governance guidelines. These guidelines must address director qualification standards, director responsibilities, director access to management and advisors, director compensation and a number of other issues. And proposed Rule 303A(10) requires companies to adopt and disclose a code of business conduct and ethics, and to disclose any waivers of the code for directors and executive officers. The requirements that a company adopt such guidelines and codes is not likely to have a great impact. Most major companies either already have guidelines and codes that cover these topics, or have existing policies that can easily be codified. The greater impact will likely arise from the requirement that the guidelines, and any waivers, be publicly disclosed. The disclosure requirement will open these policies to greater shareholder scrutiny and activism, Once again, in reviewing their policies and any possible waivers, companies will need

22.1. Phyllis Plitch, *Despite Reform, Companies Can Expect Plenty of Holder Activism,* Dow Jones Newswire, Sept. 13, 2002.

to be sensitive to how shareholders are likely to react and how the company will defend its policies or waiver decisions to its shareholders.

One of the proposed NYSE rules, Rule 303A(8), goes beyond disclosure and communication, and extends shareholder power substantively by requiring shareholder approval on most equity compensation plans. As with the proposed rules set forth above, this rule will force companies to focus on their ability to justify their equity Compensation decisions to shareholders. Requiring affirmative shareholder approval, of course, is an even more stringent standard and gives shareholders even greater power than simply requiring a company to disclose its practices fully and risk shareholder censure. But directionally it is consistent with the underlying premise of the other rules. As a practical matter, companies will generally want to avoid adopting and disclosing policies and practices in any area that meet with widespread shareholder disapproval. The only difference is that, in the area of equity compensation, they will not even have the power to adopt a plan that does not obtain shareholder approval.

Finally, proposed NYSE Rule 303A(13) provides that the NYSE issue a public reprimand letter to any listed company that violates an NYSE listing standard. This gives the NYSE the ability to take action for violations short of the extreme step of commencing a delisting proceeding. It also is consistent with the approach taken in some of the other rules described above, in that it relies on the threat of public and shareholder disapprobation to encourage compliance with good corporate practices.

NASDAQ has also proposed a set of corporate governance rules that are similar in many respects to the NYSE proposals. The proposed NASDAQ rules, like the NYSE, would require companies to adopt and disclose a code of conduct, and to disclose promptly any waivers of the code for directors or executive officers (Rule 4350(m)). Rule 4200(a)(15) would require the board to make an affirmative determination as to the independence of each director, and sets forth specific criteria that would preclude a finding of independence. It is less clear whether the board's determinations of independence must be affirmatively disclosed, however. Rule 4350(c)(2) would require, like the NYSE, regular executive sessions of the company's independent directors. While the NASDAQ proposals do not require a means for shareholders to communicate directly with the independent directors, the requirement of separate sessions of independent directors, and the NYSE precedent for communicating directly with them, will likely encourage similar communications in NASDAQ companies as well. Rule 4350(i) would require, like the NYSE, shareholder approval on most equity compensation plans.

The SEC has published for comment and approval the NYSE and NASDAQ proposals relating to shareholder approval of equity compensation plans.[22.2] As of November 2002, the other NYSE and NASDAQ proposals were still pending

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22.2. SEC Release Nos. 34-46620, Oct. 8, 2002 (NYSE rule), and 34-46649, Oct. 11, 2002 (NASDAQ rule).

before the SEC, and there have been reports that the SEC is seeking to harmonize the differences between the two sets of proposals before they are adopted.

[b] The Sarbanes-Oxley Act

The Sarbanes-Oxley Act focuses largely on accounting and auditing issues, management accountability for financial reporting, and a handful of perceived corporate abuses such as personal loans to executives. But a few Sarbanes-Oxley provisions, like some of the NYSE proposals, are designed to influence corporate behavior by requiring disclosures that will give shareholders more information on the company's corporate governance practices. As with the NYSE and NASDAQ proposals described above, these new disclosure requirements, combined with the existing shareholder communications rules, will give shareholder activists that much more power to push companies to follow practices that meet with shareholder approval.

Section 406 of the Sarbanes-Oxley Act directs the SEC to implement rules that will require companies to disclose whether they have adopted (and if not, why not) a code of ethics for senior financial officers.[22.3] It also requires companies that have adopted such a code of ethics to disclose immediately any change in or waiver of the code. Like proposed NYSE Rule 303A(10) and NASDAQ Rule 4350(m), Section 406 of Sarbanes-Oxley relies on disclosure and the threat of shareholder censure to push companies into adopting a code of ethics that will meet with shareholder approval. It also provides shareholder activists with the information they need to target any company that does not adopt a satisfactory code of ethics. Similarly, Section 407 of Sarbanes-Oxley directs the SEC to adopt rules that will require companies to disclose whether (and if not, why not) at least one member the company's audit committee is a "financial expert" (as that term will be defined by the SEC).[22.4] Again, although expressed as a disclosure requirement, Section 407 relies on the power of shareholder pressure to push companies to include at least one financial expert on their audit committees. The SEC proposed rules under Sections 406 and 407 of the Sarbanes-Oxley Act on October 22, 2002, and is required to adopt final rules by late January 2003.[22.5]

[c] Additional SEC Initiatives

In addition to the rulemaking required by the Sarbanes-Oxley Act, the SEC also continues to explore other potential reforms that would enhance the monitoring and policing power of shareholder activists. For example, on Septem-

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22.3. *See* Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 33-8138 (Oct. 22, 2002).

22.4. *See id.*

22.5. SEC Release No. 34-46701, Oct. 22, 2002.

ber 19,2002, the SEC proposed rules to require mutual funds and other registered management investment companies to disclose information on how they cast their proxy votes, as well as their voting policies and procedures.[22.6] The shareholder communications rules adopted in 1992 made clear that shareholder activists could announce their voting decisions without running afoul of the proxy rules. This paved the way for major shareholdersto use the announcement of voting decisions as a means to apply public pressure on companies and to sway the voting of other shareholders. A number of institutional investors, such as CalPERS, regularly disclose their voting decisions on their Web sites. The current SEC proposal takes this concept one step further, by mandating disclosure of proxy votes and voting policies by mutual funds and management investment companies. Further, the proposal not only ensures more widespread dissemination of voting positions by major shareholders, it also opens up the prospect of a campaign within a campaign. If the proposal is adopted, shareholders may not only seek to apply pressure on a company in which they invest, but they may also seek to apply pressure on mutual funds and investment advisors who are investors in the same company and whose voting decisions will now have to be disclosed.

In addition, in September 2002, then-SEC Chairman Harvey Pitt called for consideration of a proposal to eliminate the "ordinary business" exception that currently allows companies to exclude from their proxy statements shareholder proposals that relate to the ordinary business of the company.[22.7] The "ordinary business" exclusion has long been used as a means of deterring shareholders from submitting issues relating to the day to day operations of the company to shareholder vote. The basis for this approach is that ordinary business operations should be delegated to the board and management. The recourse of Shareholders, if they do not approve of how the business of the corporation is managed, is to replace the board. In calling for the elimination of the ordinary business exclusion, however, Pitt stated that the purpose of shareholder proposals is to let shareholders inform management of their views, and that companies "should not be able to exclude these proposals under the rubric of ordinary business exceptions." If adopted, the elimination of the ordinary business exception would open a whole new and extraordinarily wide category of shareholder proposals. But even some shareholder activists have questioned the wisdom of the proposal. For example, Kenneth Bertsch, former director of corporate governance for TIAA-CREF, states, "If the process becomes so open that a lot of companies are receiving 20 or 30 resolutions and they all become meaningless, this does not solve the problem."[22.8]

22.6. *SEC Proposal Would Require Mutual Funds, Investment Advisers to Disclose Information on Proxy Voting,* **IRRC Corporate Governance Highlights (Sept. 20, 2002).**

22.7. *Pitt Calls for Elimination of "Ordinary Business" Exclusion,* **SEC Today, Sept. 25, 2002.**

22.8. *Would Elimination of Ordinary Business Exclusion Create More Problems Than It Would Solve?,* **IRRC Corporate Governance Highlights, Oct. 4, 2002.**

§ 11.3 PROXY CONTESTS AND SHAREHOLDER ACTMSM

[1] Private Solicitations and Discussions

The ability of institutional shareholders to discuss their voting decisions in private, and of institutional shareholder groups to engage in private lobbying of their members, changes the dynamics of proxy contests and shareholder activism. A company facing a proxy fight has less ability to monitor the solicitation efforts of dissident shareholders, and less ability to respond to statements and arguments made by dissidents privately in the course of their solicitations. Even short of a proxy contest, the ability of shareholders to discuss their concerns in private gives them the power to present a united front to a company in seeking changes in management or corporate policy.

[a] Proxy Contests

The private solicitation rule[23] makes participation in a proxy contest easier and allows more varying levels of participation in proxy contests. Shareholders who are not willing to go to the expense of a full-blown proxy solicitation are still able to circulate soliciting material so iong as they do not seek their own proxy authority. The proxy contest over approval of the merger between Centel Corporation and Sprint Corporation, straddling the change in the rules, provides an example of this kind of activity.[24] Soliciting before the change in the rules, one major dissident shareholder, Moran Asset Management, had to file formal proxy materials and solicited proxy authority to vote against the merger. After the change, another dissident, Eagle Asset Management, circulated its own 32-page package in opposition to the merger, but did not solicit its own proxy authority, thereby avoiding the need to prepare and file a proxy statement with the SEC.[25] Eagle Asset Management said that it contacted the 200 largest institutional investors in Centel.[26] As discussed in the next section, the approach of simply mailing materials supporting or opposing a proposal to a limited list of the largest shareholders, without formally soliciting a separate proxy, has become standard practice for shareholder activists under the private solicitation rules.

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23. Rule 14a-2(b)(1).

24. The Centel-Sprint merger was approved in an extremely close vote, with 50.5 percent of the outstanding Centel shares voting in favor. See *Centel's Holders Approve Merger By a Thin Margin*, Wall St. J., Dec. 14, 1992. at C13.

25. Karen Donovan. *Proxy Fight Tests SEC's New Rules Easing Speech,* National Law Journal, Dec. 14, 1992 at 17.

26. Anthony Ramirez, *Shareholder Accuses Centel of Bungling a Proxy Letter,* N.Y.Times, Nov. 2, 1992. at D1.

[i] Dissident Slates

In the case of an election contest, the dissidents proposing a slate of directors must still go through the process of filing proxy materials in order to seek proxy authority to vote for the dissident candidates. Other shareholders, however, are able to solicit and lobby in private (so long as they are not soliciting on behalf of the shareholders who nominated the dissident candidates). Again, the ability to solicit in private makes participation in the contest easier and defending against the contest harder.

In 1998, the Teachers Insurance and Annuity Association—College Retirement Equities Fund (TIAA-CREF) demonstrated the increased power of institutional shareholders to win a proxy contest for the election of directors. Targeting an underperforming restaurant company, Furr's/Bishop's, TIAA-CREF successfully ran a seven-person slate to replace the company's entire board of directors.[27] This marked the first time that a pension fund had replaced a board of directors with its own slate.

Subsequently, other activists have run proxy contests to elect one or more, but less than a full slate of, dissident directors to a targeted company's board, including Guy Wyser-Pratte at Telxon, Providence Capital at Ogden, and Greenway Partners at Venator and LENS at Pioneer Group.[28] These battles demonstrate the willingness of activists and institutions to engage in the type of proxy contests for board seats that once was the almost exclusive province of takeover artists. One report on the 2000 proxy season states that over 60 percent of the election contests were fought over minority seats, and close to 80 percent were not associated with a hostile takeover attempt.[29] The success of these contests has also been rising, with about 75 percent in 2000 resulting in dissidents being elected or concessions from the target company to settle the fight." And the 2001 and 2002 proxy seasons saw dissidents elected to minority seats at a number of companies, including ICN Pharmaceuticals, Hercules, Lone Star Steakhouse & Saloon, United Industrial, and Liquid Audio. In the case of Lone Star, the chief executive officer was ousted from the board by a small investor who won public support from institutions such as CalPERS and Longview Collective

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27. John Waggoner, *Largest Pension Fund Unseats Bourd,* USA Today, May 29, 1998, at 1B.

28. See *Telxon, Wyser-Pratte Reach Settlement,* IRRC Corporate Governance Highlights, Aug. 28, 1998, at 133; *Providence Capital Was Not Able to Convince Ogden,* IRRC Corporate Governance Highlights. May 22, 1998, at 82; Erin White, *Venator Defeats Greenway in Battle fur Board Seats,* Wall St. J., July 19, 1999, at B5; Joann Lublin, *Dissident Investors Fight for Board Seats Without Seeking Full Control of Firms,* Wall St. J., June 1, 1999, at B3; Beth Healy, *Pioneer Target in Proxy Fight,* Boston Globe, Feb. 4, 2000, at D1.

29. *Open Season: Mouse-wielding Shareholder Poised to Corner "Big Cheeses,"* The M&A Journal, Volume 2, Number 7.

30. *Id.*

Investment Fund.[31] Beyond the impact on the relative handful of targeted companies, this demonstration of institutional power will almost certainly reinforce the ability of large institutional shareholders to influence the policies and management of other companies through private discussion and pressure short of an actual proxy contest.

[ii] Testing the Waters

The shareholder communications rules have also given dissidents contemplating a proxy contest the ability to "test the waters" by consulting with major shareholders before commencing a proxy solicitation. For example. Kirk Kerkorian and his lieutenant. Jerome York, spoke with a number of major Chrysler shareholders in anticipation of a possible proxy contest seeking representation on the Chrysler board of directors? After finding most of Chrysler's major shareholders generally happy with the company, Kerkorian ultimately agreed to a settlement and standstill with Chrysler under which Kerkorian gained one board representative and Chrysler elected another, mutually agreed, outside director.[33] Similarly, Carl Icahn, in the wake of his unsuccessful effort with Bennett LeBow to gain control of the board of RJR Nabisco, began contacting major RJR shareholders to discuss the possibility of mounting a new proxy challenge to RJR.[34] Shareholder activist Herbert Denton of Providence Capital has taken to holding meetings of major shareholders of various companies, and publicizing these meetings, as a means of pushing the companies to consider strategic changes.[35]

This ability to test the waters is also available to takeover bidders contemplating a concurrent proxy contest to pressure the target into accepting the bid. One noted proxy solicitor reports that this flexibility played a role in three hostile bids that turned quickly into negotiated acquisitions: IBM's bid for Lotus Development, Ingersoll Rand's bid for Clark Equipment, and FMC's bid for Moorco. In the context of these bids, "there was little question that IBM, Rand and FMC were able to poll institutional investors beforehand thanks to the relaxed

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31. David Shook. *Rebel Stockholders Are on the Move*, Business Week. Sept. 6. 2001; Gretchen Morgenson. *Shareholders Are Restless, and Starting to Pounce*, N.Y. Times, July 22. 2001, at Sec. 3, p. 1; *Dark Horse Candidate Defeats CEO*, IRRC Corporate Governance Highlights, July 13. 2001, at 111; Ron Orol, *United Industrial Expects Sale by Year-End*, The Daily Deal, Oct. 10, 2002; Benny Evangeiista. *Liquid Audio's Merger Puts It in Fluid Situation*, S.F. Chronicle, Oct. 7, 2002, at E1.

32. *See Interview—York Finds Chrysler Holders Upbeat*. Reuters. Jan. 2, 1996.

33. *See Chrysler CEO Pleased with Kerkorian Deal*. Reuters, Feb. 11, 1996.

34. See Glenn Collins, *Icahn Says He May Renew Proxy Fight at RJR Nabisco*, N.Y. Times, June 7, 1996 at D2.

35. According to a Providence Capital Press release of April 5, 2000, which invited major shareholders of Aetna to a meeting to express their concerns. Providence has convened similar meetings for Ashland, COMSAT. Digital Equipment, Disney. HealthSouth, Ogden. Tyco. and others.

rules, and were confident of prevailing in a proxy fight. Instead. each had only to write a little larger check.''[36]

In 1998, the SEC proposed further amendments to the proxy rules that would have extended the ability to "test the waters." without filing proxy materials, to companies and management.[37] The rules as adopted in 1999, however, expressly declined to adopt the "test the waters" provisions.[38] While the 1999 rules do expand the ability of companies to communicate with shareholders, the SEC based its decision not to adopt the even broader "test the waters" proposal on the basis that "it could result in unregulated and secret solicitations." Nevertheless, with the expanded ability to communicate with shareholders, and the increased investor relations focus on regular communication with major shareholders, companies are often able to predict the reactions of their major shareholders to any given proposal without having to test the waters formally. This in turn affects the company's decision as to whether to make the proposal. This effect is one more way in which the shareholder communications rules have enhanced the influence of large institutional shareholders.

[b] Shareholder Activism

Perhaps equally important as the use of the shareholder communications rules in conjunction with a formal proxy contest is the ability to conduct a private solicitation outside the traditional proxy contest arena. While the shareholder communications rules have made undertaking a formal proxy contest easier and less expensive, and recent dissident successes may spur more activity, it is still relatively rare for institutional investors to engage in a full-blown proxy contest.

[i] Targeting Large Shareholders

The shareholder communications rules have spawned a different type of proxy contest, in which shareholder activists, without seeking proxies, attempt to persuade large institutional holders to vote against a management proposal or in favor of a Rule 14a-8 shareholder proposal. The State of Wisconsin Investment

[Next page is 11-13.]

36. Daniel H. Burch and Stanley J. Kay, *A Proxy Solicitor's Highlights of the 1995 Proxy Contests: The Impact of the 'New' Proxy Rules*, The Corporate Governance Advisor, Sept./Oct. 1995, at 37.

37. Regulation of Takeovers and Security Holder Communications, Release No. 33-7607 (Nov. 3, 1998).

38. Regulation of Takeovers and Security Holder Communications, Release No. 33-7760 (Oct. 22, 1999), at Section II.C.1.c.

Board (SWIB) is a prominent example of an institutional activist that has successfully followed this approach. In recent years, SWIB has made several solicitations in favor of shareholder resolutions or against management proposals. These solicitations have involved mailings to large shareholders and follow-up discussions with major institutions. For example, in a solicitation in favor of a shareholder proposal it filed with Allergan, seeking to require a shareholder vote on the company's shareholder rights plan, SWIB mailed materials in support of the proposal to almost all shareholders with 1000 shares or more, did extensive follow-up with large institutions, and generated a majority vote in favor of the proposal.[39] Patricia Lipton, the executive director of SWIB, stated "The new rules certainly were the difference in this contest."[40] In another example, SWIB opposed a management proposal for the repricing of employee stuck options, telecopying fliers to major shareholders that stated, "Raise the stock price, don't lower the exercise price."[41] Ms. Lipton states that the cost of these efforts "generally ranges from $1,500 to $5,000," compared to the hundreds of thousands of dollars that may be spent on a full-fledged proxy contest.[42] SWIB used a similar approach, including a letter writing campaign and discussions with other shareholders of Rainforest Café, to break up a merger it opposed between Rainforest and Landry's Seafood Restaurants.[43]

Similarly, in 1998, the Hotel Employees and Restaurant Employees (HERE) union used the communications rules to solicit successfully against Marriott International's plan to adopt a dual class stock structure in connection with the split-up of Marriott's hotel and food services businesses.[44] HERE sent letters and telecopies, and talked to major shareholders, seeking their votes against the proposal, all without the need to file formal proxy materials and mail them to all shareholders. HERE also used the Internet, setting up a Web site to oppose the proposal.[45] The AFL-CIO joined in the effort, telephoning about 1,000 union pension fund managers, also without the need to file proxy materials. And Institutional Shareholders Services (ISS), a firm that makes voting recommendations to institutional shareholders, recommended a vote against the Marriott proposal. The net result of these efforts was, first, to pressure Marriott into decoupling the split-up plan and the dual class stock structure, and second, in the separate vote on the dual class stock structure, to defeat the proposal.[46]

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39. Patricia Lipton, *Experience Under the New Executive Compensation and Shareholder Communications Rules,* The Corporate Governance Advisor, Jan./Feb. 1994, at 33.

40. *Id.*

41. Leslie Scism, *Wisconsin Pension Fund Is Activist Hawk,* Wall St. J., March 18, 1994, at C1.

42. Lipton, *supra* note 39, at 33.

43. *Wisconsin Investment Manager Can Make or Break Mergers,* St. Paul Pioneer Press, June 4, 2000.

44. Barry Rehfeld, *A Suite Victory for Shareholders,* Institutional Investor, July 1998, at 37.

45. *Id.*

46. *Id.*

[ii] Pressing for Corporate Changes

Shareholder activists have also used the communications rules to press affirmatively for major corporate changes, such as a corporate restructuring or replacement of management. Shareholder pressure has played a role in management changes at a number of companies, including General Motors, Westinghouse, IBM, American Express, Kodak, Kmart, Borland, and W.R. Grace.[47] In 1997, George Soros and other investors pressured Phillip B. Rooney into resigning from his position as chief executive of WMX Technologies Inc. Following the resignation, Soros dropped plans to mount a proxy fight for four seats on WMX's board.[48] Commentators remarked in particular on the speed with which Rooney's resignation occurred. Citing the ability of shareholders to communicate more freely with each other under the shareholder communications rules, Professor Steven Kaplan of the University of Chicago, stated, "Shareholders are figuring out how to use those changes. They can now go to other large shareholders and say, 'We don't like this guy. Come argue along with us.' "[49]

Shareholder activists, as well as corporate raiders, have also campaigned for spinoffs or other restructurings at a number of companies, including U.S. Shoe, Sears, Philip Moms, Scios Nova, and Borden.[50] Greenway Partners, headed by Alfred Kingsley, a former associate of Carl Icahn, followed its successful efforts with U.S. Shoe by buying significant stakes and bringing spinoff proposals in 1996 at both Unisys and Woolworth.[51] While both proposals were defeated, Greenway has continued its efforts at Woolworth, now named Venator, running a dissident slate of director nominees, albeit unsuccessfully, at Venator's 1999 annual meeting.[52] Icahn himself has also reentered the fray of shareholder activism, successfully pressuring Nabisco into selling its foods business, and subsequently buying into General Motors in hopes of agitating for a spinoff of General Motors' subsidiary, Hughes Electronics (though he later sold out of his General Motors investment).[53]

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47. *See Bigger They Are, Harder They Fall; '93 Tough Year for Executives,* The Plain Dealer, Jan. 2, 1994, at 1E; *The Class of* 1995, IRRC Corporate Governance Highlights (March 24, 1995), at 37.

48. *Soros Drops Plan to Mount a Proxy Fight at WMX*, Wall St. J., Feb. 21, 1997, at B2.

49. Nancy Millman, *Doing the CEO Bounce: Shareholder Activism is Shaking Up That Old Gang at the Top,* San Diego Union-Tribune, March 30, 1997, at I1.

50. *Interim Proxy Season Report: Part II*, IRRC Corporate Governance Highlights (June 3, 1994), at 1-2.

51. *Proxy Season Reveals Trend Toward Spinoff Proposals,* Corporate Financing Week, (July 8, 1996), at 4.

52. White, *supra* note 28. Greenway's Gary Duberstein has stated, "Filing shareholder proposals calling on the board to put the company up for sale, do a spin-off or hire an investment bank to study such options is a favorite (and often successful) tactic." Patrick S. McGurn, *Four "N's" Underpin Activism in 1996,* IRRC Corporate Governance Bulletin (Oct.-Dec. 1995) at 13, 15.

53. Julie Creswell and Mark Borden, *Raiders Reborn,* Fortune, July 10, 2000, at 36; John Schnapp, *Icahn Promises to Shake Up and Slim GM,* Detroit News, Sept. 10, 2000, at 9; Alex

In 1997, activist investor Michael Price acquired a 4.6 percent stake in Dow Jones & Co. and publicly suggested that Dow Jones should "explore a variety of options regarding Telerate, including alliances, joint ventures or a spinoff."[54] Price has previously been involved in pressuring for restructurings or other corporate transactions at Dial Corp., Sunbeam Corp., Michigan National Corp., and Chase Manhattan.[55] Another activist investor, Guy Wyser-Pratte, has also been active in using shareholder proposals and threatened or actual proxy contests to bring pressure to bear on target companies. For example. Wyser-Pratte was able to pressure Pennzoil into amending its poison pill and adding an independent director to its board as the settlement for Wyser-Pratte's withdrawal of his proxy effort to elect himself to the Pennzoil board and to adopt bylaw amendments.[56] Wyser-Pratte immediately followed his Pennzoil proxy fight with a similar effort to elect a director to the board and adopt bylaw amendments at Telxon Corporation, resulting in a settlement under which Telxon adopted a "chewable" poison pill and agreed to add a director approved by Wyser-Pratte.[57] One commentator has observed that the shareholder communications rules have permitted corporate raiders and activist investors to use these proposal campaigns as a substitute for the hostile tender offers of the 1980s, allowing the investor "to see a potentially larger gain for a smaller investment of time and money."[58]

[iii] Union Activists

The shareholder communications rules have also encouraged the entry of another class of shareholder activists, the labor unions. Since 1994, labor unions have been among the most active shareholders in bringing Rule 14a-8 shareholder resolutions, joining the public pension funds as leading shareholder activists.[59] One commentator states "Union-affiliated groups have mounted a well-coordinated strategy with other labor groups and public pension funds of picking companies and issues. The Securities and Exchange Commission's rule changes

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Berenson, *Icahn Sells Entire General Motors Stake a Month After Purchase,* N.Y. Times, Sept. 22, 2000, at C1.

54. Susan Pulliam, *Dow Jones Stake of 4.6% is Acquired by Fund Led by Investor Michael Price,* Wall St. J., Jan. 29, 1997, at B2.

55. Matthew Greco, *An Activist's Who's Who for 1997,* Mergers and Restructuring, Jan. 13, 1997.

56. Michael Davis, *Pennzoil, Stockholder Chew Pride; Dispute Settled; Poison Pill Altered,* Houston Chronicle, April 4, 1998, at 1.

57. *Telxon, Wyser-Pratte Reach Settlement, supra* note 20.

58. *Four "N's" Underpin Activism in 1996, supra* note 52, at 15.

59. *See* James E. Heard and Jill Lyons, *Labor Unions and Public Funds Set Active Shareholder Agenda for 1995,* INSIGHTS (Dec. 1994), at 3; *Labor Again Tukes Lead Role in Activism,* IRRC Corporate Governance Bulletin (Nov.-Dec. 1994), at 3; *Chalk Up Five More "Wins" For the Unions,* IRRC Corporate Governance Highlights (May 10, 1996), at 48.

in the early 1990s letting shareholders openly discuss proxy strategies among themselves has aided that effort." [60]

In the 1996 and 1997 proxy seasons, some labor unions attempted a new proxy tactic in an effort.to circumvent the procedures and restrictions set forth in Rule 14a-8. The tactic involved sending a notice to a company after the Rule 14a-8 deadline, but well in advance of the company's annual meeting, stating that the union intended to bring a shareholder proposal to the company's annual meeting. The union then argued that, because the company had notice of the proposal a reasonable period of time before the meeting (even though too late to be included in the company's proxy statement under Rule 14a-8), the company did not have discretionary authority under Rule 14a-4 to vote proxies against the proposal. This left the company with the choice of either including information about the proposal, and the intended vote of management proxies on the proposal, in its proxy Statement, even though the union did not comply with Rule 14a-8, or facing the possibility that the company would not have the authority to vote proxies against the proposal at its annual meeting. In 1998, however, the SEC adopted amendments to Rule 14a-4 to address this new tactic. Under amended Rule 14a-4, a company will have discretionary voting authority to vote its proxies on any matter if it did not have notice of the matter at least 45 days before the anniversary of the mailing date of the prior year's annual proxy statement (or by such other date as may be specified by advance notice provisions in the company's charter or bylaws). [61] If the annual meeting is moved more than 30 days from the anniversary of the prior year's annual meeting, or in the case of a special meeting, however, the old standard is retained, and discretionary authority is permitted only if the company did not have notice of the matter a reasonable period of time prior to the solicitation. [62]

[iv] Issue-Oriented Activists

The expanded ability to communicate with shareholders has aided issue-oriented activists in promoting and publicizing their causes through proxy campaigns. For example, in the 2000 proxy season, shareholder and citizens groups calling themselves Campaign ExxonMobil stated that they had sent mailings to approximately 1,800 stockholders, holding in the aggregate over 58 percent of ExxonMobil's shares, urging support for four environmental and social resolutions. These resolutions addressed renewable energy, alleged risks associated with projects in Africa and the Arctic, and executive compensation.[63] Another

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60. Vineeta Anand, *Labor Learns Lesson Well; Unions Use Activism as Tool Against Target Companies,* Pensions & Investments, April 3, 1995, at 24.

61. Rule 14a-4(c)(1).

62. Rules 14a-4(c)(1) and 14a-4(c)(3).

63. *Dissident Shareholder Coalition Wages Proxy Fight on Environment, Human Rights, Announces Campaign ExxonMobil*, PR Newswire, May 11, 2000.

issue generating a large number of shareholderresolutions is the use of genetically modified foods, which according to one report has generated the largest number of issue-oriented resolutions since the anti-apartheid resolutions of the early 1990s.[64] While these types of issue-oriented resolutions typically do not garner even close to a majority of the votes, the shareholder communications rules have increased the proponents' ability to solicit and organize publicity around the issues addressed by the resolutions. In many cases, this has allowed the resolutions to capture enough votes to meet the threshold for resubmitting the proposal the next year (3 percent for the first resubmission in any five-year period, 6 percent for the second resubmission, and 10 percent for the third resubmission).

[v] Mandatory Bylaws

A major development in recent proxy seasons has been the prevalence of Rule 14a-8 proposals to adopt mandatory bylaws, *i.e.*, bylaws purporting to be mandatorily binding on the company. The most common example is a bylaw requiring shareholder approval for a company to adopt a poison pill. Many legal commentators have expressed the view that such a mandatory bylaw would not be valid under Delaware law, where many corporations are incorporated.[65] When a mandatory poison pill bylaw was passed by Chubb's shareholders, Chubb responded that it had been advised that the bylaw was invalid under New Jersey law and that it would not recognize the bylaw.[66] As of the 2000 proxy season, however, the only judicial precedent on the subject was the Oklahoma Supreme Court's decision in *Fleming*,[67] upholding such a bylaw under Oklahoma law. A legal challenge to Chubb's position that a mandatory bylaw was invalid under New Jersey law ended up being dismissed because the proponent of the bylaw had sold its position by the 2000 proxy season and no longer had standing. And Delaware lawyers have opined that these types of binding bylaw proposals are invalid under Delaware law. If mandatory bylaws are eventually upheld by the courts, however, particularly in Delaware, this could effect an enormous shift of power to large institutional shareholders who, through the use of mandatory bylaws, could have the power to direct the management of the company on a variety of matters.

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64. James Cox, *Shareholders Get to Put Bio-Engineered Foods to Vote,* USA Today, June 6, 2000, at 1B.

65. See Lawrence A. Hamermesh, *Shareholder Rights: Another View,* Delaware L. Wkly., Aug. 3, *1999,* at 7.

66. *Two Pill Proposals Receive Strong Shureholder Support,* IRRC Corporate Governance Highlights, Apr. 30, 1999, at 71.

67. international Brotherhood of Teamsters General Fund v. Fleming Companies, Inc., 975 P.2d 907 (W.D. Okla. 1999).

[vi] Private Negotiations with Shareholders

While the private solicitations made by shareholder activists in favor of shareholder resolutions or against management proposals have clearly had an effect on their passage or defeat in a number of instances, the **far** greater impact of the change in the rules lies in the threat that this ability **poses.** For each shareholder proposal that is actually brought to a vote. there are many more that are negotiated away in private discussions between shareholder activists and management. And, in other cases, the increased responsiveness of managers to major shareholders is quite evident before a shareholder proposal is even put on the table. For example, TIAA-CREF reached agreements privately on various issues with 32 of the **45** companies it approached privately from 1992 to 1996 without a resolution ever coming to a vote.[68] In 1999, **TIAA-CREF** submitted 16 proposals and reached agreement with the targets in 13 of the 16 cases, while 30 of TIAA-CREF's 35 targets in the 2000 proxy season negotiated settlements.[69] In 2001, **TIAA-CREF** submitted **14** proposals seeking removal of '*dead-hand poison pill" provisions and withdrew 13 of the proposals after the companies involved voluntarily eliminated these provisions. **TIAA-CREF** also submitted four board independence proposals, all of which were withdrawn after the companies agreed to increase the independent representation on their boards.[70]

The receptivity of most major corporations to corporate governance surveys and requests for review of corporate governance practices, such as those put forth by TIAA-CREF or by the California Public Employees' Retirement System (CalPERS), is a relatively new **phenomenon.**[71] Clearly, the sheer size of the shareholdings of these institutions is one reason for this receptivity. But the increased ability to organize other large shareholders in making voting decisions adds greatly to the clout that the activists now wield.

The corporate governance reforms of 2002 will almost certainly increase the ability of institutional shareholders to influence companies through private discussions and negotiations. **As** described above, the NYSE requirement that companies create a process for direct communication to non-management directors will permit major shareholders to circumvent management and bring their concerns directly to the board. The heightened scrutiny of board actions and oversight created by the governance reforms and the governance environment will put added pressure on boards to be responsive to the concerns communicated

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68. Reed Abelson, *Proxy Peace; Prosperity und Hushed Deals Quiet the Annual Meeting.* N.Y. **Times. May 28. 1998. at** D1.

69. *Stock Options May Rile Investors: Increasing Shareholder Activism Likely to Center on Executive Pay*, **Investor Relations Business, Jan. 24.** 2000; *Poison Pills: The Storm of 1999 Trickles into 2000*, **Investor Relations Business, March 20.** 2000.

70. TIAA-CREF Continues to Toll Death Knell for Poison Pill Provisions, **IRRC Corporate Governance Highlights, April 27, 2001, at** *65.*

71. *See Boards of Directors In the Spotlight,* **ISSue Alert (May 1995). at** 2.

in this manner by major shareholders. And the heightened governance disclosure requirements created by the reforms will give shareholders more information about companies' governance practices, allowing them to monitor these practices more closely and to communicate any dissatisfaction to the company and its board more quickly.

Still open to debate is whether the increased clout of institutional shareholders has become or will become too great. At the time the SEC was considering adoption of its shareholder communications rules, concern was expressed that the amendments would give institutions the power to make corporate decisions "in the back room" without public disclosure and open debate.[72] These concerns are enhanced by the increased prevalence of private negotiations between companies and large institutional investors that resolve corporate disputes out of the public eye. Kenneth Bertsch then of the Investor Responsibility Research Center, commenting on this trend toward private negotiations states, "It may stifle public discussion and development of these issues."[73] Concerns have also been raised that private negotiation of these issues may give large institutions an informational advantage over small shareholders in their investment decisions.[74] These concerns can only increase with the added power and ability to communicate privately created by the 2002 corporate governance reforms and proposals.

[2] Announcement of Voting Decisions

The unfettered right of shareholders under the new rules to make public announcements of their voting decisions (and the reasons for their decisions) adds another means of soliciting votes in a proxy contest. In the Centel proxy contest, for example, at least two major shareholders—Gabelli & Co. and David J. Greene & Co.—sought to persuade others to vote against the merger by publicly announcing their own intentions to vote against the merger on the basis that the price offered to Centel shareholders was inadequate.[75] While ultimately unsuccessful in the Centel case, this ability to announce and generate publicity for voting decisions in the last days before the shareholders meeting can be used to try to swing momentum at the end of a close proxy contest. In Kmart's unsuccessful effort to obtain shareholder approval for its stock plan, a number of institutional investors made public announcements of their intentions to vote against the plan, including TIAA-CREF, which made its announcement shortly before the shareholders meeting.[76] And small shareholder Guy Adams' successful campaign

72. See, *e.g.*, Steven A. Rosenblum, *Proxy Reform, Takeovers, and Corporate Control: The Need for a New Orientation*, 17 J. Corp. L. 185, 200 (Fall 1991).

73. Abelson, *supra* note 68.

74. *Id.*

75. *See, e.g., 4th Big Centel Corp. Shareholder Opposes Merger With Sprint*, Chicago Tribune, November 25, 1992, at 3.

76. Christina Duff, *Kmart Investor Joins Opposition to Stock Plan*, Wall St. J., June 1, 1994, at A4.

to unseat the CEO of Lone Star Steakhouse & Saloon was greatly aided by the public announcements of CalPERS and of LongView Collective Investment Fund that they were planning to vote for Adams.[77] CalPERS now regularly discloses on its Web site (www.calpers-governance.org) how it voted its top 300 equity holdings, while other organizations, such as SWIB and TIAA-CREF, issue press releases periodically with respect to their voting positions on certain proxy issues.

In addition, shareholder advisory groups, such as ISS, now regularly make voting recommendations to shareholders in contested proxy situations. For example, ISS publicly supported the successful effort of Franklin Mutual Advisers, managed by activist Michael Price. to elect a nominee to the board of Telephone & Data Systems Inc.[78] The successful effort to defeat Marriott's dual class stock plan saw both a recommendation by ISS against the proposal and public announcements by major shareholders, such as CalPERS, that they were voting against the proposal.[79]

ISS has now become a major factor in proxy fights, with both sides in close contests aggressively seeking ISS's recommendation. Some have estimated that ISS's recommendation can "swing as much as 25% of the votes in proxy contests."[79.1] In the largest proxy fight of the 2002 season, between Hewlett-Packard and Walter Hewlett over the vote on the merger of Hewlett-Packard and Compaq, ISS's recommendation in favor of the merger was the key factor in Hewlett-Packard's razor-thin victory. One study indicated that as much as 19% of the vote was either determined or strongly influenced by the ISS recommendation.[79.2] As with the concentration of institutional influence, there are some who question whether ISS's concentrated power over proxy contests is healthy. For example, noted shareholder activist Herbert Denton of Providence Capital says of ISS's role in the Hewlett-Packard proxy fight: "They're very well equipped to pass judgment on cookie-cutter proxy statements. For them to offer an opinion on a $20 billion transaction. by an analyst whom I respect but who has no particular industry background, is incomprehensible."[79.3]

Public announcement of voting decisions has also been used outside of proxy contests as a means of expressing institutional shareholder discontent with corporate policies or management. In particular, "just say no" campaigns, publicly announcing an intention to vote against or withhold authority from management board nominees, have been used by SWIB, CalPERS, and others as a way to publicize their unhappiness with certain companies.[80] While yet to

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77. *Dark Horse Candidate Defeats CEO*, *supra* note 31.

78. *Shareholder Gets Support in Proxy Fight*, Bergen Record, May 8, 1997, at 03.

79. Rehfeld, *supra* note 44.

79.1. Amy Borrus, *A Quiet Guru's Enormous Clout*, Business Week, May 20, 2002, at 64.

79.2. Steve Lohr, *Hewlett-Packard Guins Key Bucking for Compaq Merger*, N.Y. Times, March 6. 2002, at A1.

79.3. David Marcus. *Tilting at Broken Windmills*, Corporate Control Alert. July 2002, at 9.

80. *See, e.g.*, Mike Doming. *Big Investors See Corporate Clout Growing*, Chicago Tribune, Mar. 14, 1994, at C1.

garner a majority for withholding votes from the management board slate, the "just vote no" tactic has gained momentum over the last few years. In one well-publicized campaign in the fall of 1995, approximately 20 percent of the shares voting at the Archer-Danieis-Midland annual meeting, including those of more than 30 members of the Council of Institutional Investors (CII), withheld authority from the board slate.[81] CalPERS announced before the 1996 proxy season that it was not only ready to use the tactic, but also to "dedicate more effort toward it.''[82] Since then, a handful of companies have been targeted for ''vote no" campaigns each year.[83]

As described above, the SEC has proposed rules requiring mutual funds and other registered management investment companies to disclose information on how they cast their proxy votes, as well as their voting policies and procedures. If adopted, these rules are likely to have the effect of increasing the kind of shareholder pressure created by public announcement of voting decisions. Under these rules, a broad class of institutional shareholders, not just shareholder activists, would make public their views on matters put to a shareholder vote, thereby exposing to public view any dissatisfaction with or criticism of the company's proposals.

[3] Elimination of Preliminary Filing Requirements

The elimination of preliminary filing requirements, and thus of preliminary SEC review, for supplemental proxy materials has a particular effect on proxy contests, where the more contentious and argumentative statements are often found in the supplemental materials rather than in the basic proxy statement. Prior to the 1992 amendments, the SEC generally performed a moderating function in proxy contests, tempering the more aggressive materials and forcing the contestants to provide factual support for their arguments and assertions. Now, the SEC no longer performs this function for most of the materials used in the contest. While all proxy materials continue to be subject to the antifraud rules, enforcement of antifraud provisions in the courts is much more difficult and cumbersome than the reviews previously conducted by the SEC.

Unlike the private solicitation rules, however, which clearly give shareholder activists and dissidents more leverage, the elimination of prescreening applies equally to management and dissident materials. Recent proxy fights have shown an aggressive, hard-hitting style? For example, in the proxy fight waged

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81. IRRC Corporate Governance Highlights (Oct. 20, 1995), at 95.

82. Richard H. Koppes and Kayla J. Gillan, *An Institutional Investor's Perspective on the Corning Proxy Season,* The Corporate Governance Advisor (Jan./Feb. 1996), at 10, 11.

83. See. *e.g.. So Fur, Three Companies are Targetedfur Vote-No Campaigns*, IRRC Corporate Governance Highlights, March 16, 2001, at 41.

84. See Steven N. Gorfman and James K. Baer, *Fight Letters: An Effective Tool in Proxy Contests,* INSIGHTS (May 1996), p. 12.

by Carl Icahn and Bennett LeBow to force RJR Nabisco to spin off its food operations, Icahn and LeBow ran full page advertisements including one with the headline. "RJR to Shareholders: Drop Dead." [85] For its part, RJR's advertisements included one that said LeBow had wiped out $5 billion of stock market value for RJR and other tobacco companies when Liggett Group. under LeBow's control. agreed to a settlement of a class-action lawsuit brought on behalf of smokers.[86]

[4] Commencement of Proxy Solicitations

Three of the shareholder communications rules combine to give a dissident the ability to commence a proxy contest quickly: (i) the immediate public availability of preliminary filings; (ii) the ability to commence solicitations even before filing of a proxy statement; and (iii) the elimination of the Schedule 14B. These rules allow a dissident to spring a contest shortly before a shareholders meeting, giving the company little time to respond. With the increasingly concentrated institutional ownership of public companies, such a "surprise attack" may be a viable dissident strategy in some cases.

A new weapon that has recently come to the aid of the surprise attack strategy is the Internet. In 1996, a group of investors in Professional Bancorp, a California-based community bank holding company, successfully mounted a proxy fight to win control of the board in under three weeks. Besides using the mail to disseminate their message, the dissidents set up a Web site, where their proxy materials and fight letters, as well as their court complaint, were instantly posted and accessible to shareholders. Press reports described the battle as "far more of a blitzkrieg than the drawn-out siege usually required to topple management." [87] Other groups have begun to look to the Internet as a forum for ongoing shareholder activism and potential proxy contests. For example, a Web site called "eRaider.com" was launched in 2000, affiliated with an investment fund, whose stated purpose is to take positions in "underperforrning" companies and then use the Web site to solicit shareholder discussion and agitate for change in the targeted companies.[88]

The speed of communication over the Internet has made it an effective weapon in proxy contests. and its use will likely continue to increase. Dissident Web sites have already become a standard feature in proxy contests. These can be used to collect and disseminate information, as well as to facilitate

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85. Hal Lux, *Internet Becomes Tool in Nabisco Proxy Fight; Icahn und LeBow Tuke Their Message to the Web,* Investment Dealers' Digest (Jan. 29, 1996).

86. *RJR Attacks LeBow in Paper Ad,* L.A. Times (Mar. 16, 1996). at D2.

87. Jeffrey Marshall. *Web Helps Proxy Insurgents Capture Bank,* US. Banker, Jan. 1997, *at* 42.

88. Kate Berry. *A New Activist Fund Will Test Web's Clout,* N.Y. Times, Mar. 19, 2000, at Sec. 3, p. 10.

communications among shareholders. In addition, independent chat rooms are often used by shareholders to discuss matters of interest with respect to their companies, including issues raised by proxy contests. While the content of Web sites sponsored by proxy contestants must be filed with the SEC, the shareholder communications rule have clearly facilitated the use of the Internet in this arena.[89]

Many companies have adopted bylaw provisions setting forth procedures. including specified time frames, for shareholders who wish to make director nominations or bring any other business before a shareholders meeting. These bylaw provisions protect against a last minute proxy contest. The increased flexibility under the rules as to a dissident's timing of a proxy contest makes it all the more important that a company's bylaws contain such provisions. Model bylaw provisions for this purpose, designed for a Delaware company, are attached to this chapter as Exhibit 1.

As with the elimination of prescreening of supplemental proxy materials, however, the ability to commence solicitation activities before filing a proxy statement provides increased flexibility to management solicitations as well as dissident solicitations. In the Compass Bancshares proxy fight, for example, in which Compass successfully defeated a dissident's attempt to elect three directors to the Compass board, the ability to commence a solicitation upon filing of preliminary materials allowed Compass to begin communicating its message quickly, at the same time as the dissident was trying to garner support?

[5] Shareholder Lists

The SEC's decision not to adopt its originally proposed shareholder list rule, which would have created a federal right to obtain the list, is also significant in the context of a proxy contest. Direct access to a shareholders list gives a dissident greater flexibility with respect to communications with shareholders. While many states have laws giving a shareholder a right to a shareholders list for proper purposes, the proposed SEC rule would have given dissident shareholders a surer and quicker path to the list.

§ 11.4 RECOMMENDATIONS

[I] Preemptive Reforms

Much of the recent shareholder activism has been premised on the need to monitor the performance of corporate managers and provide greater account-

89. See Chapter 16, Electronic Communication and Voting; and Eugene Cowell, *Internet Technology Permits New Proxy Contest Techniques*, Insights, Oct. 2001, at 17; Broc Romanek, *Shareholder Activism on the Net: A Call to Arms?*, wallstreetlawyer.com, Dec. 2000, at 15.

90. See Michael Tomberlin, *Judgment Day at Hand: Shareholders' Shootout Tomorrow for Compass Bunk*, Birmingham Bus. J., Apr. 10, 1995, at I.

ability for poor performance. But even many shareholder activists (and academic supporters of their cause) will admit that they are not the best or most effective monitors. A strong, independent board, both in terms of specialized knowledge of the business and in terms of credibility with management, is much better suited to this role.

Prior editions of this chapter advised that companies should proactively adopt sensible corporate governance reforms to improve the functioning of their boards, arguing that this would reduce the impetus for external reforms, whether by legislation or shareholder action. Unfortunately, the corporate governance crisis of 2002 overtook this advice, and external reforms were imposed. Companies are now struggling to understand and comply with the overwhelming number of new—and sometimes confusing, ambiguous, contradictory, or poorly drafted—corporate governance rules. Notwithstanding these externally imposed reforms, it is still true that the company and its own board are in the best position to determine the corporate governance practices that are likely to be most effective for that company. In working through its compliance with the new rules, it is important for a company to assess for itself how it can best improve the corporate governance of the company, and only then figure out how to implement those procedures within the framework of the Sarbanes-Oxley Act, and the applicable stock exchange and SEC rules.

[2] Communication with Shareholders

The shareholder communications rules and recent corporate governance reforms, and the increased shareholder activism they encourage, make more important than ever an effective shareholder communications program. It is important to be able to convey to shareholders an understanding of the company's business strategy, the ways in which the company's performance has been successful, the reasons for lack of successful performance and the steps being taken to correct problems. While shareholder activism has increased, much of it has also become more sophisticated. Instead of scattershot shareholder proposals, the institutions are developing a more focused targeting of companies whose corporate performance appears to be lagging. While the best means of dealing with this focus is, of course, to perform well, the next best means is to admit the problem and to explain coherently what went wrong and what is being done about it.

Moreover, an effective communications program can help build a greater degree of trust between the company's management and its major shareholders. The hostility between managers and shareholders that grew out of the takeover decade of the 1980s is an impediment to constructive interaction with shareholders. This is not to say that companies should now concede to every demand a shareholder activist may make. But a greater receptivity to listening,,and to explaining the company's positions, may help avoid unnecessary confrontations.

In addition, to the extent a company is able to build a greater degree of trust between management and shareholders, shareholder activists may be willing to show more patience in allowing managers to carry through with their own plans to correct problems and improve performance.

[3] Avoiding Inflammatory Actions

The company and its management should be sensitive to actions or practices that institutional shareholders may find particularly inflammatory. While the particular "hot buttons" may change over time, many of the current ones focus on executive and director compensation practices: *e.g.*, interlocking directors on compensation committees, independence of directors, repricing of options to reduce exercise prices, option grants with below market exercise prices, mega-option grants, and retirement plans for outside directors. Other hot buttons relate to corporate governance items, such as "dead hand" poison pill provisions and staggered boards. Some of these hot buttons would appear relatively painless to avoid, such as interlocking directors on the compensation committees, or "dead hand" provisions which are of questionable legality in any event. Director independence is now largely mandated under the corporate governance reforms of 2002. Some items, however, such as option repricing or a large option grant, or maintaining a staggered board, may have valid business purposes under a particular set of circumstances. Even so, it is important for the company and its board at least to be aware of what types of actions are likely to inflame institutional shareholders, and to take this into account in considering whether to go forward.

[4] Curbing Abuses

While the shareholder communications rules have shown some promise for encouraging a more constructive dialogue between corporate managers and major shareholders, there is also a need to guard against abuse of the powers they give to major shareholders. Companies should keep in mind that they have not been left defenseless to fight cases of abuse. While shareholders are free under the proxy rules to discuss and lobby each other in private with respect to matters presented for a shareholder vote, to the extent their actions reach the point of a mutual understanding or agreement with respect to the voting of shares of a company, they are subject to Schedule 13D disclosure if their aggregate holdings exceed 5 percent of the company's stock.[92] Such groups are subject to attack if they fail to make the appropriate disclosure. The provisions of a standard rights plan also restrict the ability of holders of more than a threshold amount of stock (typically 10 percent to 20 percent) to act in concert as a group.

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92. Rule 13d-5(b)(1). See Dixon, *Post-Proxy Reform Era: Remaining Pitfall for the Unwary Activist Shareholder,* The Corporate Governance Advisor, Oct./Nov. 1993, at 12.

In addition, even solicitations that are permitted to be conducted in private still remain subject to the antifraud provisions of Rule 14a-9. To the extent a company becomes aware of false or misleading statements made in a private solicitation, it can challenge these solicitations under Rule 14a-9. Companies should also be alert to efforts by persons who are ineligible to solicit in private (*e.g.*, a person who is soliciting a proxy card) to have another person make a private solicitation on their behalf. The private solicitation rules do not apply to a person soliciting on behalf of someone else who is asking for direct proxy authority.

§ 11.5 CONCLUSION

The shareholder communications rules have encouraged increased shareholder activism and have increased the power and leverage of institutional shareholders, both within and outside the context of a formal proxy fight. The corporate governance reforms of 2002 are likely to extend that power and leverage. Corporate managers and directors have recognized the realities of shareholder activism and have become increasingly responsive to institutional shareholder concerns. In this environment, it is more important than ever for companies to engage in self-examination. make reforms where necessary to ensure compliance with legal and stock exchange rules. and develop effective lines of shareholder communications. If a company's performance has declined, making it a more likely shareholder target, the company should be able to identify and communicate both the reasons for the poor performance and the steps being taken to address it.

Institutional investors, for their part, must recognize that with increased power comes increased responsibility. To the extent that institutional activism encourages a company's board and managers to apply increasing focus to the effectiveness of the company's corporate governance practices and the board's oversight of the company's business operations, it is a healthy development. However, to the extent large shareholders use their increasing power to force takeovers, spinoffs, restructurings, or other steps to boost short-term stock prices at the expense of long-term business operations, there will inevitably be a backlash. Ultimately, it remains up to institutional investors to demonstrate the ability to use their powers under the shareholder communications rules in a responsible manner.

EXHIBIT 1—MODEL BYLAW FOR ADVANCE NOTICE OF STOCKHOLDER BUSINESS AND NOMINATIONS

SECTION __. Notice of Stockholder Business and Nominations.

A. Annual Meetings of Stockholders

1. Nominations of persons for election to the Board of Directors of the Corporation and the proposal of business to be considered by the stockholders may be made at an annual meeting of stockholders (a) pursuant to the Corporation's notice of meeting, (b) by or at the direction of the Board of Directors or (c) by any stockholder of the Corporation who was a stockholder of record at the time of giving of notice provided for in this Bylaw, who is entitled to vote at the meeting and who complies with the notice procedures set forth in this Bylaw.

2. For nominations or other business to be properly brought before an annual meeting by a stockholder pursuant to clause (c) of paragraph (A)(1) of this Bylaw, the stockholder must have given timely notice thereof in writing to the Secretary of the Corporation and such other business must otherwise be a proper matter for stockholder action. To be timely, a stockholder's notice shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business on the 90th day nor earlier than the close of business on the 120th day prior to the first anniversary of the preceding year's annual meeting; *provided, however,* that in the event that the date of the annual meeting is more than 30 days before or more than 60 days after such anniversary date, notice by the stockholder to be timely must be so delivered not earlier than the close of business on the 120th day prior to such annual meeting and not later than the close of business on the later of the 90th day prior to such annual meeting or the 10th day following the day on which public announcement of the date of such meeting is first made by the Corporation. In no event shall the public announcement of an adjournment of an annual meeting commence a new time period for the giving of a stockholder's notice as described above. Such stockholder's notice shall set forth (a) as to each person whom the stockholder proposes to nominate for election or reelection as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 14a-11 thereunder (including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected); (b) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest in such business of such stockholder and the beneficial owner, if any, on whose behalf the proposal is made; and (c) as to the stockholder giving the notice and the beneficial owner,

if any, on whose behalf the nomination or proposal is made (i) the name and address of such stockholder, as they appear on *the* Corporation's books, and of such beneficial owner and (ii) the class and number of shares of the Corporation which are owned beneficially and of record by such stockholder and such beneficial owner.

3. Notwithstanding anything in the second sentence of paragraph (A)(2) of this Bylaw to the contrary, in the event that the number of directors to be elected to the Board of Directors of the Corporation is increased and there is no public announcement by the Corporation naming all of the nominees for director or specifying the size of the increased Board of Directors at least 100 days prior to the first anniversary of the preceding year's annual meeting. a stockholder's notice required by this Bylaw shall also be considered timely, but only with respect to nominees for any new positions created by such increase, if it shall be delivered to the Secretary at the principal executive offices of the Corporation not later than the close of business on the 10th day following the day on which such public announcement is first made by the Corporation.

B. Special Meetings of Stockholders

Only such business shall be conducted at a special meeting of stockholders as shall have been brought before the meeting pursuant to the Corporation's notice of meeting. Nominations of persons for election to the Board of Directors may be made at a special meeting of stockholders at which directors are to be elected pursuant to the Corporation's notice of meeting (a) by or at the direction of the Board of Directors or (b) provided that the Board of Directors has determined that directors shall be elected at such meeting, by any stockholder of the Corporation who is a stockholder of record at the time of giving of notice provided for in this Bylaw, who shall be entitled to vote at the meeting and who complies with the notice procedures set forth in this Bylaw. In the event the Corporation calls a special meeting of stockholders for the purpose of electing one or more directors to the Board of Directors, any such stockholder may nominate a person or persons (as the case may be), for election to such position(s) as specified in the Corporation's notice of meeting, if the stockholder's notice required by paragraph (A)(2) of this Bylaw shall be delivered to the Secretary at the principal executive offices of the Corporation not earlier than the close of business on the 120th day prior to such special meeting and not later than the close of business on the later of the 90th day prior to such special meeting or the 10th day following the day on which public announcement is first made of the date of the special meeting and of the nominees proposed by the Board of Directors to be elected at such meeting. In no event shall the public announcement of an adjournment of a special meeting commence a new time period for the giving of a stockholder's notice as described above.

C. General

1. Only such persons who are nominated in accordance with the procedures set forth in this Bylaw shall be eligible to serve as directors and only such business shall be conducted at a meeting of stockholders as shall have been brought before the meeting in accordance with the procedures set forth in this Bylaw. Except as otherwise provided by law, the Certificate of Incorporation or these Bylaws, the Chairman of the meeting shall have the power and duty to determine whether a nomination or any business proposed to be brought before the meeting was made or proposed, as the case may be, in accordance with the procedures set forth in this Bylaw and, if any proposed nomination or business is not in compliance with this Bylaw, to declare that such defective proposal or nomination shall be disregarded.

2. For purposes of this Bylaw, "public announcement'' shall mean disclosure in a press release reported by the Dow Jones News Service, Associated Press or comparable national news service or in a document publicly filed by the Corporation with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Exchange Act.

3. Notwithstanding the foregoing provisions of this Bylaw, a stockholder shall also comply with all applicable requirements of the Exchange Act and the rules and regulations thereunder with respect to the matters set forth in this Bylaw. Nothing in this Bylaw shall be deemed to affect any rights (a) of stockholders to request inclusion of proposals in the Corporation's proxy statement pursuant to Rule 14a-8 under the Exchange Act or (b) of the holders of any series of Preferred Stock to elect directors under specified circumstances.

CHAPTER 12

"STREET NAME" REGISTRATION & THE PROXY SOLICITATION PROCESS

by John C. Wilcox and John J. Purcell III

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[1] Legal Ownership

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EXHIBIT 2 SAMPLE DTC PARTICIPANT REQUEST FOR STOCKLIST DEMAND LETTER—DELAWARE CORPORATION

EXHIBIT 3 SAMPLE DTC STOCKLIST DEMAND LETTER—DELAWARE CORPORATION

§ 12.1 INTRODUCTION

[1] Overview

The single greatest source of confusion in the proxy process is undoubtedly the separation of legal and beneficial ownership resulting from what is commonly referred to as "street name" registration. The vast majority of publicly traded shares in the United States are registered on companies' books not in the name of beneficial owners—*i.e.*, those investors who paid for, and have the right to vote and dispose of, the shares—but rather in the name of "Cede & Co.," the name used by The Depository Trust Company ("DTC").[1]

Shares registered in this manner are commonly referred to as being held in "street name." The street name registration system was created to facilitate securities trading, eliminate paperwork and preserve the confidentiality of beneficial owners' identities. DTC holds the shares on behalf of banks and brokers, which in turn hold on behalf of their clients (who are the underlying beneficial owners or other intermediaries). The result of this "daisy chain" model of ownership is that DTC—and not the beneficial owners—is considered the "legal" owner of the shares and therefore technically possesses all the rights incident thereto. (Exhibit 1 illustrates a typical public company's share ownership structure.)

Because DTC acts merely as custodian of the shares, and has no beneficial interest in them, a number of complex mechanisms have been created to transfer its legal rights down the "daisy chain" to the ultimate beneficial owners. These mechanisms have become an integral—and often misunderstood—part of the proxy process and are largely responsible for the mistakes and confusion that arise during proxy solicitations. This chapter provides practitioners with a detailed explanation of what street name registration is, why it exists, and how to avoid the pitfalls it presents in the proxy solicitation process.

[2] Why Some Investors Prefer Street Name Registration

In light of the fact that beneficial owners are divested of the rights incident to legal ownership when they hold their shares in street name, it is worth examining some of the benefits offered by street name registration:

- Active traders keep their shares in street name in order to expedite stock transfers and **subsequent reregistration;**

1. Street name shares may also be registered in the name of an investor's bank or broker on a company's share register.

- Individuals who do not want to store the certificates themselves will leave them with their stockbroker who, in turn, will register the shares in the broker's name;
- Corporate raiders or arbitrageurs often register shares in street name to hide their positions and identities from target companies (at least until their holdings exceed 5% of the total outstanding issue and they are required to file a Schedule 13D with the Securities and Exchange Commission);
- Some shareholders (primarily non-U.S. shareholders) will register their holdings in street name to hide their identities from U.S. taxing authorities;
- Shareholders purchasing shares on margin from their brokers are required to register the shares in their brokers' names until the shares have been paid in full; and
- Pension funds subject to ERISA must keep their assets in trust, thereby creating a large number of pension fund shares registered in bank nominee name.[2]

Although it increases costs and technical complexity, street name registration simplifies recordkeeping, expedites trading and preserves shareowners' anonymity.

[3] Problems Associated with Street Name Registration

Even the most seasoned practitioner will occasionally stumble over the intricacies of street name registration in the context of a proxy solicitation. The failure to fully understand street name registration can have drastic results, including:

- Votes being thrown out due to technical deficiencies;
- Denial of access to a company's stocklist and other corporate records;
- Denial of appraisal rights in a merger;
- Erroneous tabulation of so-called "broker nonvotes"; and/or
- Failure to obtain votes from loaned shares or shares purchased after the record date.

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2. Heard & Sherman, *Conflicts of Interest in the Proxy Voting System* (1987), p. 74 (hereinafter "Heard & Sherman").

From the issuer's perspective, street name registration obfuscates the identities of many of its actual owners, unless they have not objected to disclosure of their identities (so-called "NOBOs"), as discussed below. This presents a formidable impediment to directly communicating with its owners in "crisis" situations (*e.g.*, responding to hostile offers or attempting to obtain votes required for passage of material proposals).

§ 12.2 *"LEGAL"* VS. "BENEFICIAL" OWNERSHIP OF STOCK

[1] Legal Ownership

There is a variety of rights which are incident to share ownership, including the right to vote, the right to inspect a company's books and records, and the right to dissent from a merger and demand appraisal. Whether one may assert these rights depends on the nature of one's ownership interest. In Delaware, as in nearly every other jurisdiction, these rights belong solely to the "legal" owner of the stock.[3]

A company's share register sets forth the legal owners of that company's stock. The legal owners of the stock are commonly referred to as either the "registered" owners of the shares, because the owners' names appear on the company's share register or, where there is a record date (*e.g.*, for voting or dividend purposes), the "record" owners, because they legally own the shares on the record date.[4] Legal owners often hold share certificates that represent their ownership interests in the company.

[2] Beneficial Ownership

The largest "legal" owner of most public companies' shares is The Depository Trust Company ("DTC"), the world's largest securities depository.[5] DTC registers its shares on companies' share registers under the name "Cede & Co."[6]

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3. *See, e.g., In re Giant Portland Cement Company*, 21 A.2d 697 (Del. Ch. 1941) ("The right to vote shares of corporate stock having voting powers has always been incident to legal ownership.").

4. Legal, record, and registered ownership are synonymous and used interchangeably in this chapter.

5. The depository system was created in the 1960s to overcome the paper crunch caused by the rising volume of stock trading. Prior to depositories, securities trading required the transfer of physical share certificates. According to DTC, it holds 83% of the shares of all NYSE-listed companies, 70% of all Nasdaq-listed companies' shares, and 71% of all Amex-listed companies' shares (*source:* DTC 1998 Annual Report).

6. Lawyers' confusion regarding street-name ownership and the depository system is best evidenced by the fact that "Cede & Co." is frequently listed in proxy statements as a holder of greater than 5% of a company's securities (pursuant to Item 6(d) of Regulation 14A of the Securities Exchange Act of 1934 (the "Exchange Act")) although DTC has no beneficial interest in such shares as required in Item 403 of Regulation S-K.

DTC is owned by its "participants," which are the member organizations of the various national stock exchanges (*e.g.*, State Street Bank, Memll Lynch. Goldman Sachs & Co.).[7] Although DTC is the legal owner of the shares in its vaults, it has no "beneficial'' interest in them. "Beneficial" ownership is generally defined as encompassing the right to vote and dispose of the shares.[8] Shares "legally" owned by DTC are "beneficially" owned by its participants (if they hold for their own investment accounts) or its participants' clients. Shares deposited at DTC—or otherwise registered on a company's books in the name of an entity other than the beneficial owner—are said to be registered in "street name."[9]

Transactions involving street name shares are conducted using DTC's electronic "book-entry" system of accounting for share transfers. When one participant's client sells shares in a particular company, that participant's DTC account is debited and the purchasing participant's account is credited by the same amount. DTC's "book-entry" system negates the need to keep a large inventory of physical stock certificates. The shares of each company held by DTC are typically represented by only one or more immobilized jumbo stock certificates held in DTC's vaults.[10]

> Example. John Investor purchased 1,000 shares of IBM common stock through Memll Lynch, his broker (a DTC participant). John Investor's shares are a small fraction of the total shares deposited in Merrill Lynch's participant account (*i.e.*, 10 million), which in turn are a small fraction of the total number of IBM shares represented by certificates held in DTC's vaults (*i.e.*, 100 million). (DTC's entire position (100 million) is represented on IBM's share register under the name "Cede & Co.") After John Investor gave his broker the instruction to purchase the shares, his broker obtained them in the market from one or more sellers, each of which ultimately had its own DTC participant account. To effectuate the trade, DTC reduced the selling participants' accounts by an aggregate of 1,000 and increased Memll Lynch's account by 1,000.

It is important to understand that DTC legally owned those shares both before and after the transaction—it merely shifted them from one account to another.

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7. As of the end of 1998, DTC had 143 bank participants, 385 broker participants and 14 participants that are clearing agencies and securities exchanges (*source:* DTC 1998 Annual Report).

8. See Exchange Act Rule 13d-3(a).

9. Technically, shares registered through DTC in the names of banks or brokers are said to be held in "street name," while shares registered in the name of a bank nominee account are said to be held in "nominee name." In practice, however, the phrase "street name'' includes shares held in nominee name.

10. The immobilized jumbo certificates are the direct result of Section 17A(f) of the Exchange Act, in which Congress instructed the SEC to "use its authority . . . to end the physical movement of securities certificates. . . .''

Because John Investor is not the legal owner of his shares, he does not have any rights incident to "legal" ownership, *i.e.*, the authority to grant a proxy to vote at IBM's annual meeting; the right to inspect IBM's corporate books and records; and the right to demand appraisal of his shares if IBM were to be acquired. The next section discusses the established mechanisms through which John Investor can assert the legal rights incident to the shares he beneficially owns.

§ 12.3 ASSERTION OF "LEGAL" RIGHTS BY "BENEFICIAL" OWNERS

[1] Right to Vote Shares/Grant Proxies

Pursuant to state corporate law, only legal owners of stock on the record date are entitled to vote shares or grant proxies in connection with a shareholder meeting.[11] Registered shareholders may either attend the shareholder meeting and vote their shares (using a ballot) or authorize another to act as their "proxy" at the meeting and vote their shares in accordance with their voting instructions. The latter method is accomplished by using a proxy card, which typically grants proxy authority on one side and gives voting instructions and is executed on the other.

Street name holders, on the other hand, are not technically entitled to vote shares or grant proxy authority. Those rights reside with DTC as the legal owner of all street name shares. Because DTC has no beneficial interest in its shares, however, it has devised a mechanism to pass on its voting rights. This mechanism, called the "omnibus proxy," provides for the transfer of DTC's voting rights to its clients—the bank and broker participants.[12] According to DTC, "the omnibus proxy is an assignment. Cede & Co., the shareholder of record, assigns to each participant the voting rights associated with the shares in that participant's DTC account as of the record date."[13] The omnibus proxy, then, confers voting authority upon bank and broker participants with respect to the shares held in their DTC accounts on the record date. It is important to understand that, absent special

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11. See Note 3, *infra*. *See also Enstar Corp. v. Senouf*, 535 A.2d 1351, 1354-55 (Del. 1987) (hereinafter, "*Enstar*"), *citing American Hardward Corp. v. Savage Anns Corp.*, 136 A.2d 690,692 (Del. 1957) ("If an owner of stock chooses *to* register his shares in the name of a nominee, he takes the risks attendant upon such an arrangement, including the risk that he may not receive notice of corporate proceedings. or be able to obtain a proxy from his nominee. The corporation, except in special cases, is entitled to recognize the exclusive right of the registered owner to vote.")

12. The details underlying DTC's issuance of an omnibus proxy are generally set forth in the contracts between DTC and each of its participants. Thus, DTC is now typically contractually required to issue omnibus proxies with respect to shares in its custody.

13. Heard & Sherman, at 78.

circumstances, proxy authority is never transferred down to the ultimate beneficial owners.[14]

Although authorized to physically vote shares held in their clients' accounts, brokers and banks are generally prohibited from deciding *how* to vote those shares.[15] Brokers are restricted by stock exchange rules, and banks by contractual arrangements with their customers.

[a] Brokers and the "Ten-Day Rule"

Subject to certain exceptions, stock exchange regulations generally prohibit member organizations (*i.e.*, brokers) from voting shares unless they beneficially own such shares.[16] Brokers who are members of the NYSE do, however, have "discretionary" authority to vote such shares if two conditions are met: (i) the subject matter of the vote has been deemed "routine" by the NYSE;[17] and (ii) the broker has not received voting instructions from the beneficial owner by the tenth day preceding the meeting date.[18] This discretionary voting mechanism is sometimes referred to as the "ten-day rule."[19]

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14. A beneficial owner can obtain actual proxy/voting authority by requesting a "legal proxy" from its bank or broker pursuant to which its bank or broker formally confers all its rights as record holder (which rights were passed to it ultimately from DTC). *See* Note 54 and accompanying text. *infra.*

15. This restriction does not apply to shares that are beneficially held by such banks or brokers.

16. See. *e.g.*, Rules 450 and 452 of the New York Stock Exchange. The other major stock exchanges have similar voting restrictions. See Rule 576(b) of the American Stock Exchange.

17. The New York Stock Exchange makes the determination as to whether a particular proposal will be considered "routine" for purposes of discretionary voting. Its determinations are circulated to its member firms in a weekly newsletter called The *New York Stock Exchange* Weekly *Bulletin*. Examples of nonroutine matters include any contested proposals, merger proposals, authorizations or creations of preferred stock and issuances of shares exceeding more than 5% of the outstanding shares. NYSE Listed Company Manual § 402.08(B).

18. This "ten-day rule" applies if the broker transmits the proxy materials to the beneficial owner at least 15 days prior to the meeting date. If the broker sends proxy materials to the beneficial owners more than 25 days prior to the meeting date, the broker may cast a discretionary vote if it has not received voting instructions at least 15 days prior to the meeting date. NYSE Rule 451(b). Absent an active solicitation (*e.g.*, telephone campaign, reminder mailing). brokers will typically receive voting instructions from only about 30% of shares held in broker retail name; these instructed shares are generally voted promanagement.

19. On August 16,2002 the New York Stock Exchange filed with the Securities and Exchange Commission "Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors August 1, 2002."

Proposal 8 of this filing reads as follows:

> "8. To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement options, plans relating to mergers or acquisitions, and tax qualified and excess benefit plans."

A "broker nonvote" occurs when a broker has not received voting instructions from its client, and either declines to exercise its discretionary voting authority or is barred from doing so because the proposal is nontoutine.[20] Considerable confusion has arisen concerning the tabulation of discretionary broker

[Next page is 12-9.]

The Commentary under Proposal 8 includes the following statement:

> "[T]he Exchange will preclude its member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions. This is codified in NYSE Rule 452."
>
> If adopted as written, this amendment will prohibit brokers from exercising their discretionary voting authority with respect to all equity-compensation plans.

20. The tabuiation of broker nonvotes is discussed in § 12.4[2], *infra*.

votes and broker nonvotes. Neither category applies to shareholder proposals, which are considered nonroutine by the NYSE. Many investor rights advocates, including the Council of Institutional Investors, have publicly challenged this practice of discretionary broker voting on routine matters—which was originally established to help issuers achieve quorum at meetings involving nonroutine matters—as undermining the corporate democratic process.[21]

[b] Banks

Banks often hold, in a fiduciary or custodial capacity, large amounts of corporate equities on behalf of beneficial owners (primarily trusts and pension funds). They are frequently prohibited from voting the securities held in their accounts as a result of express arrangements with the beneficial owners.[22] In cases where the bank does not have voting authority, the federal proxy rules give banks the option of either (i) forwarding proxies that have been executed in blank to be filled in by the beneficial owners and returned to the issuer, or (ii) requesting voting instructions from the beneficial owners and completing and returning the proxies themselves.[23] Banks that hold shares in nominee name on behalf of smaller, regional banks[24] are required by the federal proxy rules to execute omnibus proxies, including powers of substitution, in favor of its respondent banks and to forward such omnibus proxy to the registrant.[25] In this regard, the larger, nominee banks are prohibited from voting the "piggybacked" shares in their accounts. It is important to note that, absent an independent arrangement with their clients, banks have no discretionary voting authority as do brokers under stock exchange rules.

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21. A recent example of the controversy surrounding the ten-day rule involved Greenway Partners' proxy fight with Venator. Greenway submitted proxy materials to brokers to be mailed only to holders of 5,000 or more Venator shares. Although there clearly was a "contest"—which is considered "nonroutine" for discretionary voting purposes—the NYSE ruled that brokers could nevertheless vote the uninstructed shares of clients holding less than 5,000 shares (*i.e.*, those who did not receive Greenway's proxy materials). Council Research Service Alert, Vol. 4 (July 21, 1999).

22. These arrangements range from permitting the bank to vote on all matters, routine matters, only, or no matters. See Heard & Sherman, at 79-80.

23. Exchange Act Rule 14b-2(b)(3). Banks using ADP (discussed *infra*) generally opt for the latter method, while banks that handle the proxy mailing process internally generally prefer the former method.

24. Frequently, smaller regional banks will deposit their shares at larger banks, which, in turn, deposit those shares at national banks. This process is commonly referred to as "piggybacking."

25. Exchange Act Rule 14b-2(b)(2). It is noteworthy that clearing agencies registered under Section 17A of the Exchange Act (such as DTC) are not required to execute an omnibus proxy in this fashion, because they are exempted from the definition of "entity that exercises fiduciary powers" in Rule 14a-1(c) of the Exchange Act. As discussed earlier, DTC is generally contractually bound to issue omnibus proxies to its participants.

[c] Automatic Data Processing (ADP)

For many years, banks and brokers maintained **proxy** departments that handled the back-office administrative process of distributing **proxy** materials and tabulating votes themselves. Today, however, the overwhelming majority[26] have eliminated their proxy departments and subcontracted these processes out to **the** Investor Communications Division of Automatic Data Processing (commonly referred to as "ADP"). To make these arrangements work, ADP's bank and broker clients formally transfer to **ADP** the proxy authority they received from DTC (via the Omnibus Proxy) via powers of attorney.

ADP mails directly to each beneficial owner a proxy statement and, importantly, a voting instruction form (referred to as a "VIF") rather **than a** proxy card. Beneficial owners do not receive **proxy** cards because they are not vested with the right to vote shares or to grant proxy authority—those rights belong only to legal owners (or their designees). Beneficial owners merely have the right to instruct how their shares are to be voted by **ADP** (attorney-in-fact of the DTC participants), which they accomplish by returning a VIF or, in the case of shares held in broker name, by passively allowing their shares to be voted under the ten-day rule.

It **is** important to note that because VIFs are technically not "proxies"—they merely communicate voting instructions—they are not subject to state **laws** governing the validity of proxies. **As** a result, **ADP** is **able** to offer telephone and Internet voting to all beneficial owners, regardless of any restrictions imposed by the subject company's state of incorporation.[27] In addition, the VIFs are not subject to review by Inspectors of Election during the tabulation of voted proxies.

[2] Right to Inspect a Company's Books and Records

Section 220 of the Delaware General Corporation Law[28] grants "stockholders" the right "to inspect . . . a list of [a company's] stockholders, and its other books and records, and to **make** copies or extracts therefrom." Section 220(a) defines "stockholder" as **"a** stockholder of record in **a** stock corporation." **As a** result, beneficial (street name) owners do not have this right. **A** common **reason** for denial of a demand to inspect a company's books and records is that the demand was not made by a stockholder of record.

There are two methods by which street name holders **may** inspect a company's books and records. The first is to have a portion of the holder's shares

26. Two noteworthy exceptions are Bank of New **York and** Dean Witter.

27. It should be noted that **ADP** does not offer electronic return of voting instructions in proxy contests.

28. Because most of corporate America is incorporated in Delaware, we have chosen to focus on **its** corporate **statutes.**

transferred from street name onto the company's share register, which currently takes three trading days to settle. The second is to obtain a demand letter from Cede & Co. (the legal owner of the shares). This is generally accomplished by instructing the bank or broker participant to request DTC to issue a demand letter in the name of Cede & Co. on behalf of the beneficial owner. (Model forms are set forth in Exhibits 2 and 3.) A Cede & Co. demand letter may be obtained in as little as one business day.

[3] Right *to* Demand Appraisal Rights

Section 262 of the DGCL grants a "stockholder" the right to demand the "fair value of his shares of stock" in lieu of receiving merger consideration, provided certain conditions are satisfied. Section 262(a) defines "stockholder" as "a holder of record of stock in a stock corporation." Therefore, like the right of inspection, the right to demand appraisal of one's shares is not technically available to beneficial owners of stock.[29] Instead, a beneficial owner must either: (i) register its shares in its own name prior to the record date; or (ii) cause its bank or broker participant to instruct DTC to cause Cede & Co. to demand appraisal on its behalf.

§ 12.4 TABULATION ISSUES

The tabulation of abstentions[30] and so-called "broker nonvotes"—and the proxy statement disclosure relating thereto[31]—is another commonly misunderstood topic.[32] There are two primary issues that arise in the context of any shareholder meeting: (i) is a quorum present? and (ii) have the proposals received enough "For" votes to pass? The treatment of abstentions and broker nonvotes often directly impacts the outcome of these issues.

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29. *Edgerly v. Hechinger*, 1998 Del. Ch. LEXIS 177 (beneficial owner's attempt to assert appraisal rights under DGCL § 262 denied because Cede & Co. was record holder at all relevant times). See *also Enstar*, at 1356 ("In the interest of promoting certainty in the appraisal process, . . . a valid demand must be executed by or on behalf of the holder of record, whether that holder is the beneficial owner, a trustee, agent or nominee.").

30. Although tabulation of abstentions is not really impacted by street name registration, it is commonly addressed in connection with the tabulation of broker nonvotes. See Item 21 of Exchange Act Schedule 14A.

31. Unfortunately, drafting of the language explaining the quorum calculation and the vote required for passage of particular proposals is often considered "boilerplate" and left to less experienced persons at the company or its law firm.

32. For a more comprehensive analysis of this topic, see Hanks, James J., Jr., "Disclosure of Vote Requirements and the Treatment of Abstentions and Broker Non-Votes Under the Proxy Rules," INSIGHTS, December 1998 (p.24) (hereinafter, "Hanks"); and Dixon, Catherine T., "The SEC's Expanded Requirements: Disclosure of Proxy Voting Tabulation Procedures and Results," INSIGHTS, December 1993 (p.11) (hereinafter, "Dixon").

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Merriam-Webster's Collegiate. Dictionary

TENTH EDITION

Merriam-Webster, Incorporated
Springfield, **Massachusetts,** U.**S.A.**

prow \'praü, *archaic* 'prō\ *n* [MF *proue*, prob. fr. Olt did. *prua*, fr. L *prora*, fr. Gk *prōira*] (1555) 1 : the bow of a ship : STEM 2 : a pointed projecting front part

prow·ess \'praü-əs also 'prō-\ *n* [ME *prowesse*, fr. OF *proesse*, fr. *prou*] (13c) 1 : distinguished bravery; *esp* : military valor and skill 2 : extraordinary ability (his on the football field)

prowl \'praü(ə)l\ *vb* [ME *prollen*] *vi* (14c) : to move about or wander stealthily in or as if in search of prey ~ *vt* : to roam over in a predatory manner — **prowl·er** \'praü-lər\ *n*

prowl *n* (1803) : an act or instance of prowling — **on the prowl** : in the act of prowling; *also* : in search of something ⟨his fourth wife had just left him, and he was *on the prowl* again —Mary McCarthy⟩

prowl car *n* (1937) : SQUAD CAR

prox·e·mics \präk-'sē-miks\ *n pl but sing or pl in constr* [*proximity* + *-emics* (as in *phonemics*)] (1963) : the study of the nature, degree, and effect of the spatial separation individuals naturally maintain (as in various social and interpersonal situations) and of how this separation relates to environmental and cultural factors — **prox·e·mic** \-mik\ *adj*

prox·i·mal \'präk-sə-məl\ *adj* [L *proximus*] (1727) 1 : situated close to : PROXIMATE 2 : next to or nearest the point of attachment or origin, a central point, or the point of view; *esp* : located toward the center of the body — compare DISTAL 3 : of, relating to, or being the mesial and distal surfaces of a tooth — **prox·i·mal·ly** \-mə-lē\ *adv*

proximal convoluted tubule *n* (ca. 1899) : the convoluted portion of the vertebrate nephron that lies between Bowman's capsule and the loop of Henle and functions esp. in the resorption of sugar, sodium and chloride ions, and water from the glomerular filtrate — called also *proximal tubule*

prox·i·mate \'präk-sə-mət\ *adj* [L *proximatus*, pp. of *proximare* to approach, fr. *proximus* nearest, next, superl. of *prope* near — more at APPROACH] (1661) 1 : immediately preceding or following (as in a chain of events, causes, or effects) ⟨~, rather than ultimate, goals — Reinhold Niebuhr⟩ 2 a : very near : CLOSE b : soon forthcoming : IMMINENT — **prox·i·mate·ly** *adv* — **prox·i·mate·ness** *n*

prox·im·i·ty \präk-'si-mə-tē\ *n* [MF *proximité*, fr. L *proximitat-*, *proximitas*, fr. *proximus*] (15c) : the quality or state of being proximate : CLOSENESS

proximity fuze *n* (1945) : a fuze for a projectile that uses the principle of radar to detect the presence of a target within the projectile's effective range

prox·i·mo \'präk-sə-,mō\ *adj* [L *proximo mense* in the next month] (1855) : of or occurring in the next month after the present

proxy \'präk-sē\ *n, pl* **prox·ies** [ME *procucie*, contr. of *procuracie*, fr. AF, fr. ML *procuratia*, alter. of L *procuratio* procuration (15c) 1 : the agency, function, or office of a deputy who acts as a substitute for another 2 a : authority or power to act for another b : a document giving such authority; *specif* : a power of attorney authorizing a specified person to vote corporate stock 3 : a person authorized to act for another : PROCURATOR — **proxy** *adj*

proxy marriage *n* (1900) : a marriage celebrated in the absence of one of the contracting parties who is represented at the ceremony by a proxy

prude \'prüd\ *n* [F, good woman, prudish woman, short for *prudefemme qood* woman, fr. OF *prode femme*] (1704) : a person who *is* excessively or priggishly attentive to propriety or decorum; *esp* : a woman who shows or *affects* extreme modesty

pru·dence \'prü-d'n(t)s\ *n* [ME, fr. MF, fr. L *prudentia*, alter. of *providentia* — more at PROVIDENCE] (14c) 1 : the ability to govern and discipline oneself by the use of reason 2 : sagacity or shrewdness in the management of affairs 3 : skill and good judgment in the use of resources 4 : caution or circumspection as to danger or risk

pru·dent \-d'nt\ *adj* [ME, fr. MF, fr. L *prudent-*, *prudens*, contr. of *provident-*, *providens* — more at PROVIDENT] (14c) : characterized by arising from, or showing prudence: as a : marked by wisdom or judiciousness b : shrewd in the management of practical affairs c : marked by circumspection : DISCREET d : PROVIDENT, FRUGAL *syn* see WISE — **pru·dent·ly** *adv*

pru·den·tial \prü-'den(t)-shəl\ *adj* (15c) 1 : of, relating to, or proceeding from prudence 2 : exercising prudence esp. in business matters — **pru·den·tial·ly** \-'den(t)-sh(ə-)lē\ *adv*

prud·ery \'prü-d(ə-)rē\ *n*, pl **-er·ies** (1709) 1 : the characteristic quality or state of a prude 2 : a prudish act or remark

prud·ish \'prü-dish\ *adj* (1717) : marked by prudery : PRIGGISH — **prud·ish·ly** *adv* — **prud·ish·ness** *n*

pru·i·nose \'prü-ə-,nōs\ *adj* [L *pruinosus* covered with hoarfrost, fr. *pruina* hoarfrost — more at FREEZE] (ca. 1826) : covered with whitish dust or bloom ⟨~ stems⟩

¹prune \'prün\ *n* [ME fr. ME plum, fr. L *prunum* — more at PLUM] (14c) : a plum dried or capable of drying without fermentation

²prune *vb* **pruned; prun·ing** [ME *prouynen*, fr. MF *proignier*, prob. alter. of *provigner* to layer, fr. *provain* layer, fr. L *propagin-*, *propago*, fr. *pro-* forward + *pangere* to fix — more at PRO, PACT] *vt* (15c) 1 a : to reduce esp. by eliminating superfluous matter ⟨*pruned* the text⟩ ⟨~ the budget⟩ b : to remove as superfluous ⟨~ away all ornamentation⟩ 2 : to cut off or cut back parts of for better shape or more fruitful growth ~ *vi* : to cut away what is unwanted or superfluous — **prun·er** *n*

pru·nel·la \prü-'ne-lə\ *also* **pru·nelle** \-'nel\ *n* [F *prunelle*, lit., sloe, fr. dim. of *prune* plum] (1670) 1 : a twilled woolen dress fabric 2 : a heavy woolen fabric used for the uppers of shoes

pruning hook *n* (1611) : a pole bearing a curved blade for pruning plants

pru·nus \'prü-nəs\ *n* [NL, fr. L plum tree, fr. Gk *proumnē*] (1901) : any of a genus (*Prunus*) of drupaceous trees or shrubs of the rose family that have showy clusters of usu. white or pink flowers first appearing in the spring often before the leaves including many grown for ornament or for their fruit (as the plum, cherry, or apricot)

pru·ri·ence \'prur-ē-ən(t)s\ *n* (1781) : the quality or state of being prurient

pru·ri·en·cy \-ən(t)-sē\ *n* (1795) : PRURIENCE

pru·ri·ent \-ənt\ *adj* [L *prurient-*, *pruriens*, prp. of *prurire* to itch, crave; akin to L *pruna* glowing coal, Skt *plosati* he singes, and prob. *to* L *pruina* hoarfrost — more at FREEZE] (1592) : marked by or arousing an immoderate or unwholesome interest or desire; *esp* : marked by, arousing, or appealing to unusual sexual desire — **pru·ri·ent·ly** *adv*

pru·ri·go \prü-'rī-(,)gō, -'rē-\ *n* [NL, fr. L, itch, fr. *prurire*] (ca. 1646) : a chronic inflammatory skin disease marked by itching papules

pru·rit·ic \-'ri-tik\ *adj* (1899) : of, relating to, or marked by itching

pru·ri·tus \-'ri-təs, -'rē-\ *n* [L, fr. *prurire*] (1653) : ITCH 1a

Prus·sian blue \'prə-shən-\ *n* [*Prussia*, Germany] (1724) 1 : any of numerous blue iron pigments formerly regarded as ferric ferrocyanide 2 : a dark blue crystalline hydrated ferric ferrocyanide $Fe_4[Fe(CN)_6]_3 \cdot xH_2O$ used as a test for ferric iron 3 : a greenish blue

prus·sian·ise *Brit var of* PRUSSIANIZE

Prus·sian·ism \'prə-shə-,ni-zəm\ *n* (1856) : the practices or policies (as the advocacy of militarism) held to be typically Prussian

prus·sian·ize \-,nīz\ *vt* **-ized; -iz·ing** *often cap* (1861) : to make Prussian in character or principle (as in authoritarian control or rigid discipline) — **prus·sian·i·za·tion** \,prə-shə-nə-'zā-shən\ *n*

pru·tah *or* **pru·ta** \prü-'tä\ *n, pl* **pru·toth** \-'tōt, -'tōth, -'tōs\ or **pru·tot** \-'tōt, -'tōs\ [NHeb *pĕrūṭāh*, fr. LHeb, a small coin] (1949) 1 : a former monetary unit of Israel equivalent to $^1/_{1000}$ pound 2 : a coin representing one prutah

¹pry \'prī\ *vi* **pried; pry·ing** [ME *prien*] (14c) : to look closely or inquisitively; *also* : to make a nosy or presumptuous inquiry

²pry *vt* **pried; pry·ing** [prob. back-formation fr. ³*prize*] (ca. 1806) 1 : to raise, move, or pull apart with a lever : PRIZE 2 : to extract, detach, or open with difficulty ⟨*pried* the secret out of my sister⟩

³pry *n* (1823) 1 : a tool for prying 2 : LEVERAGE

pry·er *var of* PRIER

prying *adj* (1552) : impertinently or officiously inquisitive or interrogatory *syn* see CURIOUS — **pry·ing·ly** \-iŋ-lē\ *adv*

Prze·wal·ski's horse \pshə-'väl-skēz-, shə-, ,pər-zhə-'väl-\ *n* [Nikolai M. *Przhevalskiĭ* †1888 Russ. soldier & explorer] (1881) : a small stocky bay- or dun-colored wild horse (*Equus caballus przewalskii* syn. *E. przewalskii*) of central Asia having a large head and short erect mane — called also *Prze·wal·ski home* \-skē-\

psalm \'säm, 'sälm, 'som, 'sȯlm, *NewEng also* 'sȧm\ *n. often cap* [ME, fr. OE *psealm*, fr. LL *psalmus*, fr. Gk *psalmos*, lit., twanging of a harp, fr. *psallein* to pluck, play a stringed instrument] (bef. 12c) : a sacred song or poem used in worship; *esp* : one of the biblical hymns collected in the Book of Psalms

psalm·book \-,bu̇k\ *n* (12c) *archaic* : PSALTER

psalm·ist \'sä-mist, 'säl-, 'sȯ-, 'sȯl-, *NewEng* also 'sȧ-mist\ *n* (15c) : a writer or composer of esp. biblical psalms

psalm·o·dy \'sä-mə-dē, 'säl-, 'sȯ-, 'sȯl, *NewEng also* 'sȧ-mə-dē\ *n* [ME *psalmodie*, fr. LL *psalmodia*, fr. LGk *psalmōidia*, lit., singing to the harp, fr. Gk *psalmos* + *aidein* to sing — more at ODE] (14c) 1 : the act, practice, or art of singing psalms in worship 2 : a collection of psalms

Psalms \'sämz, 'sälmz, 'sȯmz, 'sȯlmz, *NewEng* also 'sȧmz\ *n pl but sing in constr* : a collection of sacred poems forming a book of canonical Jewish and Christian Scripture — see BIBLE table

Psal·ter \'säl-tər, 'sȯl-\ *n* [ME, fr. OE *psalter* & OF *psaltier*, fr. LL *psalterium*, fr. LGk *psaltērion*, fr. Gk, psaltery] (bef. 12c) : the Book of Psalms; *also* : a collection of Psalms for liturgical or devotional use

psal·te·ri·um \säl-'tir-ē-əm, sȯl-\ *n, pl* **-ria** \-ē-ə\ [NL, fr. LL, psalter; fr. the resemblance of the folds to the pages of a book] (ca. 1846) : OMASUM

psal·tery *also* **psal·try** \'säl-t(ə-)rē, 'sȯl-\ *n, pl* **-ter·ies** *also* **-tries** [ME *psalterie*, fr. MF, fr. L *psalterium*, fr. Gk *psaltērion*, fr. *psallein* to play on a stringed instrument] (14c) : an ancient musical instrument resembling the zither

p's and q's \,pēz-ᵊn-'kyüz\ *n pl* fr. the phrase *mind* one's *p's and q's*, alluding to the difficulty a child learning to write has in distinguishing between p and q] (1779) 1 : something (as one's manners) that one should be mindful of (better watch his *p's and q's* when I get a six-gun of my own —Jean Stafford) 2 : best behavior ⟨being on her *p's and q's* for two solid days *was too* much —Guy McCrone⟩

pse·phol·o·gy \sē-'fä-lə-jē\ *n* [Gk *psēphos* pebble, ballot, vote; fr. the use of pebbles by the ancient Greeks in voting] (1952) : the scientific study of elections — **pse·pho·log·i·cal** \,sē-fə-'lä-ji-kəl\ *adj* — **pse·phol·o·gist** \sē-'fä-lə-jist\ *n*

pseud \'süd\ *n* [short for *pseudo-intellectual*] (1964) *Brit* : a person who pretends to be an intellectual

pseud- *or* **pseudo-** *comb form* [ME, fr. LL, fr. Gk, fr. *pseudēs*, fr. *pseudesthai* to lie; akin to Arm *sut* lie and prob. *to* Gk *psychein* to breathe — more at PSYCH-] : false : spurious ⟨*pseudo*classic⟩ ⟨*pseudo*podium⟩

pseud·ep·i·graph \sü-'de-pə-,graf\ *n* (1884) : PSEUDEPIGRAPHON 2

pseud·epig·ra·phon \,sü-di-'pi-grə-,fän\ *n, pl* **-pha** \-fə\ [NL, sing. of *pseudepigrapha*, fr. Gk, neut. pl. of *pseudepigraphos* falsely inscribed, fr. *pseud-* + *epigraphein* to inscribe — more at EPIGRAM] (1692) 1 *pl* : APOCRYPHA 2 : any of various pseudonymous or anonymous Jewish religious writings of the period 200 B.C. to 200 A.D.; *esp* : one of such writings (as the Psalms of Solomon) not included in any canon of biblical Scripture — usu. used in pl.

pseud·epig·ra·phy \-fē\ *n* [Gk *pseudepigraphos*] (ca. 1842) : the ascription of false names of authors to works

pseu·do \'sü-(,)dō\ *adj* [ME, fr. *pseudo-*] (15c) : being apparently rather than actually as stated : SHAM, SPURIOUS (distinction between true and ~ humanism —K. F. Reinhardt)

pseu·do·al·lele \,sü-dō-ə-'lē(ə)l\ *n* (1948) : any of two or more closely linked genes that act usu. as if a single member of an allelic pair but occas. undergo crossing-over and recombination

pseu·do·cho·lin·es·ter·ase \'sü-dō-,kō-lə-'nes-tə-,rās, -,rāz\ *n* (1943) : CHOLINESTERASE 2

pseu·do·clas·sic \,sü-dō-'kla-sik\ *adj* (1899) : pretending to be or erroneously regarded as classic — **pseudoclassic** *n*

pseu·do·clas·si·cism \-'kla-sə-,si-zəm\ *n* (1871) : imitative representation of classicism in literature and art

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ADMINISTRATIVE LAW TREATISE

Fourth Edition

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VOLUME I

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"general." Indeed, courts sometimes emphasize that agencies should not take literally the statutory adjectives "concise" and "general," in light of the realities of the process of judicial review and the needs of reviewing courts. Automotive Parts Assn. v. Boyd, 407 F.2d 330, 338 (D.C. Cir. 1968).

Statement must be long and detailed

No court today would uphold a major agency rule that incorporates only a " concise general statement of basis and purpose." To have any reasonable prospect of obtaining judicial affirmance of a major rule, 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. See, e.g., American Gas Assn. v. FERC. 888 F.2d 136 (D.C. Cir. 1989); Mobil Oil Co. v. DOE, 610 F.2d 796 (TECA 1979), *cert. denied,* 446 U.S. 937 (1980); National Tire Dealers & Retreaders v. Brinegar, 491 F.2d 31 (D.C. Cir. 1974). Failure to fulfill one of these judicially prescribed requirements of a "concise general statement of basis and purpose" has become the most frequent basis for judicial reversal of agency rules. See Pierce, the Role of the Judiciary in Implementing an Agency Theory of Government. 64 N.Y.U. L. Rev. 1239, 1263-1265 (1989); Shapiro & Levy, Heightened Scrutiny of the Fourth Branch: Separation of Powers and the Requirement of Adequate Reasons for Agency Decisions, 1987 Duke L.J. 387, 422-425; Wald, The Contribution of the D.C. Circuit to Administrative Law, 40 Admin. L. Rev. 507,528 (1988).

Original meaning of "arbitrary" and "capricious"

The extremely demanding judicial definition of the statement of basis and purpose required by APA §553(c) can be understood as the product of decades of judicial attempts to give content to several related provisions of the APA. Section 706(2)(A) compels a court to "hold unlawful and set aside agency action" that is "arbitrary" and "capricious." The arbitrary and capricious standard can mean many things, depending on the context in which it is used. In some important contexts, for instance, the Supreme Court has held that an action is rational, and thus is not arbitrary and capricious, if it has any chance of furthering a legitimate goal based on any plausible state of facts. See, e.g., Allied Stores v. Bowers, 358 U.S. 522, 530 (1959) (upholding state statute against attack based on Fourteenth Amendment); Pacific States Box & Basket Co. v. White, 296 U.S. 176 (1935)

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ADP Fee Schedule

Proxy*:

Service Fee:	$.40	Postage:	**
Contest:	$1.00	Form/Envelopes: ***	$.074-$.088
Reminder:	$.40	Bulk Processing Fee:	$.03/Letter
Wrap:	No Charge		$.055/Flat
Issuer Copy:	No Charge		
Paper & Postage elimination:	**5.50** For "Small Issuers"	Vote Return:	
	$.25 For "Large Issuers"	Mail:	$.348 per return
	$.40 For Reminders	Telephone:	$.18 per return
Intermediary Fee:	$20.00 per nominee	Internet:	$.098 per return
	+ $.10 Per Account for "Small Issuers"	Proxy **Edge;**	$.06 per return
	+ $.05 Per Account for "Large Issuers"		
		Vote Reporting:	
Small Issuers – Less than 200,000 Nominee Accounts		Daily Fax:	$50.00
Large Issuers – 200,000 or more Nominee Accounts		Day of Meeting:	$12.00

Interim*:

Service Fee:	$.15	Form/Envelope size #10:	$.015/$.013 = $.028
Wrap:	No Charge	Form/Envelope size 9 X 12:	$.020/$.033 = $.053
issuer Copy:	No Charge	Bulk Processing Fee:	$.03/Letter
Paper & Postage elimination:	$.10		$.055/Flat
Postage:	**		

Direct Communication (NOBO)*:

NOBO Fee Schedule:

	7 – 10,000 accounts	$0.165 / account
	10,000 – 100,000 accounts	$0.115 / account
	100,000 or more accounts	$0.105 / account
	Minimum fee	$100.00, plus $0.065 per account
Additional Fees:	Magnetic Tape	$20.00 per tape
	Cartridge	$20.00 per cartridge
	Compact Disc	$20.00 per CD
	Cheshire Labels	$3.00 per thousand
	Peel & Stick Labels	$75.00 per thousand
	Overnight Charge:	$20.00 minimum or as incurred

Additional Services

Stratified Mailing: $.05 per name X total file ($500 minimum, $5,000 maximum)
i.e. Mail to beneficial owners holding 7,000 shares or more via UPS Mail Innnovations and all other beneficial owners via Standard Mail.

UPS Expedited Mailina Delivery Options: (subject to current rates. based on 1 lb Package)

UPS Next Day AM:	$13.98	with return:	$17.70
UPS Next Day PM:	$12.20	with return:	$15.92
UPS Second Day:	$ 7.66	with return:	$11.37

Saturday delivery available for Next Day AM only at an additional fee of $10.00 per package.

Priority Mail through the United States Postal Service: (subject to current rates)

2 - 3 day package: $3.85 (not over 1 lb.)
$3.95 and Up (over 1 lb. – rate based on Postal Zone)

Geographic Survey: $500.00
(Number of beneficial owners and shares by state)

Record Date Comparison: $.10 per name eliminated
(If Annual reports are mailed prior to the annual meeting record date, a mailing can be done to new holders only)

Unvoted/Voted NOBO Listing:

Up to 10,000 names:	$200.00
10,000 - 700,000 names:	$400.00
100,000 and Up:	$600.00
Overnight Delivery:	$20.00 minimum or as incurred

Fees are based on the total number of accounts reported by ADP's Broker/Bank clients. A complete NOBO listing must be ordered with or prior to requesting an Unvoted/Voted list.

* Fees are based on Exchange regulations amended March 25, 2002 and on a per account basis unless otherwise indicated.
** Actual with half of any gross presort/other discounts passed to the Issuer.
*** Envelope charges are billed at out of pocket costs.

ADP-ICS Mar. 2003

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AFL-CIO Click to Print

Shareholder Access to the Proxy
AFL-CIO Fact Sheet

The Securities and Exchange Commission (SEC) recently proposed historic new rules that could, for the first time, give long-term investors a meaningful say in selecting boards of directors. The following is a brief summary of what investors should know about this critical investor reform, and what they can do to ensure that the SEC adopts final rules that give shareholders timely and effective access to the proxy. The complete SEC rule proposal is posted on the SEC website (http://www.sec.gov/rules/proposed/34-48626.htm).

What is shareholder access to the proxy?

Access to the proxy refers to the right of long-term shareholders to include their nominees to corporate boards of directors in the proxy materials mailed by corporations to all of their shareholders. This right is not currently available to shareholders.

Why *is* access to the proxy so important?

Investors expect the directors they ostensibly elect to be open and responsive to shareholder input on issues facing the company, willing to challenge management with tough questions and goals, and prepared to take independent action when needed to maximize the long-term value of the corporation. As recent corporate scandals illustrate, too many boards fail to meet these fundamental standards, and the current incumbent-dominated director election process denies shareholders the ability to hold these directors accountable for their performance. That is because under the current election process shareholders vote only on candidates nominated by the directors themselves, a practice that allows CEOs to handpick their own directors.

Although state law permits shareholders *to* run director candidates, this fundamental shareholder right remains effectively unavailable so long as shareholders' nominees are denied equal access to the corporate proxy. As a result, incumbent directors can freely spend the corporate treasury to get re-elected while shareholders must mount costly proxy contests that are hard for particular investors to justify absent a battle for corporate control (the costs to print and mail proxy materials alone can run into the millions). With no real ability to cost effectively run directors, shareholders can do little more than rubberstamp a company's nominees.

Who supports shareholder access to the proxy?

This critical reform enjoys broad investor support, including from the 165 unions, pension funds, institutional investors and institutional investor associations that sent supporting comments to the SEC as part of its recent review of the proxy rules governing director nominations and elections. The AFL-CIO, whose affiliated unions sponsor benefit plans with $400 billion in assets, took the opportunity of the SEC review to file a rulemaking petition seeking access to the proxy.

Supporters include the California Public Employees' Retirement System, the nation's largest pension fund; Barclays Global Investors, the world's largest institutional

investment manager; and the Council of Institutional Investors, whose members' assets exceed $2 trillion. In total, the SEC received 690 comment letters, overwhelmingly in support of access to the proxy, including 424 from individual investors. In addition, a recent Harris Poll found that 8 of 10 investors want the right to offer investor-nominated board candidates through the proxy ballot.

Who opposes shareholder access to the proxy?

The Business Roundtable, which is composed of the CEO's of the 150 largest companies, is leading the opposition to the rules. Other opponents include the corporate bar, the National Association of Corporate Directors, and the Investment Company Institute, which is the trade association for the mutual fund industry.

Why aren't recent regulatory reforms sufficient to address director accountability?

In response recent corporate scandals and the Sarbanes-Oxley Act, the SEC adopted a broad set of reforms, including new rules to enhance the independence of audit committees and outside audit firms, and is expected to approve new exchange listing standards to strengthen the independence of the board of directors and its key committees. Opponents to access to the proxy argue that these reforms are sufficient to address the kinds of accountability concerns that have undermined investor confidence in our capital markets, and are wary of further regulation.

In fact, these recent regulatory reforms address director conflicts, not accountability. Though essential to rein in the conflicts of interest that can compromise directors' loyalty to the corporation and its shareholders, recent regulatory reforms cannot ensure that directors act independently, are responsive to shareholder concerns and contribute to building the long-term value of the corporations they serve. By making meaningful the right to nominate directors that shareholders already ostensibly enjoy under state law, new rules granting access to the proxy would empower shareholders and thereby lessen investors' reliance on regulatory oversight.

Are the SEC's proposed rules sufficient?

The proposed rules adopt the basic principle of giving long-term investors a say in the election of directors, They also contain safeguards—including significant minimum ownership and holding period requirements for shareholders, and strict limitations on the number of shareholder nominees—to ensure that they cannot be used to facilitate hostile takeovers by short-term investors or lead to potentially frivolous nominees at numerous companies.

However, as proposed, the rules also contain unwarranted triggering requirements that would make it difficult for even the largest investors to use them, and impossible to do so in a timely manner. First, the proposed triggers mean that up *to* two years must pass between the time shareholders wish to nominate a candidate and when one could actually be elected. Second, the SEC's proposed 1 percent ownership requirement for shareholders to submit an "triggering" proposal is far too high. Rarely, if ever, do the institutional investors that sponsor shareholder proposals own even 1/2 percent of a company.

TAKE ACTION! Tell the SEC you support proxy access rules that investors can use. Click here *to* send a comment letter to the SEC voicing your strong support for final SEC rules that truly give shareholders a voice in picking corporate directors at America's largest corporations. The SEC's comment period ends Dec. 22.

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Statement by AFL-CIO President John J. Sweeney on the SEC's Proposed Rules Granting Shareholders Access to the Proxy

October 08, 2003

Today's vote by the Securities and Exchange Commission to propose rules granting long-term investors a voice in the selection of corporate directors is an act of genuine leadership by Chairman William Donaldson and the entire Cornmission. In the weeks to come the Cornmission must decide whether to adopt final rules that truly give responsible long-term investors timely and effective recourse when faced with self-serving CEOs and passive boards at America's largest companies.

Corporate scandals at companies like Enron, WorldCom, Tyco and HealthSouth are painful reminders that giving CEOs the power to handpick their own directors can have devastating consequences for corporations and the investors, employees and communities that depend on them. That is why earlier this year the AFL-CIO petitioned the Commission to issue new rules granting long-term investors access to the corporate proxy to nominate directors.

The rules proposed today adopt the basic principle of giving long-term investors a say in the election of directors. However, the proposed rules also contain triggering requirements that would make it difficult for even the largest investors to use them, and impossible to do so in a timely manner.

It is no surprise that CEOs are now speaking out against meaningful proxy access rules. But America's working families have already paid too high a price as a result of executives who put their own interests ahead of those of their corporations. The labor movement looks forward to working with the Commission to craft final rules that will hold CEOs and corporate boards accountable.

Contact Suzanne Ffolkes 202-637-5018

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Inside Track with Broc: Ned Young on Shareholder Access and Possible Changes in Control (12/16/03)

Edward "Ned" Young is a Senior Partner of Hale and Dorr LLP.

Broc: It is clear that the SEC's recent proposal on shareholder access is very controversial. 5000 comment letters and counting so far. Why is it so controversial?

Ned: For one thing, the "shareholder access" proposal is not supposed to result in changes in corporate control when utilized - at least, not immediately. But it may set up companies for a change in control at the very next annual meeting even though the company has a staggered board of directors with three-year terms.

Broc: Can you give *a* brief background of how the proposal would work in practice?

Ned: If the rules are adopted, dissatisfied shareholders will, in some cases, be able to place one or more independent nominees for director right on the company's own proxy card, at the company's expense, beginning in 2005.

Allowing dissatisfied shareholders holding just over 5% or possibly less of a company's float to place their nominees on the company's proxy card would substantially reduce the time and expense required to run candidates under existing rules - factors that deter all but the most determined and well-financed shareholders from engaging in proxy contests. And such nominees in many situations could become king-makers at the next annual meeting, with power to coalesce with a short slate nominated by other disgruntled shareholders or a prospective acquirer, to achieve either a deadlock position **or** an outright working majority on the board.

Broc: What are the SEC's intentions in proposing its framework?

Ned: Well, the SEC does not intend for the shareholder access process to provide a beachhead for a clandestine two-year proxy contest mounted by someone seeking to gain control of a company.

However, neither the independence criteria contained in the proposed rules nor the limitations on the number of directors who may be nominated and elected under the new rules fully guard against the possibility of a change in control after the next meeting following the election of one or more shareholder access candidates.

Broc: Can you provide more gloss on that point?

Ned: Sure, the SEC's proposed independence criteria for nominees prohibit shareholders from nominating candidates who are not independent of the nominating shareholders (and of the company as well) under applicable NYSE or NASDAQ guidelines. But the definition of independence is not a particularly forbidding one. Merely sharing common views (for example, that the company should be put in play and sold) is not a bar to being nominated.

Suppose, then, that a few large institutional investors in Company X are quite open to seeking Company X acquired. The investors distrust the incumbent board's willingness to entertain offers at reasonable prices. The investors lack the power to force redemption of Company X's poison pill. What can they do under the proposed rules?

Before they can make use of the shareholder access rules, they must either successfully sponsor a Rule 14a-8 shareholder proposal to opt-in to the new rules or else mount a campaign that results in at least 35% of the votes cast at a meeting being withheld from at least one incumbent director. Achieving either of these results may not be **a very** difficult task for dissident shareholders to accomplish. **A** significant number of withhold-vote campaigns have been mounted in recent years. Such campaigns are not necessarily expensive, particularly if they are conducted over the Internet. Last year, 35% of the vote was withheld at approximately 1% of all public companies.

Broc: How many directors will shareholder be allowed to nominate under the SEC's proposal?

Ned: The proposed rules limit the number of persons elected pursuant *to* the shareholder access process who may serve at any one time:

- one, if the board has 8 or fewer directors
- two, if the board has between 9 and 19 directors
- three, if the board has 20 or more directors

In many situations, however, these limitations will not alleviate the possibility of a two-meeting change in control. Depending on the size of the board, the shareholders' nominees may become "king-makers," if another disgruntled shareholder or a prospective acquirer mounts a successful short-slate challenge at the next annual or special meeting in accordance with the normal rules for proxy contests.

In fact, the shareholder nominee(s) may be the swing votes giving the insurgents a deadlock position if the board has an even number of members or a working majority if the board has an odd number of members. For example, a nine-person staggered board elected to three-year terms of office might easily come to consist of two shareholder access directors elected in year 1, three new insurgents elected in year 2 and only four old incumbents. If five of the nine directors share a desire for the company to be put in play, the company will be put in play.

Broc: So, would any boards be immune to this type of scenario?

Ned: Only boards having 15, 17, 18, 19, 21, 23 or more than 23 members are impervious to undergoing such *a two-*meeting change in control. Boards of **3, 4,** 6, 9, 10 and 12 will be vulnerable every year.

Boards of **5,** 8, 11, **14** and 20 will be vulnerable two years out of every three, depending on how many directors are up for re-election in any particular year, and boards of 7, 13, 16 and 22 will **be** vulnerable one year out of every three.

Broc: When is this two-step process for a change of control most likely to be used?

Ned: Since the **5%** shareholder who uses the shareholder access process in year 1 cannot itself mount a proxy contest in year **2, a** two-step change in control is most likely to occur if the 5% sharholder **has** an agenda shared by others - for example, that the company should be sold.

But once a company has shareholder access nominees on its board, the field is open and there is no telling who may challenge the incumbents the next year: it might, for example, be ousted former management who otherwise could not crack the defense of **a** staggered board in a single proxy contest.

*The views set forth above are **Ned's** personal views and do not necessarily reflect the views of the firm he is associated with. The views are also not **intended** to be legal advice.*

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From: Austin Brentley [mailto:a_brentley@cii.org]
Sent: Tuesday, November 18, 2003 11:40 AM
Subject: Irresponsible Directors

Hello,
This is the Council of Institutional Investors again,
The response to rule S7-19-03 has been very strong so far, but we are nowhere near where we need to be in order to get this rule passed. Remember, passage of rule S7-19-03 will make it easier for shareholders to *vote* out irresponsible directors and add their own candidates to the slate. This is one of the most important pieces of tegislation that the SEC has ever considered. Shareholders across the country should **take** note
And all that **you need to do is send a two sentence email to the SEC** at **(rule-comments@sec.gov)**.
To send this email, please include the below 3 items:
SEC's Email Address: rule-comments@sec.gov
Subject line of message: 57-19-03
BCC: Austin@cii.org (please do not ***CC me....only BCC).***
Thank you very much for your support. Together we can make a difference. Please send this to as many people as possible. Members, friends, family. Every voice counts.
-Austin Brentley
Austin@cii.org
For a more detailed discussion, please read the SEC summary at: http://www.sec.gov/rules/proposed/34-48626.htm
If you would like to see samples of letters/emails from previous respondents, just contact me, and I'll be happy to send some examples.

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GIBSON, DUNN & CRUTCHER LLP

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December 15, 2003

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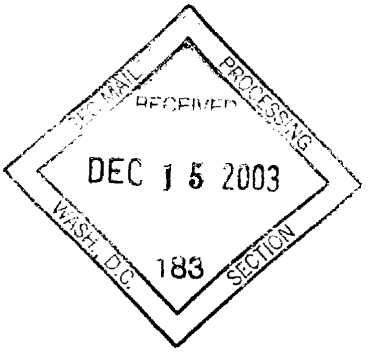
Client No.

VIA HAND-DELIVERY



FOIA/PA Office
Securities and Exchange Commission
Operations Center
Room 1418
6432 General Green Way
Mail Stop 0-5
Alexandria, VA 22312-2413

Re: *Freedom of Information Act Appeal: Request No. 2004-0835; Expedited Treatment Requested*

Dear Sir or Madam:

Pursuant to 5 U.S.C. § 552(a) and 17 C.F.R. §§ 200.80(d)(5) and (6), I am writing to appeal a December 12, 2003 decision of the Securities and Exchange Commission's FOIA/Privacy Act Office ("Office"), which declined to expedite review of a Freedom of Information Act ("FOIA") request filed with that office on November 26, 2003. A copy of that decision is attached hereto as Exhibit A.

On November 26, 2003, I submitted an electronic FOIA request to the Office, a copy of which is attached hereto as Exhibit B.* That request seeks copies of all data and studies that the

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* The Office's letter states that the request was not received until December 4, 2003. As noted above, however, our request was submitted via e-mail (in PDF format) to the Office on November 26. A copy of that e-mail transmittal is attached hereto as Exhibit C. Although we were informed that a copy of the FOIA request submitted to Jonathan Katz on that same date for inclusion in the rulemaking record in File No. S7-19-03 would need to be resubmitted in non-PDF form (which we did on December 3, 2003), we were told by the Office that

[Footnote continued on next page]

Securities and Exchange Commission ("Commission") cites or relies upon in its proposing release regarding "Security Holder Director Nominations," file number S7-19-03, and that are otherwise not publicly available. The data and studies that we request include, but are not limited to, those cited in footnotes 78-85, 114, 187, 189-92, 194-95, and 197-98 of the proposing release. The data is sought for purposes of preparing comments for the rulemaking in which the data has been cited. As we noted in our FOIA request, the Commission has rejected an informal request we made for the data cited in footnote 78 on November 18, 2003.

A "compelling need" for expedited processing of our FOIA request exists under the Administrative Procedure Act ("APA"), 5 U.S.C. § 553(c). The APA requires that interested parties have an opportunity to provide "meaningful" comment on proposed rules. See *Florida Power & Light Co. v. United States*, 846 F.2d 765, 771 (D.C. Cir. 1988). Accordingly, the courts have held, an agency must "identify and make available technical studies and data that it has employed in reaching the decision to propose certain rules . . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary." Connecticut *Light and Power Co. v. Nuclear Regulatory Comm'n*, 673 F.2d 525, 530 (D.C. Cir. 1982). Indeed, data must be "made available to interested parties in time for a proper analysis and meaningful comment to be made regarding the proposed regulation." Lloyd *Noland Hosp. & Clinic v. Heckler*, 619 F. Supp. 1, 6 (N.D. Ala. 1984). Without public access to and input regarding such data, agencies cannot satisfy their rulemaking obligations under the APA.

In the rulemaking for which this data is sought, interested parties have until only December 22, 2003 – seven days from today, but 26 days from the date of our original request – to submit comments. Plainly, expedited processing is essential to provide the meaningful opportunity to comment required by the APA.

The Office's denial of our request for expedited processing ignores the significance of the APA to our request. Instead, the Office misconstrued our request for expedited review as one based on "a desire to inform the public," rather than one based on the statutory right to inform the Commission's rulemaking under the APA. None of the cases cited by the Office – all of which concern authors seeking information to write books and articles rather than to participate in agency rulemaking under the APA – is relevant, let alone supports denial of expedited processing of our FOIA request. See Freeman *v. Department of Justice*, 822 F. Supp. 1064, 1067 (S.D.N.Y. 1993); *The Nation Magazine v. Department of State*, 805 F. Supp. 68, 73

[Footnote continued from previous page]

it indeed would accept a FOIA request submitted in PDF format. Accordingly, there is no basis for the statement that our FOIA request was received on December 4, 2003.

(D.D.C. 1992); *Lisee v. CIA*, 741 F. Supp. 988,988 (D.D.C. 1990); *Summers v. Department of Justice*, 733 F. Supp. 443 (D.D.C. 1989).

For all the foregoing reasons, we request expedited treatment of both our FOIA request and this appeal. Thank you for *your* attention to this matter.

Very truly yours,

Ashley Wright

Ashley Wright

Attachments

cc: Giovanni P. Prezioso, Esq.

EXHIBIT A

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
OPERATIONS CENTER
6432 GENERAL GREEN WAY
ALEXANDRIA, VIRGINIA 22312-2413

OFFICE OF FILINGS AND INFORMATION SERVICES

BY MAIL AND FACSIMILE (202) 530-9606

Mail Stop O-5

December 12, 2003

Ashley Wright, Esq.
Gibson, Dunn & Crutcher, LLP
1050 Connecticut Avenue, NW
Washington, DC 20036-5306

RE: Freedom of Information Act (FOIA), 5 U.S.C. § 552
Request No. 2004-0835

Dear Ms. Wright:

This letter responds to your letter, dated November 26, 2003, and received in this Office of December 4, 2003, regarding your request for expedited treatment for certain nonpublic records relating to *Security Holder Director Nominations*, (File No. S7-19-03; 68 Fed. Reg. 60,784).

Under FOIA, a request may be processed on an expedited basis when the requestor damonstrates a compelling need 5 U.S.C. § 552(a)(6)(E). While I find that there is a current interest in the information you seek, you did not demonstrate a compelling need. A desire to inform the public, while commendable, does not constitute an exceptional need." See Freeman v. Dept. of Justice, 822 F.Supp. 1064, 1067 (S.D.N.Y. 1993). Additionally, the publication date of a projected article has been held not to constitute an exceptional need. See Lisee v. CIA, 741 F.Supp. (D.D.C. 1990); Summers v. Dept. of Justice, 733 F.Supp.443 (D.D.C. 1969), appeal dismissed, 925 F.2nd 450 (D.C. Cir. 1991); The Nation Magazine v. Dept. of State, 805 F.Supp. 68, 73 (D.D.C. 1992)(declining to find media's desire for records constitutes an exceptional need or urgency). Therefore, your request is being processed under our normal guidelines.

You have the right to appeal our decision to our General Counsel under 5 U.S.C. § 552(a)(6)' 17 CFR § 200.80(d)(5) and (6). Your appeal must be in writing, clearly marked "Freedom of Information Act Appeal," and should identify the records at issue. The appeal may include facts and authorities you consider appropriate.

Send your appeal to the FOIA/PA Office, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Mail Stop 0-5, Alexandria, VA 22312-2413, or deliver it to Room 1418 at that address. Also, send a copy to our General Counsel, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0207, or deliver it to Room 1012-B at that address.

In the interim, if you have any questions, please call Mrs. Melody Adams of my staff at (202) 942-4328.

Sincerely,
FOIA/Privacy Act Officer

by: Melody A. Adams for
Brenda L. Fuller, Branch Chief
FOIA/Privacy Act Office

EXHIBIT B

GIBSON, DUNN & CRUTCHER LLP
LAWYERS
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November 26,2003

Direct Dial
(202) 887-3770
Fax No.
(202) 530-9606

Client No.

VIA E-MAIL

U.S. Securities & Exchange Commission
FOIA Office, Stop 0-5
6432 General Green Way
Alexandria, VA22312-2413

Re: Freedom of Information Act Request

Dear Sir or Madam:

Pursuant to the Freedom of Information Act ("FOIA"), we request copies of *all* data and studies *that* the Securities & Exchange Commission ("Commission") cites or relies upon in its proposing release regarding "Security Holder Director Nominations" (file number S7-19-03; 68 Fed. Reg. 60,784), and that are not otherwise publicly available. The data and studies that we request include, but *are* not limited to, those cited in footnotes 78-85, 114, 187, 189-90, 192, 194-95, and 197-98 of the proposing release. A prior request for the data cited in footnote 78 was rejected by the Commission on November 18,2003.

Under the Administrative Procedure Act, 5 U.S.C. § 553(c), interested parties are entitled to an adequate period of time to review, consider and comment meaningfully on proposed rules. Yet, only 26 days remain for interested parties to comment on the proposed rule identified above. Accordingly, we request expedited processing of this request so that we might obtain copies of the records within five business days.

Gibson, Dunn & Crutcher LLP will pay all fees associated with the search, review and duplication of these records.

If you need to contact me, I can be reached at (202) 887-3770.

Very truly yours,

Ashley Wright

Ashley Wright

EXHIBIT C

Wright, Ashley

From: Wright, Ashley
Sent: Wednesday, November 26, 2003 3:19 PM
To: 'foia/pa@sec.gov'
Subject: FOIA Request

FOIA_Req.pdf

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Georgeson Shareholder

ANNUAL CORPORATE GOVERNANCE REVIEW

*Shareholder **Proposals** and Proxy Contests*

2003

Executive Summary

The 2003 Proxy Season: Full of Sound and Fury

As expected, the 2003 annual meeting season broke records for shareholder proposals relating to corporate governance and executive compensation. Despite continuing intense criticism of Rule 14a-8, the results in 2003 confirm that the proposal process works effectively for the conduct of referenda on governance issues. Even though shareholder advocates complain about the restrictions imposed by 14a-8, proxy resolutions continue to be a popular and effective means of promoting governance reform and pressuring targeted companies.

The statistics speak for themselves. During the 2003 annual meeting season:

- Fifty-six percent more governance proposals came to a vote – 427 in 2003, versus *273* for the same period in 2002. This represents the largest increase in years.

- Executive compensation dominated the 2003 governance agenda. Nearly 40% of the resolutions dealt with compensation-related matters, with the leading proposal calling for stock options to be expensed on grant date. Sixty-seven such resolutions drew support on average from 45% of votes cast (32% of outstanding shares).

- The number of governance proposals achieving support from a majority of votes cast also increased, from 88 proposals in 2002 to 140 in 2003. In terms of raw numbers, this represents a 59% increase. However, measured against the total number of proposals presented, the approval rate is almost unchanged, from 32.2% (88/273) in *2002* to 32.8% (140/427) in 2003.

- Proposals seeking shareholder approval for, or rescission of, poison pills topped the list again this year with the highest number of resolutions – 82.

- Board declassification continued to attract the highest levels of support – an average of 62% of votes cast and 45% of outstanding shares.

- The demographics of shareholder proponents continued to evolve, with sponsorship by special interest groups continuing to dominate the agenda. Labor unions overtook individual shareholders as the leading proponents of governance resolutions, sponsoring nearly half of all resolutions that came to a vote in *2003*. Public pension funds' sponsorship shrank to a low of just 2%, down from 6% of proposals in 2002, and far from the dominant levels of institutional sponsorship that signaled the start of the governance movement in the 1980s.

Standardization and automatic voting 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 tnuch attention the company has paid to governance excellence. The situation is exacerbated by Department of Labor rules that encourage voting consistency rather than case-by-case decision-making. New rules requiring disclosure of proxy votes by mutual funds may further discourage case-by-case analysis in favor of consistency and rote voting.

These factors may increase the ability of shareholders to achieve impressive results in their referenda, but they reduce the meaning of shareholder votes in the larger context of corporate fundamentals, performance and governance. 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. Unfortunately it looks as if the SEC has been persuaded to take exactly this approach.

Executive compensation proposals

The 2003 proxy season was remarkable for what did not happen in the field of executive compensation. With the New York Stock Exchange and Nasdaq poised to eliminate the discretion of brokers to vote their clients' shares in favor of "routine" requests for more incentive shares, one might have expected a rash of buzzer-beating option plan proposals. But gaming the impact and timing of the regulatory changes (the rule changes were ultimately not implemented until well after the 2003 season) took a back seat to concerns over growing institutional opposition to the use of options. Many companies simply decided to watch from the sidelines to see how other companies fared in their efforts to obtain shareholder approval of plans. Others held back while they assessed whether they would even continue to use options if, as is expected, the Financial Accounting Standards Board requires options to be expensed on corporate income statements.

Ultimately, cooler heads prevailed and companies with reasonable and appropriately structured plan proposals met with success, even if it required a little prodding. Major Companies like PepsiCo, Merrill Lynch and General Mills successfully took their cases directly to their largest institutional investors, which by and large supported their plan proposals. Through effective communications strategies, these companies overcame significant obstacles including "overhang" issues and the sometimes inflexible dilution formulas applied to their plans by institutions and their proxy advisors.

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ISS Viewpoint

SEC Shareholder Access Proposal

ISS

INSTITUTIONAL SHAREHOLDER SERVICES

ISS Viewpoint: SEC Shareholder Access Proposal

The Securities and Exchange Commission is considering a landmark rule on director nominations by shareholders. The proposed rules would allow major, long-term shareholders access to company proxy materials to nominate directors in cases where either of two triggering events suggest a failure to heed shareholder views. In addition, the Commission recently adopted new disclosure rules for nominating committees.

The two triggering events would be:

- Withhold votes for at least one director totaling more than 35 percent of the votes cast at an annual meeting after Jan, 1,2004.
- **A** majority vote on a resolution requesting shareholder access at an annual meeting after Jan. 1, 2004. To be eligible to submit such **a** resolution, a shareholder or group of shareholders must own more than 1 percent of the company's stock for one year. The company would then be required to include in its materials the nomination proposed by shareholders owning more than **5** percent of the company's stock continuously for two years.

The nominee must be independent of both the nominating group of shareholders and the company. In the words of the **SEC,** the nominating group must affirm in a notice to the company that the nominee is independent of the nominating group and, in addition, meets the objective criteria for independence from the company **as** set forth in the listing standards of a national securities exchange or national securities association.

A board with eight or fewer directors would be required to include only one nominee; a board with nine to 19 directors, no more than two nominees; and a board with 20 directors or more, **up** to three nominees. If **a** company receives more nominees than required, the nominees from the largest shareholder group would **take** precedence.

A shareholder or group of shareholders seeking control of the company would be ineligible to nominate a director. Furthermore, the rule would only apply where shareholders are permitted by state law to nominate a candidate for election. According to an **SEC** official, the states where most public companies are incorporated, including Delaware, do **give** shareholders that right.

The SEC will reach **a** final decision on the proposal after the public comment period ends on Dec. 22. Following is ISS's point of view, which does not necessarily reflect that of our clients.

Does ISS Support the SEC's Proposed Rules for Shareholder Ballot Access?

Yes, ISS supports the proposals, which will allow reasonable access to significant investors to place their nominees on the corporation's proxy ballot.

Why?

Reform is needed to right **a** steeply tilted playing field, in which management and board incumbents dominate the elections process. Moreover, shareholder access will build on the Sarbanes-Oxley Act and the new corporate governance listing standards. While those reforms enhance boardroom oversight of management, ballot access will enable shareholders to hold boards of directors more accountable.

How will the proposals prevent special-interest abuses?

The rule provides numerous safeguards:

- Triggering events must take place before qualified shareholders can nominate directors
- Authority to nominate director candidates will be limited to significant, long-term investors
- Contests for corporate control are excluded
- Nominees must satisfy listing standards for independence
- Nominees must win a contested election to join the board

Should the SEC make any changes to the proposal?

Yes. In urgent cases, shareholders need to respond right away to redress egregious problems, without waiting for the two-step process (triggering event and then nomination) to play out over two years or more. Therefore, shareholders or groups of shareholders who have significant, long-term stakes in the company should have the unfettered right to propose candidates even in the absence of a triggering event.

The bar for unfettered authority should be set high. If the SEC keeps the current thresholds (1 percent ownership to propose a triggering resolution and 5 percent ownership to nominate a director), then eligibility for the unfettered right to nominate a director should be set at 10 percent. **As** an even better alternative, we recommend that the **SEC** adjust its thresholds to require 1 percent ownership to file a resolution calling for shareholder nominations; ***3*** percent ownership for the right to make nominations after a triggering event; and ***6*** percent ownership for the unfettered right to nominate director candidates.

What other reforms should the SEC adopt?

We recommend three:

- **Eliminate broker voting.** The SEC should curtail ballot-box stuffing at annual shareholder meetings by financial intermediaries who are allowed to vote clients' shares on "routine" items if they receive no instructions from those clients. In the current corporate governance environment, there are no routine voting items. In June, the SEC approved NYSE listing standards that ban uninstructed broker votes on equity compensation plans. The Commission should extend the ban to all resolutions on the ballots of all publicly listed companies.
- **Remove the proposed disqualification** of nominees who are affiliated with the nominating shareholders. The proposal also requires nominees to meet exchange standards on independence, and that qualification alone is sufficient. Moreover, alignment between the nominee and nominating shareholders can have benefits. **A** shareholder who owns a significant amount of shares should be able to nominate affiliated individuals.
- **Disclose timely post-election reports.** The current rules for reporting the outcome of annual shareholder meetings are inadequate, with companies allowed to wait until the filing of their next quarterly report to offer voting results. The SEC should require meaningful and accurate real-time disclosure of vote results.

How will the proposed reforms improve corporation governance?

The rule promises to have a dramatic impact, focusing shareholder energy and producing positive outcomes. Triggers will transform vote-no campaigns at recalcitrant companies from the symbolic to the critical. Corporations will gain new incentives to remove dead wood from their boards, and they are likely to prove more responsive on non-binding (precatory) proposals. By improving corporate governance, shareholder access will help restore investor confidence.

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Business Roundtable

BY EMAIL

November 17,2003

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

Re: Proposed Rules Regarding Security Holder Director Nominations, 68 Fed. Reg. 60,784 (Release Nu. 34-48626, October 23,2002); File No. S7-19-03

Dear Mr. Katz:

The Securities and Exchange Commission ("Commission") recently published proposed rules that, under certain circumstances, would require companies to include in their proxy materials shareholder nominees for election as corporate directors. *See* Security Holder Director Nominations; Proposed Rule; Exchange Act Release No. 34-48626, 68 Fed. Reg. 60,784 (October 23,2003). I am writing on behalf of the Business Roundtable to ask that the Commission extend the comment period by 60 days. The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues.

Currently, interested parties are given only 60 days to comment on the Commission's important new proposal. This short 60-day period is insufficient for parties to comprehensively review, comment, and provide requested information on the proposal; accordingly, the period is inadequate under the Administrative Procedure Act ("APA"), 5 U.S.C. § 553(c), and does not provide an opportunity for thorough, well-informed rulemaking in this important area.

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. Chairman William H. Donaldson, Introductory Remarks at the October 8 Open Meeting: Proxy Access Proposal (October 8,2003). Arnong other things, shareholder access to company proxy materials to nominate directors has the potential to alter dramatically corporate governance. It presents 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.

The Commission states in the proposing release that its proposal is "somewhat complex." 68 Fed. Reg. at 60,787. Yet, the proposing release does not include important data or provide a detailed analysis of many of the issues implicated by the proposal. Instead, the Commission has largely shifted the burden of data collection and analysis to the public. For example, the proposing release recognizes that the provisions of state law regarding director elections are fundamental factors upon which many of the assumptions, projections, and

analyses in the proposing release depend. The proposing release fails, however, to identify, discuss, or analyze the provisions of pertinent state laws. The Commission instead requests the public to provide this data and substantive analysis of state law, effectively asking the public to analyze the proposed rules in light of the applicable laws of each of the 50 states and the District of Columbia. ***See*** 68 Fed. Reg. at 60,808. Similarly, the proposal places on commenters a large part of the burden of estimating the likely costs of the proposal for companies, a **task** that will require commenters such **as** the Business Roundtable to engage in detailed survey research that will take many weeks to complete. ***See 68*** Fed. Reg. at 60,787.

Indeed, the Commission has posed hundreds of questions for public consideration. Commissioner Atluns has referred to the extraordinary number of questions in the proposing release as "unique," stating:

> 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.

Commissioner Paul S. Atkins, Remarks at Open Meeting Regarding Shareholder Access Proposal (October 8,2003). Similarly, Commissioner Glassman **has** stated that ". . . the release . . . may have broken all records in terms of the number of questions asked." Commissioner Cynthia **A.** Glassman, Remarks at Open Meeting Regarding Shareholder **Access** Proposal (October 8,2003).

In light of the serious nature of the proposed rules and the important questions that have been presented to the public rather than addressed in the proposing release, the current **60-**day comment period is inadequate. Interested parties cannot consider and respond meaningfully to all of the questions posed by the Commission within 60 days. ***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).

The **APA** requires the Commission to provide notice of a proposed rulemaking "'adequate to afford interested parties a reasonable opportunity to participate in the rulemaking ***process.'''*** *MCI Telecomm. Corp. v. FCC*, ***57*** F.3d 1136, 1140 (D.C. Cir. 1995) (quoting ***Florida Power & Light Co. v. United States,*** 846 F.2d 765, 771 (D.C. Cir. 1988)). The length of **a** comment period must enable interested parties to comment "meaningfully." ***Florida Power,*** 846 F.2d at 771. 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.'" *MCI*, 57 F.3d at 1141 (quoting ***National Ass'n of Home Health Agencies v. Schweiker, 690*** **F.2d 932,949** (D.C. Cir. **1982)).** These principles are compromised where, as here, a comment period is too short to permit interested parties to provide meaningful comment **and** to supply the extensive information the agency itself has requested.

Under these circumstances, the **APA** and principles of sound public administration indicate that the Commission should extend the comment period for the proposed rules regarding

security holder director nominations. The proposing release suggests that the Commission has been evaluating a proposal of this nature periodically for more than 60 years; there would be no harm, and would be great public benefit, in allowing the public an additional 60 days to respond.

Sincerely,

John J. Castellani

cc: Hon. William H. Donaldson
Hon. Paul S. Atkins
Hon. Roel C. Campos
Hon. Cynthia A. Glassman
Hon. Harvey J. Goldschmid
Giovanni P. Prezioso
Alan L. Beller

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Business Roundtable

BY EMAIL

November 21,2003

Desk Officer for the Securities and Exchange Commission
Office of Information and Regulatory Affairs

Office of Management and Budget
New Executive Office Building
725 17th Street, N.W.
Washington, DC 20503

Re: ***Proposed rule regarding security holder director nominations,***
68 ***Fed.*** *Reg. 60,784* ***(Release No. 34-48626, October 23,*** *2002);*
File *No. S7-19-03*

Dear Sir or Madam:

Pursuant to the Paperwork Reduction Act of 1995, P.L. 104-13, 109 Stat. 195, the Business Roundtable submits these comments on the collection of information requirements contained in the proposed rule regarding security holder director nominations published by the Securities and Exchange Commission ("Commission") on October 23,2003. Security Holder Director Nominations; Proposed Rule; Exchange Act Release No. 34-48626, 68 Fed. **Reg.** 60,784, 60,807-60,812 (October 23,2003).

The Business Roundtable **is** an association of chief executive officers of leading corporations with **a** combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. We respectfully request that the Office of Management and Budget ("OMB") raise and resolve with the Commission the concerns identified below with this important proposed rule, instructing the Commission to include all OMB comments in the preamble to a final rule, if one is adopted. ***See*** 5 C.F.R. § 1320.11(f).

1. Introduction And Summary Of The Proposed Rule.

For more than 60 **years,** the Commission periodically has considered and rejected proposals that would have provided shareholders with direct access to company **proxy** materials to nominate directors. The Commission most recently rejected such **a** proposal in 1992. ***See*** Release No. 34-31326 (October 16, 1992). At that time, the Commission acknowledged that "requir[ing] . . . compan[ies] to include shareholder nominees in the company's proxy statement would represent a ***substantial change*** in the Commission's proxy rules." Release No. 34-31326 (October 16, 1992) (emphasis added).

On October 23,2003, without fully considering these substantial changes, the Commission proposed a rule that, under certain circumstances, would require companies to include in their proxy materials shareholder nominees for election **as** corporate directors. ***See generally*** 68 Fed. Reg. at 60,784-60,807. The Commission has stated that the proposed rule

will enhance the ability of shareholders to participate in the proxy process for the nomination and election of corporate board directors, but only "in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process." 68 Fed Reg. at 60,784.

The Commission has proposed two events that would trigger shareholder access to a company's proxy materials to nominate one or more directors:

- The first trigger is based on the receipt of 35% "withhold" votes in director elections. Where at least one of a company's nominees for election to the board receives "withhold" votes from more than 35% of the votes cast at an annual meeting of shareholders, shareholder access to the company's proxy materials to nominate directors would be triggered.

- The second trigger is based on approval of a qualifying shareholder proposal to activate shareholder access. Shareholder access to a company's proxy materials to nominate directors would be triggered where (a) a shareholder or group of shareholders holding 1% or more of a company's securities for at least one year submit a shareholder access proposal at an annual meeting seeking access to the Company's proxy materials to nominate a director; and (b) more than 50% of the votes cast at the meeting support that "direct access" proposal.

- In addition, the Commission seeks comment on a third possible trigger that is not a component of the proposed rule. The third trigger would be premised on a company not timely implementing a shareholder proposal that received a majority of the votes cast on the proposal.

68 Fed Reg. at 60,789-60,790. Upon the occurrence of one of these events, a shareholder or a group of shareholders beneficially owning at least 5% of the company's stock for at least two years would become eligible to submit director nominees for inclusion in the company's proxy materials at the next annual meeting. 68 Fed. Reg. at 60,794.

The Commission has provided interested parties only 60 days to comment on the complex proposed rule. Moreover, its proposing release poses hundreds of questions to the public. And, critical data-based analysis is absent from the proposing release. Accordingly, the Business Roundtable is still in the process of collecting and analyzing data necessary to provide full comments on this complex proposal to the Commission and OMB. (A request has been made to the Commission to extend the comment period by 60 days.) Because OMB must respond in the near future to the Commission's collection of information proposal, however, we submit these preliminary comments to OMB at this time.

* * *

Even at this early stage, it is clear that the requirements of the Paperwork Reduction Act have not been satisfied and that OMB should disapprove the Commission's proposed collection of information requirements. First, the Commission has not evaluated adequately the true burdens that the proposed rule, if adopted, would impose on companies and their investors. Indeed, the Commission concedes that its burden estimates are unreliable. 68 Fed. Reg. at 60,811. Second, the Commission provides no substantive analysis of the practical utility of the proposed rule's collection of information requirements. In fact, the

utility of the proposal is doubtful and does not justify the great burdens that it would impose.

Moreover, as discussed in the section immediately following, there are certain irregular aspects of this rulemaking that will interest OMB in light of the requirements not only of the Paperwork Reduction Act, but of the Administrative Procedure Act as well.

2. Unusual Procedures Followed By The Proposing Agency.

Although we write at this time to bring to OMB's attention to issues associated with the Paperwork Reduction Act, it is worth noting at the outset certain other aspects of the rulemaking that may be of interest to OMB and, specifically, to the Office of Information and Regulatory Affairs.

In its preamble to the proposed rule, the Commission acknowledges (with considerable understatement) that its proposal is "somewhat complex." 68 Fed. Reg. at 60,787. Despite the proposal's great complexity, however, the Commission has failed to provide the sort of rationale for its proposal and detailed analysis that are customary in light of the many issues the proposal implicates. Instead, the Commission has largely shifted to the public the burden of data collection and analysis. For instance, the application, effect, and burden of the proposal will depend greatly on what the laws of the various states provide; yet, the proposing release places on commenters the burden of identifying and interpreting pertinent state laws, and, in large part, for estimating the proposed rule's true costs. See 68 Fed. Reg. at 60,787, 60,808.

Also indicative of the degree to which the agency has shifted to the public functions ordinarily performed by the proposing agency is the extraordinary number of questions the proposing release addresses to the public for response. SEC Commissioner Atkins has referred to the hundreds of questions in the proposing release as "unique," stating:

> 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.

Commissioner Paul S. Atkins, Remarks at Open Meeting Regarding Shareholder Access Proposal (October 8, 2003).

Similarly, SEC Commissioner Glassman stated that "the release . . . may have broken all records in terms of the number of questions asked." Commissioner Cynthia A. Glassman, Remarks at Open Meeting Regarding Shareholder Access Proposal (October 8, 2003).

The proposal also is exceptional in its explicit attempt to direct steps to be taken by the regulated community ***now, before*** the rule becomes effective or is even finalized. (This aspect of the proposal has drawn objections from the Section of Business Law of the American Bar Association, whose comment letter to the Commission is Exhibit A hereto.) Under proposed Exchange Act Rule 14a-11, a direct access shareholder proposal adopted after January 1,2004 would constitute a triggering event for shareholder access. 68 Fed. Reg. at 60,790. In the proposing release, the Commission explicitly states that, "pending

final action" on the proposed rule, companies should advise shareholders in their 2004 proxy statements whether a 1% shareholder of group of shareholders has submitted **a** direct access proposal. Such a statement to shareholders is not required by current law and is designed solely as a step in implementing a proposed rule that remains in **the** early stages of the rulemaking process. Yet, the Commission suggests in its proposing release, failure to advise shareholders of the implications of such a direct access proposal could constitute a violation of the securities laws. ***See*** 68 Fed. Reg. at 60,790. The Business Roundtable respectfully submits that it is inconsistent with the notice and comment requirements of the Administrative Procedure Act to attempt to compel regulated entities to take steps that are not required by law now, and that would only be required if the rulemaking now underway resulted in a final rule in which the pertinent provisions of the proposals were retained without material change.

* * *

The issues identified above are all aspects of the proposed rule that OMB **may** wish to examine more closely as this rulemaking progresses.

3. The Commission Has Provided Unreliable Burden Estimates That Greatly Underestimate The Burden The Proposed Rule Places On The Private Sector.

The Paperwork Reduction Act requires the Commission to provide "specific," "objectively supported," and "accurate" estimates of **the** burdens that would result under the proposed rule. 44 U.S.C. §§ 3506(c)(1)(A)(iv), 3506(c)(2)(A)(ii). "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). The burden estimates in the proposing release are unreliable in the judgment of the Cornmission itself, and do not account adequately for the time, effort and financial resources that companies would **expend** to comply with the proposed collection of information requirements. ***See*** 68 Fed. Reg. at 60,811. Specifically, the Commission has failed to identify with any specificity whatsoever the scope of entities that would be covered by its proposed rule, and has gravely underestimated the frequency with which the rules' requirements would be "triggered" by corporations that are covered, and the costs the rules would impose when that triggering occurs.

a. The Commission Has Failed To Identify The Scope Of Entities Covered By Its Proposed Rule.

As the Business Roundtable will demonstrate at length in comments to be filed subsequently in this rulemaking, the Commission's proposal to regulate the election of corporate directors intrudes on matters reserved for regulation by the states. In an (insufficient) attempt to overcome this improper intrusion on the prerogatives of the states, the proposed rule states that its requirements "would not provide security holders with the right to nominate directors where it is prohibited by state law." **68** Fed. Reg. at 60,784. And yet, although ascertaining the provisions of the laws of the various states is accordingly a necessary first step in determining the number of entities covered by the proposed rule, the Commission has nowhere determined the number of states that, in its judgment, explicitly or implicitly prohibit the form of regulation the Commission proposes. Instead, the Commission requests the public to provide such data and a substantive analysis of pertinent state laws. **68** Fed. Reg. at 60,808.

By failing to investigate and determine the actual consequences of the laws of the various states for the proposed rule, the Commission has failed to 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 rule would apply. 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 or incorporation or bylaws." *68* Fed. Reg. at 60,808. Accordingly, the Commission does not know whether the proposed rule would take effect in no states or all fifty states. Moreover, the type and nature of state laws that would be pertinent are unclear from the proposing release. Due to these uncertainties, the Cornmission has not reliably estimated the number of companies that will be affected and burdened by the proposed rule.

b. The Commission's Estimates Are Concededly Unreliable And Seriously Underestimate How Many Times The Security Holder Nominating Procedure Would Be Triggered.

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 shareholders would be able to meet the applicable requirements." 68 Fed. Reg. at 60,811 (emphasis added). Indeed, the Commission's burden estimates are not merely unreliable, they also are artificially low. This is so in part because the Commission fails to account for the fact that the proposed rule would give rise to an increased number of shareholders seeking direct access to company proxy materials to nominate directors. If such increased shareholder activity were not to be expected, the proposed rule would lack practical utility. The Commission cannot have it both ways: if, as it suggests, the rules will have practical utility because they will lead to increased shareholder activity, then there will be a material burden resulting from that increased activity.

The proposed rule contains triggers to shareholder nominations that do not currently exist. Thus, if the proposed rule is adopted, shareholders would be encouraged to file more shareholder proposals, would expend more resources on achieving 35% or more "withhold" votes on board nominees, and would actually nominate more candidates for director in company proxy materials. Shareholders currently pay for proxy contests themselves. The proposed rule would shift some of the financial burdens of such contests to companies, thereby encouraging more shareholders to file direct access proposals. *See, e.g.*, 68 Fed. Reg. at 60,800 (requiring companies to include shareholder nominees in the proxy materials that they send to all shareholders). The Commission's contention that any new costs to companies that arise as a result of the proposed rule would simply replace current costs to companies and shareholders combined is unfounded. *See 68* Fed. Reg. at 60,814. Because of increased shareholder activity, companies would spend significantly more money than currently is spent (by all parties) to, among other things, print and mail proxy materials to shareholders, contest shareholder efforts to trigger direct access to company proxy materials to nominate directors, and engage in expensive election contests.

The Commission underestimates the burden that will result from the proposed triggers. For example, the Commission's burden analysis regarding the Rule 14a-8/ 14a-11 trigger

appears to be based on an assumption that only individual shareholders with a stake of 1% or more will file such direct access proposals. 68 Fed. Reg. at 60,809 n. 187 (calculating individual rather than group estimates of 1% shareholders). This is not the case. The proposed rule clearly provides that either an individual shareholder or group of shareholders with a combined 1% stake can file a direct access proposal. 68 Fed. Reg. at 60,790. Of eighty companies responding to a limited survey conducted by the Business Roundtable regarding the number of shareholders holding certain percentages of outstanding shares, the average number of shareholders holding specified percentages was as follows:

- 46.15 shareholders hold 1/4% or more shares outstanding;
- 25.35 shareholders hold 1/2% or more shares outstanding;
- 13.38 shareholders hold 1% or more shares outstanding;
- 6.89 shareholders hold 2% or more shares outstanding; and
- 4.25 shareholders hold 3% or more shares outstanding.

Even this limited survey demonstrates that, given the almost infinite number of combinations of shareholders holding even 1/4 of a company's outstanding shares, there would be a significantly greater number of 1% shareholder entities submitting direct access proposals than is accounted for by the Commission, whose analysis takes account of only individual shareholders with a stake of 1% or more.

The Commission further underestimates the number of direct access shareholder proposals that would be filed because its estimate is based on how many direct access shareholder proposals were submitted in 2003 rather than on how many would be filed if the proposed rule were to be adopted. The Commission's estimate does not provide for an increase of even one shareholder proposal over the number submitted in 2003, even though the new Rule 14a-8 / 14a-11 trigger was created specifically to facilitate shareholder access to company proxy materials to nominate directors. 68 Fed. Reg. at 60,809 n. 189.

Moreover, even if it were sufficient to use historical data to predict future behavior under the proposed rule - which it is not - the Commission's use of estimated data from 2003 is inadequate. As this chart demonstrates, the number of shareholder proposals submitted, voted on, and passed by majority vote all have increased substantially over the last three years:

	2001	2002	2003*	Percentage Increase: 2001-2003
Shareholder Proposals Proposed	744	803	1078	45%
Shareholder Proposals Voted On	406	439	580	43%

Majority Votes	66	99	160	242%

Source: Investor Responsibility Research Center's Database on Shareholder Proposals

***As** of November 11.2003

Accordingly. any estimates based on historical data would need to account for the increase in the submission and passage of shareholder proposals that has continued over time. separate and **apart** from the acceleration of this trend that would result from the proposed rule. The Commission's burden estimates do not account for these trends.

The Commission also does not account adequately for the number of times that the 35% "withhold" trigger likely would be tripped. It does not include any burden estimates in its proposing reiease for collection of information related to this trigger. ***See*** 68 Fed. Reg. at 60,809. Rather than evaluate the number of 35% "withhold" votes that are likely under the proposed rule, the Commission again relies on historical voting data from the last two years.

Yet. in the absence of the proposed rule, shareholders have had little motivation to organize to satisfy the 35% threshold. If the proposed rule take effect, however, activist shareholders will be incentivized to cast "withhold" votes by the possibility that a 35% "withhold" vote would. in turn. give them an opportunity to nominate their own candidates. They thus will be more likely to engage in campaigns to ensure that company nominees receive the requisite percentage of "withhold" votes to trigger direct access. Given the voting practices of many institutional investors - they usually either adhere to the voting recommendations of the Institutional Shareholder Services, a proxy advisor service that has adopted proxy voting policies that call for recommending "withhold" votes for directors in numerous situations. or have their own voting guidelines that call for withholding votes for directors - the 35% "withhold" trigger may be met frequently. Adoption of the 35% "withhold" trigger could spur revisions to the proxy voting guidelines of institutional investors and proxy advisory services that call for more frequent "withhold" votes for directors. See Ken Brown, *Vanguard Gives Corporate Chiefs A Report Curd*. Wall St. J.. November 10. 2003, at C1 (describing institutional investors' increasing willingness to cast "withhold" votes). Moreover. observers have noted that shareholders are likely to concentrate their efforts on tripping the 35% trigger at Spring 2004 annual meetings. a fact not considered in the Commission's analysis. Richard Ferlauto, director of pension investment policy at the American Federation of State. County and Municipal Employees "predicts that many activists will concentrate their efforts [on the 35% "withhold" trigger] mechanism that is more clear cut - `vote-no' campaigns." *Proposed Proxy Access Rule Leaves Proponents Uncertain About Preparations For 2004 Proxy Season*, 14 Corporate Governance Highlights (October 31. 2003).

The Commission's reliance on historical data regarding "withhold" votes is flawed for another reason: it relies upon the wrong historical data. The data cited by the Commission relates to how many "withhold" votes occurred at the level of the whole board rather than at the level of individual director. *See* 68 Fed. Reg. at 60,790 n.78. The trigger, however, would be tripped when an individual director - not the whole Board - receives more than 35% in "withhold" votes.

Finally. the proposing release fails to project the number of times that the third trigger - premised on a company not timely implementing a majority vote shareholder proposal - would be tripped. In addition to new costs associated with an increase in the number of shareholder proposals submitted as a result of the trigger, the trigger would require significant expenditures of executive time and legal resources to determine whether a particular proposal could be implemented consistent with both state law (i.e., fiduciary duty) and the company's business objectives.

c. The Commission Underestimates Costs.

Because the Commission fails to analyze critical information - such as pertinent state laws - and underestimates the number of times that shareholders would attempt to trigger and actually trigger the shareholder nomination process, the Commission's cost estimates are artificially low. For purposes of the Paperwork Reduction Act. the Cornmission estimates a total annual incremental expenditure of *only 14 hours of company personnel time (at an estimated total cost of $1.200)* and *only 10 hours of outside professional time (at an estimated total cost of $3,000)* for each "affected" company. 68 Fed. Reg. at 60.814.

These burden and cost estimates - *a total of 24 burden hours at a cost of $4.200* - allegedly would cover the work and expenses of all executive officers, in-house counsel. other company personnel. outside counsel. other outside professionals and consultants. and members of the board of directors that would result from the proposed rule. The Commission contends that the following tasks and expenses all would be covered by a total of 24 hours of work and $4.200:

- a new disclosure requirement that the company notifi shareholders that it has received a proposal seeking direct access by a more than 1% 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 withdrawal, counsel's preparation of a request to the Commission for permission to exclude the proposal (*see* 17 C.F.R. § 240.14a-8) ("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 a shareholder proposal seeking direct access, to announce that it would be subject to the shareholder nomination procedure. and to announce a 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.

68 Fed. Reg. at 60,809-60,811; Aranow & Einhorn On Proxy Contests For Corporate Control § 21.01(3d ed. 1998).

The Commission's contention that *all of **these** activities* could be performed in just 24 hours at a total cost of $4.200 fails on its face. Examples of just a few of the costs that would result from the proposed rule illustrate the inadequacy of the Commission's estimate:

First, the Commission's burden estimates fail to account adequately for the fact that companies would often treat direct access shareholder proposals as contested events. 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 defeat direct access shareholder proposals. See *Proposed Proxy Access Rule Leaves Proponents Uncertain About Preparations For 2004 Proxy Season,* 14 Corporate Governance Highlights (October 31, 2003). Because more shareholder proposals would be submitted under the proposed rule. 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 past data rather than on analysis under the proposed rule. application of even the Commission's historical data 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. By comparison, the Commission estimates that the proposed rule would cause only **a** total of 24 burden hours a year for each "affected" company. Thus. a company challenging even one shareholder proposal as a result of the proposed rule (which all "affected" companies likely would do) would exceed the Commission's total annual burden estimate. **68** Fed. Reg. at 60.814 (adding the Cornmission's estimated burden hours for company personnel and outside professionals).

Second. the Commission's burden estimates fail to account adequately for increased printing and mailing expenses that would result from the proposed rule. Contrary to the Commission's statement that there would be no additional printing and mailing burdens under the proposed rule, all companies that are "affected" by the proposed rule would be likely to experience increased printing and mailing expenses that outpace current expenditures. See **68** Fed. Reg. at 60.814. 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. ***See.*** *e.g.*. 68 Fed. Reg. at 60.800 (requiring companies to include shareholder nominees in company proxy materials, and permitting supporting statements of all nominees in company proxy materials). 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. **68** Fed. Reg. at 60,814. 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 estimates for the "affected" company. Again, the Commission

estimates the total annual burden for each "affected" company to be **a** mere $4,200. **68** Fed. Reg. at 60,8 14 (adding the Commission's estimated costs for company personnel and outside professional time).

Third, the Commission's burden estimates fail to account for the fact that the proposed rule has the potential to turn every director election into an election contest. Although it concedes the "high costs associated with undertaking an election contest." the Commission erroneously contends that resources that would be expended by companies for election contests under the proposed rule would merely offset current election contest expenditures. 68 Fed. Reg. at 60.8 14. In fact. as noted above, the proposed rule would give rise to increased opportunities for shareholder to nominate directors in company proxy materials. Accordingly, there would be by definition 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.

Indeed, elections may well be contested even where no shareholder nominee appears on the ballot. since companies now will have incentive to expend resources to ensure not merely that their nominees win. but that they do so with less than a 35% "withhold" vote. Company costs in this area, which also are unaccounted for in the Commission's burden estimates, 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. *See. e g.*, 68 Fed. Reg. at 60,800 (companies may include supporting statements of nominees in their proxy materials). The cost of even one proxy contest likely would exceed the total $4,200 cost burden estimated by the Commission. See Aranow & Einhorn On Prosy Contests For Corporate Control § *2* 1.01 ("Proxy Contest Expenses"), Exhibit 21-1 (3d ed. 1998).

* * *

Given that the Commission has provided unreliable. artificially low estimates of the burden that would result from year-round process related to shareholder proposals and director nominations and elections. OMB should disapprove the Commission's proposed collection of information.

4. The Commission Provides No Evidence That The Collection Of Information Would Have Practical Utility.

The Commission's proposed collection of information also lacks practical utility. *See* Paperwork Reduction Act. 44 U.S.C. § 3506(c)(2)(A)(1) (requiring practical utility). The Paperwork Reduction Act provides that "[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." 44 U.S.C. § 3508. 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(1). The Commission provides no rationale for the proposed rule. and offers no substantive analysis of the practical utility of the rule's collection of information requirements. See 68 Fed. Reg. at 60,808-60,8 15.

The Commission's position that the proposed rule would apply only "in those instances where evidence suggests that the company has been unresponsive to shareholder concerns as they relate to the proxy process" is unfounded. 68 Fed. Reg. at 60,784. Rather, as discussed above. the proposed rule would empower shareholders in most if not all companies (not just "unresponsive" companies) to seek direct access to company proxy materials to nominate directors, thereby triggering collection of infomation burdens. Even companies with good corporate governance records would be burdened by the Commission's collection of information requirements. For example, a disgruntled shareholder or group of disgruntled shareholders with a 1% stake in a company could take advantage of the low 1% shareholder access threshold to submit a direct access proposal to the company, thereby subjecting the company to collection of information burdens. 68 Fed. Reg. at 60,790.

The role of state law in the area of shareholder access also suggests that the proposed collection of information lacks practical utility. State corporate law largely governs shareholder access to a company's proxy for director elections. 68 Fed. Reg. at 60,788. The Commission acknowledges this fact, stating that the proposed rule "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." 68 Fed. Reg. at 60.787, 60,808. 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 the practical utility of the collection of information requirements outlined in the proposal would be dependent on pertinent state laws. Even if that were not the case, potential conflicts between state and federal law could affect the Commission's authority and ability to collect information.

Because the proposing release provides no substantive analysis let alone actual evidence of practical utility, OMB should disapprove the Cornmission's proposed collection of information requirements.

* * *

The Paperwork Reduction Act requires the disallowance of the Commission's collection of information proposal. The Commission provides unreliable burden estimates that are artificially low because they fail to account for the true number of companies affected by and the true costs of the proposed rule. Moreover. the Commission provides no substantive analysis of practical utility.

The Business Roundtable appreciates this opportunity to provide its views to the OMB.

Sincerely.

John J. Castellani President Business Roundtable

cc: Jonathan G. Katz Hon. William H. Donaldson Hon. Paul S. Atkins Hon. Roel C. Carnpos Hon. Cynthia A. Glassman Hon. Harvey J. Goldschrnid Giovanni P. Prezioso Alan L. Beller

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Institutional Shareholder Services

June 13. 2003

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street N.W.
Washington. DC 20549-0609

Re: S7-10-03

Dear Mr. Katz.

We appreciate the opportunity to submit our comments on the Securities and Exchange Commission's request for suggestions on possible reforms of corporate elections and the proxy voting process. This statement represents the views of Institutional Shareholder Services (ISS) and not necessarily those of our clients.

Overview

Enactment of Sarbanes-Oxley by the U.S. Congress and adoption of related rules by the Securities and Exchange Commission (SEC) encourage better governance at U.S. corporations. Tougher penalties for individuals who mislead investors and enhanced oversight of auditors also will help to deter abuses.

While these recent reforms represent a major leap forward. the SEC must take steps to insure that the new reforms are fully implemented and strongly enforced. The big boost in the SEC budget is a plus. Even at this increased funding level. however. the SEC alone will not be able to provide the level of oversight that the investing public demands.

It is impossible to put a SEC cop on every street corner in the marketplace. so Sarbanes-Oxley and the new listing standards proposed by the New York Stock Exchange (NYSE) and the Nasdaq Stock Market seek to augment enhanced enforcement with better boardroom oversight of management. For this process to succeed. the Commission must insure that shareholders can hold boards of directors accountable.

The SEC review of the federal prosy rules provides a real opportunity to provide the investing public with tools that will allow for enhanced oversight of boards. The SEC should take several steps to insure that shareholders can effectively exercise their board oversight responsibilities.

Provide Shareholders Access To The Proxy Ballot-Any democracy is only as robust as its electoral process. Elections at U.S. corporations lack several attributes of any good democratic system. Most nominees run unopposed. Challengers to the incumbent directors lack any meaningful opportunity to place their names on the ballot.

Although some boards invite shareholders to suggest possible candidates to board nominating panels. few of these individuals actually make it onto ballots as nominees. Instead. shareholders who wish to offer alternative candidates must expend enormous sums of time and money to produce separate proxy solicitation materials and forward them to

other investors. Few investors are willing or able to afford such costs (outlays now run in the multi-million dollar range at large companies) or to tolerate the no-holds-barred tactics that typically accompany such aptly named "proxy fights."

To level the playing field. the SEC (and, if necessary. Congress) should allow reasonable access to significant investors to place their nominees on the corporation's pros!. ballot. To safeguard against abuse. the power to offer such nominees should be limited to significant. long-term investors, who do not seek to change control of the corporation.

- Qualifying significant shareholdings should vary with the size of the issuer. At the very largest public companies. holdings of as little as 3 percent to 5 percent of the outstanding shares should suffice. At smaller companies, however. qualifying holdings of 10 percenr or more may be prudent. Groups of smaller shareholders should be allowed to combine their holdings to reach these ownership thresholds. (To prevent the filing of director candidates from triggering poison pill or other takeover devices, the ownership threshold should be set below the triggering level at companies that have such takeover defenses.)

- Each qualified shareholder or group should be limited to one nominee at a meeting for each qualified investment stake that it holds, Thus. **a** shareholder with a 10-percent stake would be eligible to place two candidates on the ballot at a company where the access threshold is 5 percent.

- Long-term should mean at least one year of continuous ownership of the qualifying block of shares.

- The number of shareholder nominated candidates at any meeting should be limited to less than a majority of the entire board. Qualified shareholders. for example. could nominate candidates for no more than four seats on a nine-member board at a single meeting. If more shareholders qualify to offer nominees than the number of seats available for shareholder nomination. the individual or group with the largest stakes-rather than the first in line-should receive preference.

- Shareholder-proposed candidates should get equal time-equivalent space and treatment-in the company's pros. statement as that afforded to the board's nominees. Shareholders who exercise this access right should be required to disclose any expenditure that they make on supplemental solicitation efforts.

- Use of ballot access should be limited to investors who qualify under the SEC's existing rules regarding exempt shareholder communications. So-called 13D filers and other investors who seek control of the corporation should be prohibited from using the access process to gain seats. Likewise a 13D filer or an individual associated with it should not qualify as a bona fide nominee of **a** qualified investor.

Allow Ticket-Splitting in Contested Election-Providing access to the proxy would not eliminate full-blown prosy contests. Various investors, including 13D filers. would continue to use such contests as a means of seeking more substantial representation or outright control of a board.

However. even traditional pros). contests limit voter choice. Proxy fights under the current rules leave investors with an all or nothing decision. Investors can support the dissident's

slate or the incumbent board's slate. Although the SEC's so-called short-slate rules allow a dissident group to fill out its slate with some of the incumbent board's nominees. these rules do not provide shareholders with the ability *to* make their own choice of directors by selecting a combination of candidates from competing slates.

Shareholders must have the right to choose the best candidates in any election-not just the best slate. The current proxy process makes it difficult or impossible for investors to cast votes for candidates on more than one ballot in **a** given election. The SEC should adjust the rules and **work** with the various players in the back-end of the voting process to provide investors with true choice in contested elections.

Eliminate Broker Voting-The SEC should curtail ballot-box stuffing at annual shareholder meetings by financial intermediaries. The NYSE's practice of allowing brokers to vote (under its "10-day rule") uninstructed shares held by their clients on ballot items that the NYSE labels routine distorts voting results and disrupts the shareholder-director communication process.

A current proposal from the NYSE would fix part of the problem by reclassifiing proposals seeking shareholder approval of all stock option plans as non-routine voting items. This proposal. however. does not go far enough.

Many shareowners use their votes on the board of directors, the selection of auditors and other ballot items to communicate their views on these issues, The NYSE classifies the election of directors as a routine voting item unless a full-blown proxy contest has erupted. The NYSE also considers votes on auditors to be routine in most cases. **As** a result. efforts this proxy season to communicate disapproval of board actions at companies such as Sprint and Tyco were watered down by broker votes.

Attempts to categorize issues as routine or non-routine are a relic of the past. In the current corporate governance environment. there are no routine voting items. Companies should be allowed to count broker votes for the sole purpose of reaching quorum at the meeting.

Disclose Post-Election Report-The current rules for reporting the outcome of annual shareholder meetings are grossly inadequate. Allowing issuers to wait until the filing of their nest quarterly report to offer voting results weakens the communicative value of shareholder votes.

Meaningful and accurate real-time disclosure of preliminary vote tallies is voluntary. In many instances, companies report the bare minimum ("the shareholder proposal failed" or "all ballot items passed") or spin the information in ways that sometimes give a misleading impression about the level of voting support or opposition on controversial proposals. This prosy season. for example. numerous companies reported that resolutions had failed to pass at meetings only to report in later SEC filings that support for the proposals was in excess of a majority of the votes cast. Investors also typically receive no post-election information on the cost of the incumbent board's solicitation activities.

To cure these shortcomings and to provide timely disclosures to shareholders. the SEC should require companies to file (as an 8K or via a new post-election report filing) and publish (via press release and on their web sites) the best available results of the voting at the annual meeting (including a breakout. if applicable. of broker votes) and an estimate of the total expenditure made by the company on its solicitation efforts. Requiring real-time,

material event disclosure will close the communications gap. Follow-up quarterly filings would provide investors with the official certified vote results and a full accounting (line-item breakouts. for example. of out-of-pocket solicitation costs) of the expenditures made by the issuer with regard to the prosy solicitation.

Such a requirement is not burdensome. Some issuers already announce voting results at meetings. and some firms even issue press releases with preliminary results at the time of the meeting.

Enhanced Disclosure

Support New Corporate **Governance** Disclosures-The SEC should formulate new disclosure rules that give shareholders a clearer picture of actions taken in the boardroom.

- Shareholders deserve to know about any and all relationships (personal and professional: monetary and non-monetary) between corporate directors (and their immediate families) and the corporations where they serve on boards.

- The SEC should mandate disclosure of boardroom disagreements-in the form of split votes. for example-on matters such as executive compensation and the audit process (the pre-approval of certain non-audit related services, for example).

- The SEC also should provide shareholders with the full picture on executive compensation. Current rules provide loopholes that allow for less than full disclosure of executive severance plans. post-retirement benefits and deferred cornpensation.

The Stock Exchanges

Support for New Listing Standards-ISS and most investors generally support the pending listing standards changes proposed by the NYSE and Nasdaq. ISS strongly encourages the SEC to move forward on the adoption of these standards as soon as possible. Further delay in their adoption may result in postponement of the effective date of new shareholder approval requirements for stock option plans beyond the 2004 annual meeting cycle.

Broader **SEC Oversight of Self Regulatory** Organizations-The SEC's delay in adopting the new listing standards appears to stem from its lack of authority to impose listing standards on the NYSE and the Nasdaq. Absent such authority, the SEC can do little more than cajole the Self Regulatory Organizations (SROs). The SEC should seek clear authority from Congress to override determinations made by the SROs that run counter to their self-regulatory mission of investor protection. The SEC should have clear authority to mandate listing standards when the SROs are unable or unwilling to adopt needed changes.

Governance Reforms at **Stock** Markets-The SEC should continue its efforts to improve internal governance practices at the NYSE, Nasdaq and the other market self-regulatory bodies. The self-regulatory arms of the stock markets typically operate behind closed doors with little or no disclosure to the investing public. **A** higher degree of transparency is needed in regard to the internal governance of the SROs. The same holds true regarding not only the adoption of corporate governance listing standards at both the NYSE and Nasdaq, but also their enforcement. This is especially important in light of the role that governance listing requirements are now expected to play in setting higher standards for boards of directors ***of*** public companies.

Thank you for this opportunity to share our views with the Commission on these important issues. We look forward to working with the Commission and its staff in crafting new rules that will enable shareholders to exercise their voting rights more effectively. Please contact me or ISS Special Counsel Patrick McGurn with any questions.

Sincerely.

James E. Heard
Chief Executive Officer
Institutional Shareholder Services

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2 of 2 DOCUMENTS

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TITLE: LABOR DEPARTMENT LETTER OX PROXY VOTING BY **PLAN** FIDUCIARIES.

TEXT;

Mr. Helmuth Fand! Feb. 23. 1985

Chairman of the Retirement

Board

Avon Products. Inc.

9 West 57th Street

New York, New York 100I9

Re. Avon Products. Inc. Employees' Retirement Plan

Dear Mr. Fandl.

The Pension and Welfare Benefits Administration (PWBA) of the Department of Labor is responsible for administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Title I establishes standards governing the operation of employee benefit plans and includes fiduciary responsibility rules governing the conduct of plan officialsand others who exercise discretionary authority or control with respect to the assets of employee benefit plans. such as the Avon Products. inc Employees' Retirement Plan (the Plan), which are subject to ERISA.

PWBA has concluded its investigation *of* the Plan and of your activities as a fiduciary of the Plan, in connection with certain activities concerning the voting of proxies appurtenant to shares held in the accounts of the Plan's investment managers. The facts adduced during this investigation are not conclusive. However. because of the possibility that violations have occurred, and in view of rhc recurring nature of this aspect of Plan asset management. **we** believe that it would be appropriate to apprise you of the Department s views concerning the general fiduciary obligations of a named fiduciary and an investment manager appointed pursuant to section 402(c)(3) of ERISA with rcspcct to the voting of proxies on plan-owned stock. Since we expect that this information will be useful to rhe other members of the Plan's rcrirement board. and to the investment managers of the Plan. we are providing them with copies of this letter.

I THE APPLICABLE PROVISIONS OF ERISA

Taken together. the provisions of ERISA sections 402. 403. 404 and 405 are intended *to*. among other things. provide a basis for certainty regarding the identity and responsibilities of those panics involved in managing and operating the plan, as well as each party's liability for mismanagement

Section 402(a) of ERISA provides that every employee benefit plan shall be established and maintained pursuant to a written instrument. This instrument must provide for one or more named fiduciaries who have authority to control and manage the operation and administration of the plan The named fiduciaries may be either named in the plan instrument or chosen. through a procedure specified in the plan. by the plan sponsor.

Section 402(b)(2) of **ERISA** requires plans to describe any procedure for allocating responsibilities for operation and administration of the plan, including any procedure described in section 405(c)(1).

Section 405(c)(1) of ERISA provides, in part, that the named fiduciaries may designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan. Section 405(c)(3) of **ERISA** defines "trustee responsibility" to mean any responsibility provided in the plan's trust instrument to manage or control the assets of the plan. other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with section 402(c)(3).

Section 403(a) of ERISA provides. in part. that **all** assets of an employee benefit plan must be held in trust by one or more trustees. The trustee(s) must have exclusive authority and discretion to manage and control such assets. with two exceptions: (1) when the plan expressly provides that the trustee(s) are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees are subject *to* proper directions made in accordance with the terms of the plan and not contrary to ERISA, and *(2)* when the authority to manage. acquire or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 402(c)(3).

Section 402(c)(3) of ERISA states that a plan may provide that with respect to control or management of plan assets a named fiduciary may appoint an investment manager or managers to manage (including the power to acquire and dispose of) plan assets.

Section 3(38) of ERISA defines "investment manager" as any fiduciary (other than a trustee or named fiduciary) **(A)** who has the power to manage, acquire. or dispose of any plan asset; (B) who is (i) a registered investment adviser under the Investment Advisers Act of 1930; (ii) **a** bank. or (iii) an insurance company; and (C) who has acknowledged in writing that he is a fiduciary with respect to the plan

Section 405(c)(2) of ERISA provides. in part. that if a plan expressly provides for a procedure described in section 405(c)(1). and pursuant to such procedure a person is designated to carry out a fiduciary responsibility of a named fiduciary, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that **(A)** the named fiduciary violated section 404(a)(1) — (i) with respect to such designation. (ii) with respect to the establishment or implementation of the procedure under 405(c)(1). *or* (iii) in continuing the designation; or (B) the named fiduciary would otherwise be liable under ERISA section 405(a).

Section 404(a)(1)(B) of ERISA requires a fiduciary to discharge his duties to a plan with the care, **skill.** prudence and diligence under the circumstances ihcn prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with **like** aims.

Section 404(a)(1)(D) of ERISA requires a fiduciary to discharge his duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments arc consistent with the provisions of Titles I and IV of ERISA.

II. PROXY VOTING BY PLAN FIDUCIARIES

In general. the fiduciary act of managing plan assets which art shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department's position that the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management: a proposal to change the state of incorporation of a corporation in which a plan owned shares (thereby possibly affecting shareholders' rights to participate in the decision-making process ***of*** the corporation which. in turn. affects the value of their investment) and a proposal to rescind "poison pill" arrangements with regard to various corporations in which a plan *is* invested. Moreover, because voting such proxies involves plan asset management, section 403(a) requires that plan trustees have the exclusive authority and responsibility for voting these proxies. unless one of the two exceptions stated in section 403(a) applies.

To the extent that the documents governing the plan permit a named fiduciary to appoint an investment manager pursuant to sections 402(c)(3) and 403(a)(2) of ERISA to manage. acquire. and dispose of plan assets, there would be an ERISA violation if. during the duration of such delegation, either the trustee or the named fiduciary makes the decision how to vote any proxv appurtenant to shares owned by the plan with respecr to which the investment manager has investment authority because under the plan documents neither the trustee nor the named fiduciary has authority to make that decision with regard to those shares. Indeed. under such plan provisions if any person other than the investment manager (or a person under the fiduciary supervision of the investment manager) n1 were to **make** the proxy voting decision. there would

be a section 404(a)(1)(D) violation because that person does not have that fiduciary authority under the plan. Finally, with limited exceptions n2, the named fiduciary, having delegated such responsibility to the investment manager, no longer has the authority to decide how the investment manager votes proxies and would be engaging in a section 404(a)(1)(D) violation in doing so unless, in delegating such management responsibility to the investment manager, it reserves to itself the right to vote proxies. n3

n1 **If** the investment manager attempted to delegate his responsibility for proxy voting to another, the manager would not be relieved of his fiduciary responsibilities and related liabilities with regard to the voting decisions of that delegatee. (See discussion infra.)

n2 The general fiduciary responsibility provisions of ERISA, including the co-fiduciary liability provisions, remain applicable to the named fiduciary's continuation of the delegation of asset management to the investment manager. Thus. no violation of section 404(a)(1)(D) would occur to the extent that **ERISA's** fiduciary responsibility provisions would require the named fiduciary to formally rescind the delegation to preclude the investment manager from engaging in **a** breach of fiduciary responsibility.

n3 To the extent that a named fiduciary reserves to itself the right to direct the trustee to vote proxies. the investment manager would not have fiduciary responsibility and related liability for the exercise of the vote. Moreover, to the extent the named fiduciary retains the voting rights, it would have full fiduciary responsibility and related liability for the exercise of those rights.

Moreover, **ERISA** contains no provision which would relieve an investment manager of fiduciary liability for any decision he made at the direction of another person. Under ERISA's construct, only trustees are able to relieve themselves of fiduciary responsibility and related liabilities by accepting directions. if plan documents so provide. and then only if such directions are "proper directions" made in accordance with the terms of the plan and not contrary to **ERISA.** Furthermore, neither section 3(38) nor 405(c) of ERISA grants an investment manager the powers of a named fiduciary to allocate or designate its investment management function for plan assets to other persons so as to relieve itself of its fiduciary responsibilities and related liabilities. Therefore. *to* the extent that anyone purports to direct an investment manager as to the voting of proxies, or to the extent that an investment manager purports to delegate *to* another the responsibility for such voting decisions, the manager would not be relieved of its own responsibilities and related liabilities merely because it either follows the direction of some other person. or has delegated the responsibility to some other person. The manager would continue to have full responsibility (and liability) for the exercise of the proxy voting decision.

Finally, the Department notes that section 404(a)(1)(B) requires the named fiduciary appointing the investment manager to periodically monitor the activities of the Investment manager with respect to the management of plan assets. In general, this duty would encompass the monitoring ***of*** decisions made and actions taken **by** investment managers with regard to proxy voting. In this regard. it is the opinion of the Department that section 404(a)(1)(B) requires proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager Specifically, with respect *to* pros!: voting. this would require the investment manager or other responsible fiduciary to keep accurate records as to the voting of proxies. n4

n4 Although this letter is concerned with the procedural requirements of ERISA as applied to proxy voting where an investment manager is appointed, the Department wishes *to* reiterare its longstanding interpretation of the substantive requirements of section 404(a)(1). Section 404(a)(1) requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries. and for the exclusive purpose of providing benefits to participants and beneficiaries. To act prudently in the voting of proxies (as well as in all other fiduciary matters), **a** plan fiduciary must consider those factors which would affect the value of the plan's investment. Similarly, the Department has construed the requirements that a fiduciary act solely in the interest of. and for **the** exclusive purpose of providing bcncfits to. participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.

We trust you will find the above information useful in discharging your **ERISA** responsibilities dunng the 1988 proxy season and thereafter.

Sincerely,

Alan D. Lebowitz

Deputy Assistant Secretary

LANGUAGE: ENGLISH

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W. James McNerney, Jr.
Chairman of the Board and
Chief Executive Officer

3M General Office

3M Center. Building **0220-14-W-05**
St. Paul. MN 55144-1000

3M

December 5,2003

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20539-0609

Re: File No. 57-19-03
Security Holder Director Nominations

Dear Mr. Katz:

I appreciate the opportunity to comment on the Commission's proposals to give stockholder-nominated director candidates access to company prosy statements in certain circumstances.

These comments reflect my first-hand knowledge of how the 3M Board of Directors operates and my observations of other successful and effective boards of directors.

The SEC's proposals are terrible public policy because they risk impairing the continued functioning of effective boards while failing to improve the operation of deficient boards. While the intent of the proposed "triggers" is sensible -- to permit easy ballot access for stockholders of companies whose directors are not appropriate!!. aligned with the stockholders' interests while retaining the current system for those companies whose boards are performing conscientiously and competently -- the pending proposal is unfortunately not adequately tailored to achieve that objective. The proposed "triggers" are dangerously deficient because they fail to address the current realities of lock-step institutional voting and the insufficient resources available to institutions to assess the merits of stockholder proposals. As a result. the pending proposals will serve principally to permit groups with a narrow. specific focus to achieve board representation (with the attendant adverse consequences for the vast majority of stockholders described below). or to disrupt the company in the process of trying.

The pending proposals are far different from the positive reforms created by the Sarbanes-Oxley Act. While many companies arguably did not "need" that statute's new provisions. no company is significantly adversely impacted by them. Indeed. even the best managed companies benefit from the additional rigor and discipline provided by that Act. In contrast, for the reasons described below, the pending proposals risk palpable. adverse consequences for the functioning of the most effective boards. Because the proposed "triggers" fail to recognize the

reality of contemporary institutional voting behavior, they make the risk of such unintended adverse consequences unacceptably substantial.

A. The Overbroad Applicability of the Triggers

1. The Proposal's "Triggers" are Unable to Distinguish Merited from Unmerited. The proposal attempts to confine the authority conferred on stockholders to only certain companies that have been "unresponsive" to shareholder concerns. presumably in recognition that the proposed remedy entails a risk of negative consequences (with which I agree as explained below) and is not appropriate for all companies. Unfortunately, the proposed "triggers" will eventually be satisfied by most companies. Currently a large majority of stockholders are institutional investors that typically cast their stockholder ballots in lock-step with the recommendation of a tiny number of associations. such as Institutional Shareholder Services (ISS). Approximately 55% of our top 50 institutional shareholders (representing about 50% of shares outstanding) follow ISS prosy voting guidelines. Neither the investors nor ISS or other such entities have the staff or resources to evaluate board-nominated director candidates on their individual merits. Instead they rely on a handful of litmus tests reflecting the policy decisions of ISS that are divorced from any one company's particular circumstances and, in most cases. have nothing to do with the company's "unresponsiveness" to shareholder concerns. The outcome of the elections that constitute the "trigger" mechanisms are controlled by these associations. The pending proposal is akin to having the U.S. Department of Education allocate federal education aid based on the suspect rankings of universities in U.S. News & World Report.

   Conferring such power on a small group of associations with ranking systems is unwarranted. A recent experience at 3M provides a case in point: earlier this year a majority of our institutional holders approved a stockholder proposal related to "poison pills" that would have required the board to violate its fiduciary duties if it adopted the proposal as written.[1] Notably, 3M has never had any poison pill. Nonetheless. ISS recommended approval.

   In response to a similar stockholder proposal in the previous year, 3M's board resolved not to adopt a poison pill without stockholder approval. unless exigent circumstances led a majority of the independent directors *to* conclude that their fiduciary duties required them to act without the delay attendant on submission to stockholders. Despite this reasonable implementing resolution, which adopted the proposal to the extent permitted by the directors' fiduciary duties. ISS recommended that 3M stockholders approve this year's inapposite shareholder proposal. despite its inconsistency

with fundamental notions of lawful corporate governance. and it won 58.9% of the vote. Many of the top 30 institutional shareholders we contacted in each of the past two years to discuss our position would not engage in any meaningful discussions, often citing adherence to ISS proxy voting guidelines that called for support of the shareholder proposal.

This recent experience at 3M. and others like it at other well-run companies. persuade me that the various "triggers" in the pending proposal. while intended to tailor the remedy to the perceived need, will in fact have broad application. including companies whose managements are properly aligned with the interests of investors. **As** our recent example illustrates. the "35% withheld" vote can be readily satisfied if one of the associations simply decides to recommend such withholding in the belief that it is useful to make the stockholder-nominating process "active." regardless of the merit of the directors at issue. Similarly, the 1% and **5%** stock ownership requirements are far too low to constitute a reasonable test of significant stockholder dissatisfaction with existing management in light of two key factors: the absence of any meaningful transaction costs that might otherwise deter such holders from seeking access to the pros! : and the increase in narrowly-focused groups that **seek** board membership. In other words. the proposal will enable access not cnly to those boards that need a wake-up call. but also to any board where membership by a narrowly-focused group will be perceived by that group to advance its goals. For similar reasons. we believe the one-year holding period is too short to distinguish the casual holder seeking to advance a specific purpose from long-term investors concerned with the overall interests of the company and its other investors While two years Mould appear reasonable for a test based on longevity of ownership, the stockholders comprising the group should be expected to commit *to* retain their holdings for a comparable period into the future. and any sale before then should be justified by clear changed circumstances.

In view of our strongly-held belief that the proposed triggers are not well aligned with the objective they are intended to serve, we advance alternative triggers for your consideration in the next section.

2. Alternative Triggers. If the SEC concludes that it is necessary to experiment with risk. it should at most do so in a pilot program that targets those companies that have manifested objective earmarks of poor governance. This could be achieved by initially providing that the new election rules **apply** only to issuers with multiple management directors. or to those that have in recent periods been the subject of criminal prosecution.

In addition, the SEC's Enforcement Division could consider adding stockholder-nomination-of-director provisions, where appropriate, to the terms of consent decrees and administrative orders it enters into with companies that it has found have violated the securities laws. **As** you know, the SEC followed an analogous course for years in settling enforcement proceedings with individuals by barring them from serving in similar capacities with public issuers. despite the absence of explicit statutory authority for such relief.

Implementing the nomination proposal in a truly targeted manner would avoid risking the adverse consequences I foresee (and describe below) if the proposal is implemented with respect to all companies. It will also enable the SEC to develop empirical data concerning the operation of the proposed new procedures in actual practice, which it may then consider in determining whether to broaden the procedures' applicability in the future.

B. The Foreseeable Harm

1. Board Dynamics. The proposal appears to increase the election of stockholder-sponsored directors who have not been endorsed by a Board's nominating committee (if that is not the goal one would need to question the point of the exercise). The question is whether the resulting Board functions more effectively than a Board whose members are all approved by the Board's nominating committee. The potential for adversely impacting the Board is significant. and is not addressed by the comments I have reviewed to date.

   Dean Sonnenfeld's seminal study of effective Board dynamics (Harvard Business Review. *What Makes Great Boards Great,* September *2002)* correctly points out that:

   > *What distinguishes exemplary boards is that they are robust. effective social systems. ... Team members develop mutual respect: because they respect one another. they develop trust; because they trust one another. they share difficult information; because they all have the same. reasonably complete information, they can challenge one another's conclusions coherently; because a spirited give-and-take becomes the norm, they learn to adjust their* ***own*** *interpretations in response to intelligent questions.*

   I agree with that observation. in discharging its oversight and supervisory functions, the Board acts best when it uses its collective insight and experience to test. question and challenge the plans of the CEO and senior management. It is important that Board dynamics

promote a spirit of constructive challenge, which occurs when board members respect one another and are committed to working well together. Introducing one or more directors who may lack the respect of other board members, or who consider themselves accountable to the stockholder subgroup that nominated them. risks developing political factions within the board and disrupting the critically important goal of developing and sustaining effective board dynamics.

An effective board must also serve as a sounding board for and give trustworthy advice to the CEO. The position of CEO in a modern major publicly held American corporation is very demanding. and the dynamics of corporate management *makes* the CEO's position a lonely one. CEOs must have confidence in the wisdom of the board so that they can confide in and seek guidance from the group responsible for the business' direction. Including a director not approved by other board members will risk constricting the communication between board and CEO that is critical to effective oversight and management.

No director selection mechanism can absolutely guarantee a thoughtful. responsible group of directors who feel empowered and obligated to perform the key Board tasks - asking hard questions when senior management may stray from sensible and ethical business decisions, providing support where senior management is on a path that is correct but challenging or uncertain. and advising the CEO on the myriad issues that must be resolved if the corporation is to prosper. The most effective selection process needs independent directors on the board's nominating committee who take their selection responsibility seriously. approach the task of director nominations with the same sense of fiduciary duty they apply to other significant board decisions. and devote the time necessary to assure that the new director(s) meet the board's current needs and enhance the diverse qualities that a board collectively requires.

It is equally appropriate for the nominating committee to consider nominees proposed by stockholders. as it is for the committee to consider nominees proposed by the CEO, search firms or others. A rule (whether promulgated by a state legislature. or if within its authority, the Commission) that mandates such consideration may be useful for those companies whose board members do not carefully and independently consider all potential nominees. A rule that overrides the role of the independent nominating committee in favor of ballot access for stockholder-nominated director candidates increases the chance for a dysfunctional board, and reduces the chance for a collegial board of thoughtful and challenging directors from whom the CEO seeks guidance.

The recent conduct of the United States Senate Judiciary Committee on judicial nominees shows why selecting members by individual constituency elections does not foster cooperation devoted to the good of the whole. The Senate's divisiveness may reflect a divided electorate, but it is **a** dysfunctional model for selecting members who oversee and supervise a profit-making enterprise.

2. Director Selection Process. **A** basic tenet of Delaware corporate law is that the board of directors is ultimately responsible for managing the business and affairs of a corporation. Directors. as fiduciaries to the corporation and its shareholders, must diligently exercise their responsibilities as managers of the corporation. and are strictly forbidden from delegating their responsibilities to stockholders. The process for selecting directors is one of the most important **tasks** a board performs. At 3M, the Nominating and Governance Committee and 3M's Board devote substantial efforts to ensure that the Board is comprised of individuals with distinguished records of leadership and success who will contribute substantially to Board operations.

   The 3M Board's Governance Guidelines address this important responsibility as follows:

   > *The Nominating and Governance Committee periodically reviews with the Board the appropriate skills and characteristics required of Board members given the current Board composition. It is the intent of the Board that the Board, itself, will be a* ***high*** *performance organization creating competitive advantage for the Company. To perform as such, the Bourd will be comprised of individuals who have distinguished records of leadership and success in their arena of activity und who will make substantial contributions to Board operations. The Board's assessment of Board candidates includes, but is riot limited to, consideration of:*
   >
   > > *(i) Roles und contributions valuable to the business community,*
   > >
   > > *(ii) Personal qualities of leadership, character, judgment and whether the candidate possesses and maintains throughout service an the Board a reputation in the community at large of integrity, trust, respect, competence and adherence to the highest ethical standards,*
   > >
   > > *(iii) Relevant knowledge and diversity of*

background and experience in such things as business, manufacturing, technology, finance and accounting, marketing, international business, government and the like; or

(iv) Whether the candidate is free of conflicts and has the time required for preparation, participation and attendance at all meetings.

A Director's qualifications in light of these criteria is considered at least each time the Director is re-nominated for Board membership.

The SEC's proposal is inadvisable because it (i) impermissibly delegates the board's responsibilities for director selection to certain shareholders for shareholder-nominated candidates. (ii) excludes consideration of the board's membership criteria for such candidates, and (iii) completely removes the Nominating and Governance committee and the full board from the process of ensuring "the Board will be comprised of individuals who have distinguished records of leadership and success in their arena of activity and who will make substantial contributions to Board operations."

3. Availability of Superb Director Candidates. Also undesirable is the disincentive the proposals create for encouraging qualified director candidates to stand for election to corporate boards. Government policies ought to actively encourage eminently qualified candidates to serve on publicly held corporate boards. Instead. the proposals are a disincentive for that service at a critical time in the nation's business history. There are already too few attractive candidates for board service. This is due not so much to a fear of serving in the current climate. hut to the added time board duties now plainly require. The added demands of time and attention limit the number of boards on which qualified people may serve. The proposals are another disincentive because qualified candidates are unlikely to agree to be nominated if they will risk becoming subject to a proxy contest that focuses on them personally. Many attractive candidates already facing many complicated demands will not participate in a process burdened by a significant risk of a contested election. **As** a result. actuating the stockholder nominating process can be expected to deter the willingness of qualified directors to serve.

Those seeking to improve the governance process in the university setting may view the recent contested election for membership in the Yale Corporation (Yale University's supervisory body) **as** instructive. Apparently, neither Yale nor the diverse members of its Corporation found the experience to be positive.

4. Distraction of Board and Management. When the inevitable occurs. the management and directors will likely try to defeat the actuating resolution *or* the election of the stockholder-appointed nominee. Any such effort requires extensive communications with stockholders. including travel to the locations of major institutional holders. Management has a finite amount of time and energy to operate the business; allocating a substantial portion of it to this pursuit necessarily detracts from managing the enterprise.

5. Ineffectiveness of the Proposal. **Risks** to the functioning of currently successful boards might be worthwhile if the proposal clearly promised to enhance oversight and effectiveness of deficient boards. But it is hard to see how adding one or two stockholder-nominated directors is highly likely to make a positive material difference. Can the SEC identify the person who, if selected by stockholders to the Fnron board. would have altered the course of Enron's misconduct? Without engaging in hindsight. does the Commission believe a single director who perceives ambiguous corporate wrongdoing can persuade other directors to act on that perception? Without a significant basis to conclude that the pending proposal. had it been enacted in 1997. would have prevented Enron's misdeeds. the potential benefits of the proposal do not outweigh its clear risks.

6. A final note. There is at most an imperfect analogy between "stockholder democracy" and political democracy. Political democracy is premised on electing legislators and executive officers. not supervisory or oversight boards similar to a corporation's board of directors. The characteristics of a legislative body in a democracy are rery different from those of a corporate board. Legislators must try to reach a compromise between political interests. Corporate boards are not in tho business of achieving compromise but instead must set a clear. coherent, and productive agenda for the corporation and management to follow.

   Democratic government limits people's right to vote on the theory that non-citizens do not have the same long-tern1 stake in the polity. Corporation law does not make a long-term stake a prerequisite to voting. perhaps because economic investment is a surrogate for such a stake. Unlike citizens. however. dissatisfied stockholders can express their dissatisfaction with management by selling their stock. Citizens. in contrast. rarely can move to a different country and must use the democratic process to express their dissatisfaction with elected officials. If there is any useful analogy to draw, it is that citizens' access to the ballot for nominating candidates should be less restricted than that of stockholders'.

   In short. theoretical notions of "stockholder democracy" should not

drive changes in corporate governance that are likely to undermine the very objectives they seek.

The SEC's recent initiatives on the conduct of board nominating committees and improved transparency of board actions have not been in place long enough to be tested in practice. Such reforms are intended to improve materially the board composition in those companies where improvement is needed. It seems radical to adopt the pending proposals before evaluating the effectiveness of other recent initiatives. It would be prudent to defer consideration of such risk-laden experiments until the other recent initiatives **are** implemented and their effectiveness assessed.

I would be pleased to discuss these issues with the Commission or its representatives.

Very truly yours.

W. James McNerney, Jr

cc: Hon. William H. Donaldson-Chairman, U.S. Securities and Exchange Commission
Hon. Paul Atkins-Commissioner
Hon. Roel Campos-Commissioner
Hon. Cynthia A. Glassman-Commissioner
Hon. Harvey Goldschmid-Commissioner
Alan L. Beiler-Director, Division of Corporation Finance

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1 This proposal, presented in boilerplate form applicable to any corporate entity, was in its entirety: "This is to recommend that the Board of Directors redeem any poison pill previously issued (if applicable) and not adopt or extend any poison pill unless such adoption or extension has been submitted to a shareholder vote." Notably, the Delaware courts shortly before our annual meeting this spring reaffirmed the potential desirability of a "poison pill" as a means for conscientious directors to protect important stockholder interests in certain circumstances. See Creo, Inc. v. Printcafe Software, Inc., **C.A.** No. 20164, Chandler, C (Del. Ch. Feb. 21, 2003)(TRANSCRIPT) (rejecting injunction against adoption of rights plan, as directors "were acting consisteni with their obligations and fiduciary duties to achieve the highest and best value reasonably obtainable for the Printcafe shareholders if in fact the company is going to be sold.")

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Council of Institutional Investors

May 10, 2003

Jonathan G. Katz

Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington. DC 20549-0609

Re: File No. S7-10-03

Dear Mr. Katz

The Council of Institutional Investors, an association of more than 130 corporate. public and union pension funds collectively holding more than $3 trillion in pension assets, commends the Securities and Exchange Commission for its decision to review the prosy rules and regulations. A review of these important issues. coming as it does on the heels of the Commission's Herculean efforts to implement the Sarbanes-Oxley Act. shows both a genuine commitment to investor interests and personal courage. *This* is the missing piece that is needed. not just to restore investor confidence but, in fact, to clean up our financial markets.

Council members have long been at the forefront of corporate governance issues. They have consistently pressed for reforms to improve shareholder rights and strengthen corporate governance standards for U.S. companies. They have also consistently called for changes to rules that aren't providing adequate protections for investors or ensuring full and fair disclosure of critical information to investors.

Council members agree that it is time for the SEC to review the current proxy rules and regulations and to modernize them to reflect current market conditions and to correct past problems. We believe several issues warrant close attention.

First, the Council believes that the single niost important reform is to give shareholders more of a voice regarding who represents them on corporate boards. The Council believes that reasonable access to company proxy cards for long-term investors to nominate candidates fur directors would substantially contribute to the health of the U.S. corporate governance model and U.S. corporations by making boards more vigilant about their oversight responsibilities.

The cornerstone of our private sector is the concept that wealth is maximized when owners control-maintain and care for-their own property. Car owners maintain their cars better than car-renters. whether or not they are car experts. But. at publicly traded U.S. companies, this function is not working.

It is clear why the current system is not working. In theory. shareholders are given the right to select individuals to oversee the company on their behalf. This delegation of oversight authority is necessitated by the fact that there are simply too many shareholders at most publicly traded companies for shareholders to oversee managers themselves.

However. current regulations prevent shareholders from exercising this important right. Indeed. current regulations largely prevent shareholders from having any meaningful input at all. Boards of directors. all too often dominated by management. select the director candidates. Shareholders have no meaningful opportunity to suggest alternate candidates. Management's proxy card includes just enough candidates to fill the open board seats.

Shareholders can now only recommend their own candidates by launching an expensive and complicated proxy fight. And while companies **can** freely tap company coffers to fund their campaigns for the board-recommended candidates. shareholders must spend their own money to finance their efforts. And companies often erect many obstacles. including expensive litigation. to thwart investors running proxy fights for board seats.

We cannot expect our economy to be the dominant force it has been if we allow rules like this to stand. All great civilizations have eventually fallen-and they fall when special interests pervert the mechanisms that had made the society great. If we do not let shareholders act like owners. rather than just buyers and sellers. of the biggest employers and wealth creators of our private sector. we cannot expect to have as bright a future as we have had a past. Despite all the details that swirl around these issues. it is really that simple.

The issue of shareholder access to management proxy cards has been around for decades. The SEC first considered the issue in 1932. when it proposed giving shareholders access to nominate director candidates.

In the 1970s. in response to a series of corporate scandals and several highly publicized bankruptcies. the SEC solicited comments and held hearings on corporate governance issues. including shareholder communications and shareholder participation in the corporate electoral process. The Business Roundtable responded to the SEC request by expressing support for the equal access concept and recommending that "the SEC should adopt. if necessary. amendments to Rule 14a-8 that would permit shareholders to propose amendments to corporate bylaws which would provide for shareholder nominations of candidates for election to hoards of' directors."

The Council believes it is time for the SEC to act on this important. and long overdue, reform.

Second, we ***believe enhanced shareholder access to management's proxy cards must be carefully structured to ensure that such a mechanism would not impose unnecessary costs or burdens on companies arid not be used for change-in-control purposes.***

There are models in our democracy that provide some guidance here. Citizens largely delegate government authority to elected officials. as they should. But citizens retain the ability to put initiatives on public ballots if enough citizens sign petitions to support placing the issue on the ballot. Currently. candidates for corporate boards are almost never selected by shareholders: there needs to be an initiative-like mechanism that would allow a substantial number of long-term shareholders to select one or more directors to be their eyes and ears on the board.

This process needs to be established in a way that avoids undue disruption and cost and prevents abuses by shareholders. The Council believes it is possible to define a process. complete with necessary hurdles (a certain percentage of shareholders supporting the inclusion of a candidate or candidates is just one example), that facilitates the nomination of

one or more shareholder-selected directors.

The Council's policy on access issues addresses these concerns by recommending that:

Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 5 percent of a company's voting stock to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least three years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations presented by qualifying investors.

Contests for corporate control are another matter. They are currently governed by complex rules that are justified as investor-protective. There is little doubt that any director-selection process that has the potential to shift corporate control needs to be governed different]!, than processes that can only result in shareholders having their own eyes and ears on a board. Whether the current control contest regulations unduly burden the dynamic and continual modernizing that our markets are supposed to allow is a complex question. and one on which there is a lot of anecdotal and statistical information. The Council would be happy to work with the Commission to collect this information to ensure that any changes in the regulations in this area properly balance competing interests.

Third, the SEC needs to review arid modernize the 13D filing requirements to ensure that the rule applies only to an investor or group of investors attempting to truly change the control of a company.

The Council agrees that a shareholder or group of shareholders attempting to change the control of a company should be subject *to* the SEC's more stringent 13D disclosure requirements. However. the Council does not believe that 13D requirements should be tripped in situations when investors are merely seeking minority representation on a board.

The Council believes that any new access mechanism should expressly provide 13D relief for any investor or group of investors suggesting an alternative to certain of management's hand-picked candidates.

And regardless of whether the SEC proposes an access mechanism. the Commission needs to update the 13D rules to ensure that the intent of the 1992 changes to shareholder communications rules can be full! realized. In particular. the SEC needs to amend the 13D rules to expressly provide relief for certain non-control activities. Otherwise. shareholders will remain passive captives of management. unable to have their voices heard-as management disregard of the passage of non-binding proposals clearly evidences.

While the 1992 rule changes. endorsed by the Council. relaxed the communications rules for situations when shareholders are not seeking proxy authority or are not attempting to change or influence the control of the company. they failed to provide concurrent 13D/G relief for many of these situations. This failure has created some gray legal areas that have hampered the full effectiveness of the intent of the 1992 rule changes.

The Council urges the SEC to consider amending the rules to clarify that the 13D/G regulatory scheme is intended to only capture shareholders or groups of shareholders who intend to change or modify control of a public company. either through a tender offer or a proxy contest for board control. The SEC should create a safe harbor for the following

activities: "short slate" campaigns that do not constitute a majority of the board and "just vote no" efforts in which Shareholders urge other shareholders to simply withhold votes from directors.

Fourth, the Council believes that to ensure that shareholders have a meaningful opportunity to vote on directors, broker votes should be prohibited on contested and uncontested elections of directors.

Currently, the New York Stock Exchange allows companies to stuff the ballot box for management-nominated directors by allowing brokers to vote on uncontested elections of directors. Under the NYSE's "10-day rule," adopted in 1937. brokers may vote on certain proposals if the beneficial owner hasn't provided voting instructions at least 10 days before a scheduled meeting. These broker votes are always cast in favor of management.

The exchange justifies this unfair system by claiming that these proxy items are "routine," However. if investors have learned anything in the wake of the recent extraordinary corporate scandals and market collapse. it's that the election of directors is hardly a "routine" matter. Indeed. it may be the single most important vote cast by shareholders.

The Council believes this rule-now more than 60 years old-is out of date and unfair to shareholders. and we have repeatedly called on the NYSE to repeal it. The Council believes that there is no public policy justification for the current "broker may vote" policy.

Fifth, the Council believes that the shareholder proposal rules should be updated to streamline the process for companies, shareholders and the SEC.

While there are. no doubt. strongly different views on how director elections should be regulated. there is probably general agreement that the shareholder proposal process is in desperate need of repair.

The Council believes that over the long term. the need for shareholder proposals may decline if shareholders have meaningful ways to communicate with independent directors and the securities rules are amended to facilitate shareholder nominations of independent directors. But in the meantime. shareholder proposals continue to be an important mechanism for investors to communicate with companies and with other shareholders. It's time to review and modernize these rules.

One area worthy of consideration is the "ordinary business" exemption. which the Council believes has been used too often to exclude resolutions addressing important and longstanding public policy issues.

Another area ripe for review is the requirement that proponents must attend annual meetings to introduce their resolutions. Current rules don't require company executives or directors to attend the annual meetings to present management proposals. Why should shareholders be held to a higher standard?

The Council supports changing the rules to eliminate the "ordinary business" exemption, a reform suggested in September 2002 by former SEC chairman Harvey Pitt. and it would support other changes to improve the shareholder proposal process.

Finally, it's time for the SEC to improve the disclosure requirements regarding director

relationships, executive compensation and director compensation.

The recent corporate scandals have highlighted the importance of truly independent directors and the need for improved disclosure of executive and director **pay** details. Unfortunately. the current disclosure rules are lacking in these areas.

Since basic, yet material. information about director relationships doesn't have to be disclosed. shareholders cannot assess the independence of directors serving on the boards of companies. And in the decade since the SEC last amended the compensation disclosure rules, compensation practices have changed dramatically. and it's increasingly difficult for shareholders to understand how much an executive or director is paid. It's time to for the SEC to review and modernize the current disclosure rules.

In October 1997, the Council submitted to the SEC a rulemaking petition requesting an amendment to paragraph (d) of item 401 of Regulation S-K to require company disclosure of "personal, professional and financial relationships" between directors and top management. Recognizing that personal relationships may be too difficult to depict clearly in regulatory language. the Council amended its petition language in October 1998 to require disclosure of "familial. professional and financial relationships."

The Council urges the Commission to act on the Council's rulemaking petition.

Reforms designed to help investors have a meaningful role in the governance of the companies they invest are iong overdue. The Council has repeatedly called for these changes. And so have other investors. including Warren Buffett and Jack Bogie. who have called on large shareholders to get more involved in governance issues. it's time for the SEC to move forward to enable shareholders to act like the owners that they are.

The Council appreciates this opportunity to comment. Please contact me or Ann Yerger with any questions.

Sincerely,

Sarah A.B. Teslik
Executive Director

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December 12,2003

Jonathan G. **Katz**
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609.

Re: File No. S7-19-03

The Council of Institutional Investors (Council), an organization of more than 300 investment professionals, including more than 140 public, corporate and union pension funds with more than $3 trillion in investments, the National Association of State Retirement Administrators (NASRA), which represents directors and administrators of the nation's state employee retirement plans and the largest statewide public retirement systems responsible for combined assets exceeding $1.4 trillion and the National Council on Teacher Retirement (NCTR), which represents 77 state, territorial, local, and university pension systems serving more than 16 million active and retired teachers, non-teaching personnel, and other public employees and holding combined assets of more than $1.4 trillion, ***support*** the Commission's proposal to amend the proxy rules *to* give shareowners limited access to management's proxy card to nominate directors. (Lists of our members are attached.) ***However, the Council, NASRA and NCTR believe that certain modifications would enhance the proposed rule.***

Sixty years have passed since the Securities and Exchange Commission first considered whether shareowners should be able to include director candidates on management's proxy card. This reform has been studied for **decades** and is long overdue. Its adoption would be the single most significant **and** important Investor reform adopted by any regulatory or legislative body in decades. We congratulate and thank the SEC for its leadership in this important area.

The corporate scandals of the past few years have highlighted a longstanding concern — some directors are not doing the jobs expected by their employers, the shareowners. Compounding the problem is the fact that in too many cases the director nomination process is flawed, largely due to limitations imposed by companies and the securities laws.

Some boards are dominated **by** the CEO, who plays the key role in selecting and nomtnating directors All-independent nominating committees ostensibly address this concern, but problems persist Some companies don't have nominating committees, others won't accept shareowner nominations for directors, and our members' sense is that shareowner-suggested candidates — whether or not submitted to all-independent nominating committees — are rarely given serious consideration

Shareowners can now only ensure that their candidates get full consideration by launching **an** expensive and complicated proxy fight—an unworkable alternative for most investors, particularly fiduciaries who must determine whether the very significant costs of a proxy contest are in the best interests of plan participants and beneficiaries. While companies can freely tap company coffers to fund their campaigns for board-recommended candidates, shareowners must spend their own money to finance their efforts. **And** companies often erect various obstacles, including expensive litigation, to thwart investors running proxy fights for board seats.

We believe that reasonable access to company proxy cards for long-term shareowners would address some of these problems. We believe such access would substantially contribute to the health of the U.S. corporate governance model and U.S. corporations by making boards more responsive to shareowners, more thoughtful about whom they nominate to serve *as* directors and more vigilant about their oversight responsibilities.

More detailed responses to the various issues raised in the release are included in the attached appendix, which was prepared **by** the Council. Our comments are based on the following Council policy:

> *Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 5 percent of a company's voting stock to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least three years. Company proxy materials and related mailings should provide equal space and equal treatment for nominations presented **by** qualifying investors.*

This policy is intended to be straightforward and intentionally limiting—reflecting the overriding principle that any access mechanism should not be used to affect a change in control.

While the SEC's proposal is an important and significant step in the right direction, ***the Council, NCTR and NASRA believe the following modifications would strengthen the proposed rule and enhance its effectiveness***.

1. Ideally, the final rule should include no triggers. To enable long-term shareowners to act quickly if they have concerns with **a** certain company's board, the Council's access policy **does** not contain any triggers. The SEC's proposal imposes **a** two-year wait before shareowners may include candidates on management's card. Such a delay **is** too long at seriously troubled companies.
2. If the final rule includes triggers:
   - The **SEC** should **add** "immediate triggers," so that at least in certain situations, shareowners would not have wait two years to include one or more candidates on management's proxy **card.**
   - The withhold vote threshold should be lowered to 20 percent of the votes cast—the yardstick long used by the business and shareowner communities to gauge the significance of a **"no"** vote.

- Ownership requirements for a shareholder-sponsored access resolution should be consistent with current 14-8 rules. When it comes to proposals—whether sponsored by management or shareowners—the primary issue is and should be whether the resolution wins a majority vote. A proponent's ownership level is irrelevant.
- The SEC should add a trigger based on non-implementation of majority-vote-winning shareowner resolutions. Because the failure to act on a majority vote is significant evidence of a breakdown in the proxy process, such a trigger should be incorporated in the final rule. All voting-result-related triggers should be based on votes cast for and against. Most management proposals require approval of a majority of votes cast. A higher standard for the access mechanism would be inappropriate and unfair *to* shareowners.

3. Requiring shareowner-suggested nominees to be independent of the nominating shareowner or group *is* unnecessary. instead, we recommend requiring companies and nominating shareowners to fully disclose all relationships between director candidates and the company, company executives, and in the case of candidates nominated by shareowners, the nominating shareowners. Full and meaningful information about each candidate will ensure that shareowners can make reasoned, informed voting decisions.
4. The Council, NASRA and NCTR agree that an access mechanism should not be used to unseat a board or facilitate a change in control. However, we believe an access mechanism should be structured to allow shareowners to nominate less than a majority of the board. The numerical Itmits proposed by the SEC overly complicate the rule and may hinder its effectiveness, particularly when shareowners are limited to including only one candidate on management's proxy card.
5. The state law carve-out from the rule may be abused by companies. We request that the SEC require prompt 8-K disclosure of any bylaw or charter amendments or state law changes impacting the effectiveness *of* the access mechanism. Such disclosure would ensure that shareowners are promptly and fully aware of any changes to their rights.
6. Shareowners need more time than 30 days before a scheduled meeting *to* learn of a company's determination to *omit* a shareowner-suggested candidate.
7. The 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. Without SEC involvement, shareowners will face extremely expensive litigation that would end up seriously impairing the effectiveness and usefulness of the access mechanism.

The Council, NCTR and NASRA appreciate this opportunity to comment. Please contact us with any questions.

Sincerely,

Sarah A.B. Teslik
Executive Director
Council

Jeannine Markoe Raymond
Director of Federal Relations
NASRA

Jim Mosman
Executive Director
NCTR

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Alan L. Beller, Director, Division of Corporation Finance
Martin P. Dunn, Deputy Director, Division of Corporation Finance

Council of Institutional Investors
Appendix

General Questions

The Council of Institutional Investors wholeheartedly supports revising the proxy rules to give shareowners the right to include director nominees on company proxy cards. Current alternatives for shareowners to have a meaningful say on director nominations are not working and have not worked for decades.

The Council believes that the value of enhanced director accountability, the primary benefit of the proposed mechanism, would far outweigh the very limited costs of including additional director candidates on management's proxy card and in management's proxy materials. Of course, companies and sponsoring shareowners may elect to devote significant resources to electing their candidates. However, these costs are discretionary and not relevant to the analysis of the costs and benefits of the proposed mechanism.

Another benefit of the proposed mechanism is that shareowners would have the option to elect "outside" directors with new viewpoints. Groups such **as boards** of directors benefit from members' diverse perspectives and different experiences. An emphasis on boardroom collegiality — a focus of the business community — can be harmful when it leads to "groupthink," **a** term introduced by Irving Janis in 1971 to refer to situations when an emphasis on group cohesion and unity outweighs efforts to realistically evaluate alternative courses of action. Eroupthink can lead to poor judgments and bad decisions. The Council does not believe that adding new viewpoints would harm boardroom operations. Indeed, such fresh Perspectives may protect against groupthink and invigorate boardroom discussions.

Eligible Companies

The proposed access mechanism is intended to address situations "where there are indications that the proxy process has been ineffective or that security holders are dissatisfied with that process." Since such problems aren't isolated to certain companies, the Council believes the rule should apply to all companies subject to the proxy rules, including investment management firms.

The Council opposes restricting the rule to accelerated filers or imposing other limitations or carve-outs for companies taking specific steps or actions, such as adopting shareholder-recommended actions or including shareowner resoiutions on proxy cards. Such limitations would significantly weaken the effectiveness of the rule.

State Law *Considerations*

Ideally, all companies, regardless of state laws, should be eligible for the proposed access procedure.

The Council understands that the SEC must craft the rules to work with state laws, but we are very concerned that the proposed *state* law carve-outs will negatively impact the effectiveness of the rule,

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Time and again, we have watched state legislatures rush to approve last minute laws designed to protect in-state-incorporated companies. The Council is concerned that adoption of this rule would result in intense, big money corporate lobbying efforts to pressure states into adopting new laws banning or limiting shareholder nominations. Such pressure would be most intense after one or more companies report that triggers activating the mechanism are satisfied.

And of course, some companies may have already amended their bylaws and charters, if permitted, to eliminate or weaken the right of shareowners to use the access mechanism.

The end result is ironic — the companies most unresponsive to investors and displaying the most problems with the proxy process are likely to be the ones most inclined to run to their state legislatures for protection or, if permitted, to adopt bylaw or charter amendments restricting shareowner involvement in the director nomination process or imposing procedural hurdles and other blocks to shareowners.

Compounding these problems is the fact that shareowners are generally unaware of state law changes and bylaw and charter amendments affecting shareowner rights.

To remedy this problem, the Council requests that the SEC require prompt 8-K disclosure of any amendments to company charters or bylaws — including the adoption of any procedural requirements — since Oct. 14, 2003, and of any state law changes since Oct. 14, 2003, affecting the applicability of the access mechanism. This disclosure is consistent with a pending SEC rule change that would require near immediate Form 8-K disclosure of an expanded list of items, including material modifications to security-holders' rights. Although this disclosure wouldn't stop companies from doing all they can to limit shareowners' rights, it would ensure that shareowners are fully aware of these activities.

Triggering Events

The Council's policy does not contain any triggers. We believe a long-term shareowner or group of shareowners owning a significant stake in a company should have the ability to act like an owner and participate meaningfully in the director nomination process without facing numerous hurdles.

As a result, the Council believes that an access mechanism should allow for immediate activation of the process, at least in certain circumstances, since a two-year delay may be unfeasible for failing companies or other firms with significant governance problems.

However, if the final rules include triggers, the Council supports a Jan. 1, 2004, start date for triggering events. Shareowners have been waiting for this reform for more 60 years — it's time to move ahead with this important rule.

a. Withhold Votes

The 35 percent withhold vote trigger is high relative to the 20 percent yardstick used by investors and corporations to measure the significance of a withhold vote.

The "just vote no" strategy was first suggested more than 10 years ago by Joseph Grundfest, a former SEC Commissioner. In his keynote speech at the Council's fall 1990 meeting, he argued that a large "no" vote would signal that shareowners were seriously disaffected.

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Bruce Atwater, then chairman and CEO of General Mills and chairman of the Business Roundtable's corporate governance task force, told an Oct. 17 1991, hearing of the Senate Banking Committee's Subcommittee on Securities, "If 20 percent of the votes of the given company for the board were withheld...it would be an open indication to all kinds of people that the board was vulnerable to an effort to mount an alternative slate."

The corporate and investor communities have long held that significant withhold votes are a meaningful signal of investor discontent, and a 20 percent withhold vote is clearly a significant show of discontent.

The Council's random survey of 2003 director votes at 100 S&P 500 firms, 100 S&P MidCap 400 companies, and 108 S&P SmallCap companies found only six companies (two S&P Midcap, four S&P SmallCap and no large cap companies)—2 percent of the entire survey group—reporting that at least one director received withhold votes of more than 35 percent of the votes cast. The Council would be pleased to forward this data to you.

Lowering the withhold vote threshold to 20 percent would increase the number of companies triggering the hurdle to 48—just under 16 percent of the sample. In both cases, the result is a modest number of companies that could potentially be eligible for the access mechanism.

The Council strongly believes that a withhold vote trigger should be based on votes cast, <u>not</u> votes outstanding. Companies and investors have historically evaluated the significance of director votes based on votes cast—not votes outstanding. The Council continues to believe that all vote tallies—including ones for director—should exclude broker votes. Automatic Data Processing reports that broker votes are always cast for management, which skews final vote tallies in favor of management-sanctioned candidates and management-recommended positions.

Requiring a vote based on outstanding shares would render the rule nearly meaningless for investors. if the hurdle is raised to 35 percent of the outstanding shares, only three companies—1 percent of the entire survey—would qualify. The difference is significant, and the Council believes the higher threshold would inappropriately hamstring shareowners and materially harm the effectiveness of the rule.

Of note, since inclusion of a shareowner-suggested director on management's proxy card results in a contest for board seats, broker votes should be prohibited in these situations. The Council encourages the SEC to work with the New York Stock Exchange to ensure that the stock exchange amends its rules to appropriately categorize access elections as "contests" not eligible for broker votes.

<u>b. Shareowner Resolutions</u>

The Council believes the current 14-8 rules—including ownership documentation, submission and resubmission requirements—should apply to all shareowner resolutions, including ones to activate the access mechanism. Requiring sponsors of access resolutions to own at least 1 percent of the stock unnecessarily complicates the rule and may adversely impact the effectiveness of the procedure.

When it comes to proposals—whether sponsored by management or shareowners—the primary issue is and should be whether the resolution wins support of a majority of the votes. A proponent's ownership level is irrelevant.

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Concerns that lowering the ownership requirements for such proposals would open the floodgates and result in hundreds of resolutions are exaggerated. Once such a triggering event would be satisfied, a shareowner candidate may only be placed on management's card by a shareowner or group of shareowners holding at least 5 percent of the shares. And shareowner-suggested candidates will only end up on the board if they win the necessary support.

The Council strongly believes that a minimum of 50 percent of the votes cast for and against is the appropriate standard for determining whether a direct access shareholder proposal "passed" and activated the triggering event. Most management proposals, including the election of directors, equity compensation plans and other compensation plans, only need approval of a majority of votes cast. A higher standard for shareowner resolutions is inappropriate and unfair to shareowners.

c. Other Triqgers

The Council believes that the failure to adopt or to take steps necessary to adopt actions recommended by a winning shareholder resolution is significant evidence that the proxy process has been ineffective. As a result, we believe such a trigger is appropriate and should be incorporated in the final rule.

A majority-vote trigger should be effective regardless of who sponsored the resolution, how many shares were owned by the proponent or the topic of the resolution. The issue here is whether a shareholder-suggested action wins support of a majority of the votes cast for and against. The proponent's name and stock ownership is irrelevant.

The Council strongly believes that using votes cast for and against is the appropriate measure for all shareowner resolutions. Basing the votes on outstanding shares is inappropriate and unfair to shareowners, since most management proposals, including the election of directors, equity compensation plans and other compensation plans, require only the approval of a majority of votes cast.

Companies should be required to file an Exchange Act Form 8-K stating any determination by a board of directors as to whether or not a majority-vote-winning security holder proposal, including one to trigger the access rule, has been implemented. For those isolated instances when companies and shareowners disagree over whether a resolution was implemented, a mechanism similar to the no-action process should be in place at the SEC for shareowners to contest such determinations.

The Councit also urges the Commission *to* consider requiring companies to file Form 8-Ks promptly fotlowing the annual meetings to detail the vote totals on each item presented at the annual meeting. It is not uncommon for shareowners to wait more than six months to discover the voting results of annual meetings. Such a delay is unwarranted and unnecessary.

The Council asks the Commission to clarify and update the disclosure requirements for vote tallies. Some companies currently only disclose whether an item passed or failed. Such limited information is inadequate. Companies should be required to follow a consistent tabular format detailing votes for, against, withheld, abstained and broker votes. When broker votes are permitted on "routine" items, the voting detail should separately break out broker votes and detail how those votes were cast.

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d. Consequences of Triggers

It's impossible to predict the consequences of the adoption of an **access** mechanism. However, it's important to note that Council members have **a** fiduciary duty to act in the best interests of plan participants and beneficiaries. **As** a result, they do not take actions — whether withholding votes from directors, supporting shareowner resolutions or suggesting director candidates — on a whim.

Such care **is** reflected by the results of a survey of public pension systems conducted by Lussier, Gregor, Vienna & Associates on behalf of the American Federation of State, County and Municipal Employees. According to the study, the top three significant reasons why public funds currently withhold votes from corporate directors are: (1) excessive absenteeism, (2) failure to implement shareholder resolutions receiving majority votes, (3) lack of independence or concerns with potential conflicts of interest.

The results are consistent with the Council's informal review of the proxy voting policies of 15 pension funds and investment managers. Specific guidelines varied widely, and reasons for withholding votes from directors included:

- boards do not have at least a majority of independent directors
- an insider is nominated to the audit, compensation, nominating or corporate governance committee
- a re-nominated director attended less than 75% of board and committee meetings
- a company has a history of substandard performance relative to a peer index and broad market index — particularly when coupled with other factors listed
- a director serves on more than a certain number of public company boards
- a company establishes or maintains anti-takeover devices
- CEO/management compensation is excessive relative to industry standards
- a company ignores shareholder proposals that receive majority votes — especially majority votes on the same issue received in two consecutive years
- directors have a poor governance record at other companies

The Council is aware of concerns that the access mechanism may have the unintentional consequence of increasing the power of Institutional Shareholder Services, a proxy advisory firm. **We** believe such concern is misplaced for several reasons.

- The largest institutional money managers, along with most of the Council's largest members, have their own voting guidelines; they **do** not "blindly" follow the recommendations of proxy advisory firms. And on complex issues, including ones that would be raised by the access mechanism, they generally have case-by-case policies requiring careful review and analysis before voting decisions are made. None of the Council's 10 largest public fund members, with pension assets totaling $750 billion (representing about a third of all assets held by public pension funds, according to a recent Conference Board report). base their domestic proxy votes solely on ISS recommendations. In each case, their domestic equity holdings are voted based on the funds' own proxy voting guidelines
- More than 70 percent of the equity holdings of all institutional investors are held by corporate pension funds, mutual funds, bank trust funds and insurance companies that tend to support management's recommendations.
- The Council **believes** that the number of institutional investors, particularly mutual funds, voting based on their own guidelines will increase in the future, due in part to the SEC's new rules requiring greater disclosure of proxy votes **by** mutual funds and money managers.

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- Competition is increasing in the proxy advisory business, and the Council believes that institutional investors will increasingly rely on more than one firm for proxy voting advice.
- The Council expects that institutional investors will **be** even more careful in the future **on** voting items that may trigger the access mechanism or on care in the future

Of note, the Council does not believe that the commencement of a proxy contest should halt the access mechanism once legitimately triggered. Such a restriction would overly complicate the rule **and be** unnecessary, since both the access mechanism **and** a proxy contest reflect dissatisfaction with a board.

Notice of Triggering Event(s)

Too often, important disclosures get lost in the larger 10-Q or 10-K filings. To ensure that shareowners don't have to sift through hundreds of pages of filings to find the relevant disclosure, the Council believes such disclosure should **be** consistently tagged/identified by all companies so that investors can readily locate the information. Notice of triggering events should also **be** posted on company websites.

Eligible Nominating Shareholders

The Council supports the proposed eligibility standards. While individual Council members have different preferred ownership levels, with several advocating **a** 3 percent level, Council policy holds that the access mechanism should be available to any long-term shareowner or group of shareowners owning in aggregate at least 5 percent of a company's voting stock for at least three years. Since the Council policy is not intended to facilitate corporate takeovers, the Council agrees that the access mechanism should not be available to Schedule 13D filers.

Shareowners should **be** permitted to aggregate their holdings in order to meet the ownership requirements. The proposed two-year holding requirement should apply to all shareowners of any "group" formed for purposes of the access mechanism.

While SEC data suggests that about 42 percent of all filers have at least one shareowner satisfying this standard, the Council's experience is that in most cases these 5-percent shareowners are not actively involved in governance activities. Large owners most likely vote their shares, but they tend to not **be** involved in more assertive activities, such as filing shareowner resolutions or suggesting candidates for director. **As** a result, prohibiting shareowners from aggregating their holdings in order to satisfy the 5 percent ownership threshold would render this reform meaningless.

It's important to stress that reaching a 5 percent ownership threshold will **be** no easy feat. According to a recent Conference Board report on institutional investor investments, U.S. institutional investors, which are more likely than individual investors to use an access mechanism, controlled 55.8 percent of the U.S. equity market at the end of 2001. Institutional ownership was higher—61.4 percent on aggregate—at the nation's largest 1,000 companies.

But institutional investors **are** not a monolithic block—they are very different in terms of their investment philosophies, the influences they are subject to and the roles they may or may not play in corporate governance. In terms of corporate governance efforts, the most active institutional investors have tended to be public pension funds, which in aggregate own ***only 8 percent*** of total U.S. equity market.

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The Council expects that other institutional investors such as corporate pension funds, mutual funds, insurance companies, bank trust departments — which in aggregate own about **40** percent of **U.S.** equities, are unlikely to use the mechanism.

The data is solid evidence proof that the 5 percent ownership threshold is a significant hurdle that in most cases will only be satisfied if investors are permitted to combine holdings.

Nominee Independence and Other Standards

The Council agrees that shareowner-suggested candidates should qualify as independent under relevant non-subjective stock exchange listing standards and that nominating shareowners or groups should be required to disclose all relationships between the candidate, the company and the nominating shareowners. The Council also agrees that nominating shareowners should **be** required to represent that they don't have any direct or indirect agreements with the companies and that their candidates qualify as independent under the relevant stock exchange standards.

However, requiring candidates to comply with state laws may be necessary but also problematic, if, **as** discussed earlier, states adopt laws giving companies flexibility to block or otherwise impose hurdles applicable to shareowner-nominated candidates.

To ensure that shareowners understand the definitions and requirements used by each company, the Council suggests that the SEC require companies to provide proxy statement disclosure of independence and other qualifications for shareowner candidates.

While the Council agrees that shareowner-nominated candidates should satisfy certain independence requirements, the Council strongly disagrees that candidates should have to be independent of the nominating shareowner or group.

The Council is puzzled why a shareholder-suggested candidate should be held to a different standard than board-nominated candidates. Corporate boards are currently free to nominate candidates with a range of special interests. such as individuals from firms that provide investment banking, legal and other professional services, relatives of company executives and directors and other individuals with various links to the company and its executives. **It's** unclear to the Council why significant shareowners cannot nominate employees, service providers or other "non-independent" candidates

Corporate concerns over "spectal interest" representation are exaggerated, since candidates will ultimately only **be** added to the board if the shareowners — the directors' bosses — vote to **do** so. Once shareowners have full information about relationships between all nominees — including board-nominated and shareowner-nominated candidates — they can make a reasoned and informed voting decision.

To ensure that shareowners have access to sufficient information to **assess** each director's independence, the SEC should require enhanced disclosure of relationships between directors, corporations, corporate executives and, if appropriate, nominating shareowners. Current disclosures are weak, and too often shareholders learn of ties between directors when it's been too late, with a company **mired** in a scandal and director independence called into question. We urge the Commission to act on the Council's rulemaking petition on this issue submitted In October 1997 and amended and resubmitted in October 1998.

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The Council does not believe a candidate should **be** subject to resubmission requirements. Similar resubmission requirements aren't applicable to management's candidates, so they shouldn't apply to candidates suggested by shareowners.

Limit on Shareowner Candidates

Council members approved the Council's policy with the understanding that an access mechanism should not **be** structured to permit a shareowner or group to unseat an entire board or facilitate a change in control.

The Council policy advocates that the access mechanism be used to nominate less than a majority of the directors. Numeric limits such as the one proposed by the SEC overly complicate the rule and may also impair the effectiveness of the access mechanism, particularly when shareowners are restricted to including only one candidate on management's proxy card.

The Council is aware of too many situations where a lone "dissident" director faced a hostile board, was blackballed from key committees and was effectively cut out of key discussions. From a practical standpoint, giving shareowners the opportunity to nominate at least two candidates would improve the possibility that "dissident'' directors might have one director willing to second their motions.

Timing Considerations

The Council is concerned that giving companies until 30 days before annual meetings to notify nominating shareowners of determinations to omit shareowner-suggested candidates would not give shareowners adequate time to contest a determination and cure a defective notice. Such a short time period also does not provide adequate time for the SEC to address any disputes regarding director determinations — a mechanism which the Council believes should **be** incorporated in the final rule.

Candidate Determinations

Giving companies too much latitude to request additional information to determine the eligibility of shareowner is problematic. The Council is concerned that some companies—unfortunately and ironically, usually the ones most in need of governance reforms — may spend countless hours and devote significant resources to ' nit-picking" candidates and harassing nominating shareowners

The final rule should be written to ensure that required disclosures include all necessary information, so that additional company inquiries should be minimal. If companies need to obtain additional information, such ability should be restricted to a very short period of time, and shareowners should **be** given a reasonable amount of time to respond to legitimate requests and to cure defective notices.

The final rule should include an SEC-handled mechanism to mediate shareowner concerns that companies are overstepping their rights to request additional information or to review shareowner objections of decisions to exclude shareowner candidates from management's proxy card. Without such an SEC mechanism, shareowners will be forced to undertake expensive litigation that would effectively render the access mechanism useless.

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Proxy Statement Disclosure

The Council's **access** policy calls for company proxy materials and related mailings to provide equal space and equal treatment of nominations presented by qualifying investors. **As a** result, we believe shareowners should **be** permitted to include supporting statements regardless of whether companies include supporting/opposing statements.

At **a** minimum, **a** supporting statement of at **least** 500 words should be permitted. If companies devote more than 500 words to supporting their candidates or opposing shareowners' candidates, shareowners should be given equal **space.**

The final rule should prohibit companies from grouping management candidates to allow shareowners to vote for the entire slate. In contested elections such **as** ones resulting from the use of an access mechanism, shareowners should have separate votes on each candidate.

73-G Filing Requirement

The Council agrees that any Schedule 13D filers should not be eligible to use the access mechanism and that use of the access option should not result in the loss of 13G filing status.

The Council also agrees that shareowners participating in 5 percent groups should **be** required to sign a group Schedule 13G indicating ownership and intent to nominate candidates.

Regarding current rules and "vote no" campaigns, the Council has long called on the SEC to amend the rules to clarify that the 13D regulatory scheme is intended to only capture shareholders or groups of Shareholders who intend to change or modify control of a public company, either through a tender offer or a proxy contest for **board** control. Specifically, the Council advocates establishing a safe harbor for the following activities: "short slate" campaigns that do not constitute a majority of the board and "just vote no" efforts in which shareholders urge other shareholders to simply withhold votes from directors.

While the 1992 rule changes, endorsed **by** the Council, relaxed the communications rules for situations when shareholders are not seeking proxy authority or are not attempting to change or influence the control of the company, they failed to provide concurrent 13D relief for many of these situations. This failure has created some gray legal areas that have hampered the full effectiveness of the intent *of* the 1992 rule changes.

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the White House
President George W. Bush

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For Immediate Release
Office of the Press Secretary
January 20, 2001

Memorandum
January 20, 2001
Memorandum for the Heads and Acting Heads of Executive Departments and Agencies

FROM: ANDREW H. CARD, JR.
Assistant to the President
and Chief of Staff

SUBJECT: Regulatory Review Plan

The President has asked me to communicate to each of you his plan for managing the Federal regulatory process at the outset of his Administration. In order to ensure that the President's appointees have the opportunity to review any new or pending regulations, I ask on behalf of the President that you immediately take the following steps:

1 Subject to any exceptions the Director or Acting Director of the Office of Management and Budget (the "OMB Director") allows for emergency or other urgent situations relating to health and safety, send no proposed or final regulation to the Office of the Federal Register (the "OFR") unless and until a department or agency head appointed by the President after noon on January 20, 2001, reviews and approves the regulatory action The department or agency head may delegate this power of review and approval to any other person so appointed by the President. consistent with applicable law

2 With respect to regulations that have been sent *to* the OFR but not published in the Federal Register, withdraw them from OFR for review and approval as described in paragraph 1, subject to exception as described in paragraph 1 This withdrawal must be conducted consistent with the OFR procedures

3. With respect to regutations that have been published in the OFR but have not taken effect, temporarily postpone the effective date of the regulations for 60 days, subject to exception as described in paragraph 1

4 Exclude from the requested actions in paragraphs 1-3 any regulations promulgated pursuant to statutory or judicial deadlines and identify such exclusions to the OMB Director as soon as possible.

5 Notify the OMB Director promptly of any regulations that, in your view. impact critical health and safety functions of the agency and therefore should be also excluded from the directives in paragraphs 1-3. The Director will review any such notifications and determine whether exception is appropriate under the circumstances.

6 Continue in all instances to comply with Executive Order 12866, pending our review of that order, as well as any other applicable Executive Orders concerning regulatory management

As used in this memorandum, "regulation" has the meaning set out in section 3(e) of Executive Order 12866. That is. this plan covers "any substantive action by an agency (normally published in the Federal Register) that promulgates or is expected to lead to the promulgation of a final rule or regulation, including notices of inquiry, advance notices of proposed rulemaking. and notices of proposed rulemaking "

This regulatory review will be implemented by the Director or Acting Director of the OMB. Communications regarding exceptions to the review, or questions regarding the review generally, should be addressed to that individual.

Finally, in the interest of sound regulatory practice and the avoidance of costly, burdensome, or unnecessary regulation, independent agencies are encouraged to participate voluntarily in this review.

This memorandum shall **be** published in the Federal Register

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REPORT TO CONGRESS
ON THE COSTS AND BENEFITS OF FEDERAL REGULATIONS

Introduction

The Office of Management and Budget issued its first report to Congress on the costs and benefits of Federal regulations in 1997. Section *625* of the Treasury and General Government Appropriations Act, 1998 (P.L. 105-61) directs OMB to issue **a** second regulatory accounting report. The requirements of the report are the same as those of last year, to include:

> "(1) estimates of the total annual costs and benefits of Federal regulatory programs. including quantitative and non-quantitative measures of regulatory costs and benefits;
>
> "(2) estimates of the costs and benefits (including quantitative and non-quantitative measures) of each rule that is likely to have a gross annual effect on the economy of $100.000.000 or more in increased costs;
>
> "(3) an assessment of the direct ana indirect impacts of Federal rules on the private sector, State and local government. and the Federal Government; and
>
> "(4) recommendations from the Director and a description of significant public comments to reform or eliminate any Federal regulatory program or program element that is inefficient, ineffective, or is not a sound use of the Nation's resources."

Section 625(b) requires the Director of OMB to provide public notice and an opportunity to comment on the draft report before it is submitted to Congress. The draft report was published in the *Federal Register* on August 17, 1998 with a 30 day comment period. However, as a result of requests from both the public and Members of Congress, we extended the comment period an additional 30 days to October 16. 1998. and established. after discussion with congressional staff, a new schedule for final publication.

As we noted in the 1997 report. there is not yet a professional consensus on methods that would permit a complete, consistent and accounting of total costs and benefits of Federal regulation. The 1997 report was our effort to begin an incremental process which we believe will lead to improved information on the effects of regulations, and will help solve the many methodological problems associated with this exercise. This year's report builds on last year's work. In particular, we have additional data to supplement our discussion of the aggregate costs and benefits of regulation and expand our database of costs and benefits of individual, major rules from one year (1997) to three years (1996 to 1998). In addition, we have more experience in dealing with the methodological problems.

While the findings of the Section 812 Retrospective suggest that the aggregate historical benefits of the clean air regulatory programs substantially exceed the aggregate costs. the Section 812 Retrospective itself provides the following cautionary note on page ES-10:

> Finally, the results of the retrospective study provide useful lessons with respect to the value and limitations of cost-benefit analysis as a tool for evaluating environmental programs. Cost-benefit analysis can provide a valuable framework for organizing and evaluating information on the effects of environmental programs. When used properly. cost-benefit analysis can help illuminate important effects of changes in policy and can help set priorities for closing information gaps and reducing uncertainty. Such proper use. however. 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. Given the substantial uncertainties which permeate cost-benefit assessment of environmental programs, as demonstrated by the broad range of estimated benefits presented in this study, cost-benefit analysis is best used to inform. but not dictate, decisions related to environmental protection policies, programs. and research.

In terms of our charge under section 625(a), we must also consider these new benefit and cost estimates in developing an overall estimate of the benefits and costs of Federal regulation. The magnitude of EPA's benefit estimate, $22 trillion over the 1970 to 1990 period. is very large. The expected value of the estimated monetized benefit for 1990 is $1.25 trillion per year. This estimate implies that the average citizen was willing to pay over 25 percent of her personal income per year to attain the monetized benefits of the Clean Air. There are several important

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Office of Management and Budget

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February 10, 1998

CIRCULAR NO. A-119

Revised

MEMORANDUM FOR HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES

SUBJECT: Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities

Revised OMB Circular A-119 establishes policies on Federal use and development of voluntary consensus standards and on conformity assessment activities. Pub. L. 104-113. the "National Technology Transfer and Advancement Act of 1995," codified existing policies in A-119, established reporting requirements. and authorized the National Institute of Standards and Technology to coordinate conformity assessment activities of the agencies. OMB is issuing this revision of the Circular in order to make the terminology of the Circular consistent with the National Technology Transfer and Advancement Act of 1995. to issue guidance to the agencies on making their reports to OMB. to direct the Secretary of Commerce to issue policy guidance for conformity assessment, and to make changes for clarity.

Franklin D. Raines

Circular No. A-119

Revised

(Accompanying Federal Register Materials - 2/10/98)

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities

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BACKGROUND

1. What Is The Purpose Of This Circular?

This Circular establishes policies to improve the internal management of the Executive Branch. Consistent with Section 12(d) of P.L. 104-113, the "National Technology Transfer and Advancement Act of 1995" (hereinafter "the Act"), this

Circular directs agencies to use voluntary consensus standards in lieu of government-unique standards except where inconsistent with law or otherwise impractical. It also provides guidance for apencies participating in voluntary consensus standards bodies and describes procedures for satisfying the reporting requirements in the Act. The policies in this Circular are intended to reduce to a minimum the reliance by agencies on government-unique standards. These policies do not create the bases for discrimination in agency procurement or regulatory activities among standards developed in the private sector, whether or not they are developed by voluntary consensus standards bodies. Consistent with Section 12(b) of the Act, this Circular directs the Secretary of Commerce to issue guidance to the agencies in order to coordinate conformity assessment activities. This Circular replaces OMB Circular No. A-119, dated October 20, 1993.

2. **What Are The Goals Of The Government In Using Voluntary Consensus Standards?**

Many voluntary consensus standards are appropriate or adaptable for the Government's purposes. The use of such standards?whenever practicable and appropriate, is intended to achieve the following goals:

a. Eliminate the cost to the Government of developing its own standards and decrease the cost of goods procured and the burden of complying with agency regulation

b. Provide incentives and opportunities to establish standards that serve national needs.

c. Encourage long-term growth for U.S. enterprises andpromote efficiency and economic competition through harmonization of standards.

d. Further the policy of reliance upon the private sector to supply Government needs for goods and services.

WHAT DEFINITIONS OF STANDARDS

3. **What Is A Standard?**

a. The term "standard," or "technical standard" as cited in the Act, includes all of the following:

(1) Common and repeated use of rules, conditions,guidelines or characteristics for products or related processes and production methods, and related management systems practices.

(2) The definition of terms; classification of components: delineation of procedures; specification of dimensions, materials, performance, designs, or operations; measurement of quality and quantity in describing materials, processes. products. systems, services. or practices; test methods and sampling procedures; or descriptions of fit and measurements of size or strength.

b. The term "standard" does not include the following:

(1) Professional standards of personal conduct.

(2) Institutional codes of ethics.

c. "Performance standard" is a standard as defined above that states requirements in terms of required results with criteria for verifying compliance but without stating the methods for achieving required results. A performance standard may define the functional requirements for the item, operational requirements. and/or interface and interchangeability characteristics. A performance standard may be viewed in juxtaposition to a prescriptive standard which may specify design requirements, such as materials to be used. how a requirement is to be achieved, or how an item is to be fabricated or constructed.

d. "Non-government standard" is a standard as defined above that is in the form of a standardization document developed by a private sector association. organization or technical society which plans. develops, establishes or coordinates standards. specifications. handbooks, or related documents.

4. **What Are Voluntary, Consensus Standards?**

a. For purposes of this policy. "voluntary consensus standards" are standards developed or adopted by voluntary consensus standards bodies. both domestic and international. These standards include provisions requiring that owners of relevant intellectual property have agreed to make that intellectual property available on a non-discriminatory, royalty-free or reasonable royalty basis to all interested parties. For purposes of this Circular. "technical standards that are developed or adopted by voluntary consensus standard bodies" is an equivalent term.

(1) "Voluntary consensus standards bodies" are domestic or international organizations which plan. develop. establish. or coordinate voluntary consensus standards using agreed-upon procedures. For purposes of this Circular. "voluntary, private sector. consensus standards bodies." as cited in Act, is an equivalent term. The Act and the Circular encourage the participation of federal representatives in these bodies to increase the likelihood that the standards they develop will meet both public and private sector needs. A voluntary consensus standards body is defined by the following attributes:

(i) Openness.

(ii) Balance of interest.

(iii) Due process.

(vi) An appeals process.

(v) Consensus, which is defined as general agreement. but not necessarily unanimity, and includes a process for attempting to resolve objections by

interested parties. as long as all comments have been fairly considered. each objector is advised of the disposition of his or her objection(s) and the reasons why. and the consensus body members are given an opportunity to change their votes after reviewing the comments.

b. Other types of standards, which are distinct from voluntary consensus standards, are the following:

(1) "Non-consensus standards," "Industry standards," "Company standards." or "de facto standards." which are developed in the private sector but not in the full consensus process.

(2) "Government-unique standards," which are developed by the government for its own uses.

(3) Standards mandated by law. such as those contained in the United States Pharmacopeia and the National Formulary, as referenced in 21 U.S.C. 351.

POLICY

5. Who Does This Policy Apply To?

This Circular applies to all agencies and agency employees who use standards and participate in voluntary consensus standards activities. domestic and international. except for activities carried out pursuant to treaties. "Agency" means any executive department. independent commission. board. bureau. office. agency. Government-owned or controlled corporation or other establishment of the Federal Government. It also includes any regulatory commission or board. except for independent regulatory commissions insofar as they are subject to separate statutory requirements regarding the use of voluntary consensus standards. It does not include the legislative or judicial branches of the Federal Government.

6. What Is The Policy For Federal Use Of Standards?

All federal agencies must use voluntary consensus standards in lieu of government-unique standards in their procurement and regulatory activities, sscept where inconsistent with law or otherwise impractical. In these circumstances. your agency must submit a report describing the reason(s) for its use of government-unique standards in lieu of voluntary consensus standards to the Office of Management and Budget (OMB) through the National Institute of Standards and Technology (NIST).

a. When must my agency use voluntary consensus standards?

Your agency must use voluntary consensus standards, both domestic and international, in its regulatory and procurement activities in lieu of government-unique standards. unless use of such standards would be inconsistent with applicable law or otherwise impractical. In all cases, your agency has the

discretion to decline to use existing voluntary consensus standards if your agency determines that such standards **are** inconsistent with applicable **law** or otherwise impractical.

(1) "Use" means incorporation of a standard in whole. in **part,** or by reference for procurement purposes. and the inclusion of **a** standard in whole. in **part.** or by reference in regulation(s).

(2) "Impractical" includes circumstances in which such use would fail to serve the agency's program needs; would be infeasible; would be inadequate, ineffectual, inefficient. or inconsistent with agency mission; or would impose more burdens, or would be less useful. than the use of another standard.

b. **What must my agency do when such use is determined by my agency to be inconsistent with applicable law or otherwise impractical?**

The head of your agency must transmit to the Office of Management and Budget (OMB), through the National Institute of Standards and Technology (NIST), an explanation of the reason(s) for using government-unique standards in lieu of voluntary consensus standards. For more information on reporting, see section 9.

c. **How does this policy affect my agency's regulatory authorities and responsibilities?**

This policy does not preempt or restrict agencies' authorities and responsibilities to make regulatory decisions authorized by statute. Such regulatory authorities and responsibilities include determining the level of acceptable risk: setting the level of protection: and balancing risk. cost, and availability of technology in establishing regulatory standards. However. to determine whether established regulatory limits or targets have beer. met. agencies should use voluntary consensus standards for test methods. sampling procedures. or protocols.

d. **How does this policy affect my agency's procurement authority?**

This policy does nor preempt or restrict agencies' authorities and responsibilities to identify the capabilities that they need to obtain through procurements. Rather. this policy limits an agency's authority to pursue an identified capability through reliance on a government-unique standard when a voluntary consensus standard exists (see Section 6a).

e. **What are the goals of agency use of voluntary consensus standards?**

Agencies should recognize the positive contribution of standards development and related activities. When properly conducted. standards development can increase productivity and efficiency in Government and industry, expand opportunities for international trade. conserve resources. improve health and safety, and protect the environment.

f. **What considerations should my agency make when it is considering using**

a standard?

When considering using a standard, your agency should take full account of the effect of using the standard on the economy. and of applicable federal laws and policies, including laws and regulations relating to antitrust, national security. small business, product safety, environment, metrication. technology development, **and** conflicts of interest. Your agency should also recognize that use of standards, if improperly conducted. can suppress free and fair competition; impede innovation and technical progress; exclude safer or less expensive products: or otherwise adversely affect trade. commerce, health. or safety. If your agency is proposing to incorporate a standard into a proposed or final rulemaking, your agency must comply with the "Principles of Regulation" (enumerated in Section 1(b)) and with the other analytical requirements of Executive Order 12866, "Regulatory Planning and Review."

g. **Does this policy establish a preference between consensus and non-consensus standards that are developed in the private sector?**

This policy does not establish a preference among standards developed in the private sector. Specifically, agencies that promulgate regulations referencing non-consensus standards developed in the private sector are not required to report on these actions, and agencies that procure products or services based on non-consensus standards are not required to report on such procurements. For example. this policy allows agencies to select a non-consensus standard developed in the private sector as a means of establishing testing methods in **a** regulation and to choose among commercial-off-the-shelf products. regardless of whether the underlying standards are developed by voluntary consensus standards bodies or not.

h. **Does this policy establish a preference between domestic and international voluntary consensus standards?**

This policy does not establish a preference between domestic and international voluntary consensus standards. However, in the interests of promoting trade and implementing the provisions of international treaty agreements. your agency should consider international standards in procurement and regulatory applications.

i. **Should my agency give preference to performance standards?**

In using voluntary consensus standards. your agency should give preference to performance standards when such standards may reasonably be used in lieu of prrscriptive standards.

j. **How should my agency reference voluntary consensus standards?**

Your agency should reference voluntary consensus standards. along with sources of availability, in appropriate publications. regulatory orders. and related internal documents. In regulations. the reference must include the date of issuance. For all

other uses! your agency must determine the most appropriate form of reference. which may exclude the date of issuance as long as users are elsewhere directed to the latest issue. If a voluntary standard is used and published in an agency document, your agency must observe and protect the rights of the copyright holder and any other similar obligations.

k. What if no voluntary consensus standard exists?

In cases where no voluntary consensus standards exist, an agency may use government-unique standards (in addition to other standards. see Section *4g)* and is not required to file a report on its use of government-unique standards. As explained above (see Section 6a). an agency may use government-unique standards in lieu of voluntary consensus standards if the use of such standards would be inconsistent with applicable law or otherwise impractical: in such cases. the agency must file a report under Section 9a regarding its use of government-unique standards.

1 **How may my agency identify voluntary consensus standards?**

Your agency may identify voluntary consensus standards through databases of standards maintained by the National Institute of Standards and Technology (NIST). or by other organizations including voluntary consensus standards bodies. other federal agencies. or standards publishing companies.

7. What Is The Policy For Federal Participation In Voluntary Consensus Standards Bodies?

Agencies must consult with voluntary consensus standards bodies. both domestic and international. and must participate with such bodies in the development of voluntary consensus standards when consultation and participation is in the public interest and is compatible with their missions. authorities. priorities. and budget resources.

a. **What are the purposes of agency participation?**

Agency representatives should participate in voluntary consensus standards activities in order to accomplish the following purposes:

(1) Eliminate the necessity for development or maintenance of separate Government-unique standards.

(2) Further such national goals and objectives as increased use of the metric system of measurement; use of environmentally sound and energy efficient materials, products. systems. services. or practices; and improvement of public health and safety.

b. **What are the general principles that apply to agency support?**

Agency support provided to a voluntary consensus standards activity must be

limited to that which clearly furthers agency and departmental missions, authorities, priorities, and is consistent with budget resources. Agency support must not be contingent upon the outcome of the standards activity. Normally. the total amount of federal support should be no greater than that of other participants in that activity. except when it is in the direct and predominant interest of the Government to develop or revise a standard. and its timely development or revision appears **unlikely** in the absence of such support.

c. **What forms of support may my agency provide?**

The form of agency support. may include the following:

(1) Direct financial support; e.g., grants, memberships, and contracts.

(2) Administrative support; e.g., travel costs. hosting of meetings. and secretarial functions.

(3) Technical support; e.g., cooperative testing for standards evaluation and participation of agency personnel in the activities of voluntary consensus standards bodies.

(4) Joint planning with voluntary consensus standards bodies to promote the identification and development of needed standards.

(5) Participation of agency personnel.

d. **Must agency participants be authorized?**

Agency employees who, at Government expense. participate in standards activities of voluntary consensus standards bodies on behalf of the agency must do so as specifically authorized agency representatives. Agency support for. and participation by agency personnel in, voluntary consensus standards bodies must be in compliance with applicable laws and regulations. For example. agency support is subject to legal and budgetary authority and availability of funds. Similarly, participation by agency employees (whether or not on behalf of the agency) in the activities of voluntary consensus standards bodies is subject to the laws and regulations that apply to participation by federal employees in the activities of outside organizations. While we anticipate that participation in a committee that is developing a standard would generally not raise significant issues. participation as an officer, director. or trustee of an organization would raise more significant issues. *An* agency should involve its agency ethics officer, as appropriate. before authorizing support for or participation in a voluntary consensus standards body.

e. **Does agency participation indicate endorsement of any decisions reached by voluntary consensus standards bodies?**

Agency participation in voluntary consensus standards bodies does not necessarily connote agency agreement with, or endorsement of, decisions reached

by such organizations

f. **Do agency representatives participate equally with other members?**

Agency representatives serving as members of voluntary consensus standards bodies should participate actively and on an **equal** basis with other members. consistent with the procedures of those bodies, particularly in matters such as establishing priorities, developing procedures for preparing. reviewing, and approving standards. and developing or adopting new standards. Active participation includes full involvement in discussions and technical debates. registering of opinions and, if selected. serving as chairpersons or in other official capacities. Agency representatives may vote. in accordance with the procedures of the voluntary consensus standards body, at each stage of the standards development process unless prohibited from doing so by law or their agencies.

g. **Are there any limitations on participation by agency representatives?**

In order to maintain the independence of voluntary consensus standards bodies. agency representatives must refrain from involvement in the internal management of such organizations (e.g., selection of salaried officers and employees, establishment of staff salaries, and administrative policies). Agency representatives must not dominate such bodies. and in any case are bound by voluntary consensus standards bodies' rules and procedures, including those regarding domination of proceedings by any individual. Regardless. such agency employees must avoid the practice or the appearance of undue influence relating to their agency representation and activities in voluntary consensus standards bodies.

h. **Are there any limits on the number of federal participants in voluntary consensus standards bodies?**

The number of individual agency participants in a given voluntary standards activity should be kept to the minimum required for effective representation of the various program. technical. or other concerns of federal agencies.

i. **Is there anything else agency representatives should know?**

This Circular does not provide guidance concerning the internal operating procedures that may be applicable to voluntary consensus standards bodies because of their relationships to agencies under this Circular. Agencies should. however. carefully consider what laws or rules may apply in a particular instance because of these relationships. For example. these relationships may involve the Federal Advisory Committee ***Act.*** **as** amended (5 U.S.C. **App.** I), or a provision of an authorizing statute for **a** particular agency.

j. **What if a voluntary consensus standards body is likely to develop an acceptable, needed standard in a timely fashion?**

If a voluntary consensus standards body is in the process of developing or

adopting a voluntary consensus standard that would likely be lawful and practical for an agency to use, and would likely be developed or adopted on a timely basis. an agency should not be developing its own government-unique standard and instead should be participating in the activities of the voluntary consensus standards body.

8. What Is The Policy On Conformity Assessment?

Section 12(b) of *the* Act requires NIST to coordinate Federal, State, and local standards activities and conformity assessment activities with private sector standards activities and conformity assessment activities, with the goal of eliminating unnecessary duplication and complexity in the development and promulgation of conformity assessment requirements and measures. To ensure effective coordination, the Secretary of Commerce must issue guidance to the agencies.

MANAGEMENT AND REPORTING OF STANDARDS USE

9. What Is My Agency Required to Report?

a. As required by the Act, your agency must report to NIST. no later than December 31 of each year, the decisions by your agency in the previous fiscal year to use government-unique standards in lieu of voluntary consensus standards. If no voluntary consensus standard exists, your agency does not need to report its use of government-unique standards. (In addition. an agency is not required to report on its use of other standards. See Section 6g.) Your agency must include an explanation of the reason(s) why use of such voluntary consensus standard would be inconsistent with applicable law or otherwise impractical. as described in Sections 11b(2). 12a(3). and 12b(2) of this Circular. Your agency must report in accordance with format instructions issued by NIST.

b. Your agency must report to NIST. no later than December 31 of each year. information on the nature and extent of agency participation in the development and use of voluntary consensus standards from the previous fiscal year. Your agency must report in accordance with format instructions issued by NIST. Such reporting must include the following:

(1) The number of voluntary consensus standards bodies in which there is agency participation. as well as the number of agency employees participating.

(2) The number of voluntary consensus standards the agency has used since the last report. based on the procedures set forth in sections 11 and 12 of this Circular.

(3) Identification of voluntary consensus standards that have been substituted for government-unique standards as a result of an agency review under section 15b (7) of this Circular.

(4) An evaluation of the effectiveness of this policy and recommendations for any changes.

c. No later than the following January 31. NIST must transmit to OMB a summary report of the information received.

10. **How Does My Agency Manage And Report Its Development and Use Of Standards?**

Your agency must establish a process to identify, manage. and review your agency's development and use of standards. At minimum, your agency must have the ability to (1) report to OMB through NIST on the agency's use of government-unique standards in lieu of voluntary consensus standards?along with an explanation of the reasons for such non-usage, as described in section 9a. and (2) report on your agency's participation in the development and use of voluntary consensus standards. as described in section 9b. This policy establishes two ways. category based reporting and transaction based reporting, for agencies to manage and report their use of standards. Your agency must report all uses of standards in one or both ways.

11. **What Are The Procedures For Reporting My Agency's Use Of Standards In Regulations?**

Your agency should use transaction based reporting if your agency issues regulations that use or reference standards. If your agency is issuing or revising a regulation that contains a standard. your agency must follow these procedures:

a. Publish a request for comment within the preamble of a Notice of Proposed Rulemaking (NPRM) or Interim Final Rule (IFR). Such request must provide the appropriate information, as follows:

(1) When your agency is proposing to use a voluntary consensus standard, provide a statement which identifies such standard.

(2) When your agency is proposing to use a government-unique standard in lieu of'a voluntary consensus standard. provide a statement which identifies such standards and provides a preliminary explanation for the proposed use of a government-unique standard in lieu of a voluntary consensus standard.

(3) When your agency is proposing to use a government-unique standard. and no voluntary consensus standard has been identified. a statement to that effect and an invitation to identify any such standard and to explain why such standard should be used.

b. Publish a discussion in the preamble of a Final Rulemaking that restates the statement in the NPRM or IFR. acknowledges and summarizes any comments received and responds to them. and explains the agency's final decision. This discussion must provide the appropriate information, as follows:

(1) When a voluntary consensus standard is being used, provide a statement that identifies such standard and any alternative voluntary consensus standards which have been identified.

(2) When a government-unique standard is being used in lieu of a voluntary consensus standard, provide a statement that identifies the standards and explains why using the voluntary consensus standard would be inconsistent with applicable law or otherwise impractical. Such explanation must be transmitted in accordance with the requirements of Section 9a.

(3) When a government-unique standard is being used. and no voluntary consensus standard has been identified. provide a statement to that effect.

12. **What Are The Procedures For Reporting My Agency's Use Of Standards In Procurements?**

To identify, manage, and review the standards used in your agency's procurements, your agency must either report on a categorical basis or on a transaction basis.

a. **How does my agency report the use of standards in procurements on a categorical basis?**

Your agency must report on a category basis when your agency identifies. manages. and reviews the use of standards by group or category. Category based reporting is especially useful when your agency either conducts large procurements or large numbers of procurements using government-unique standards. or is involved in long-term procurement contracts which require replacement parts based on government-unique standards. To report use of government-unique standards on a categorical basis. your agency must:

(1) Maintain a centralized standards management system that identifies how your agency uses both government-unique and voluntary consensus standards.

(2) Systematically review your agency's use of government-unique standards for conversion to voluntary consensus standards.

(3) Maintain records on the groups or categories in which your agency uses government-unique standards in lieu of voluntary consensus standards. including an explanation of the reasons for such use. which must be transmitted according to Section 9a.

(4) Enable potential offerors to suggest voluntary consensus standards that can replace government-unique standards.

b. **How does my agency report the use of standards in procurements on a transaction basis?**

Your agency should report on a transaction basis when your agency identifies. manages, and reviews the use of standards on a transaction basis rather than a category basis. Transaction based reporting is especially useful when your agency conducts procurement mostly through commercial products and services. but is occasionally involved in a procurement involving government-unique standards. To report use of government-unique standards on a transaction basis, your agency must follow the following procedures:

(1) In each solicitation which references government-unique standards, the solicitation must:

(i) Identify such standards.

(ii) Provide potential offerors an opportunity to suggest alternative voluntary consensus standards that meet the agency's requirements.

(2) If such suggestions are made and the agency decides to use government-unique standards in lieu of voluntary consensus standards. the agency must explain in its report to OMB as described in Section 9a why using such voluntary consensus standards is inconsistent with applicable law or otherwise impractical.

c. For those solicitations that are for commercial-off-the-shelf products (COTS), or for products or services that rely on voluntary consensus standards or non-consensus standards developed in the private sector. or for products that otherwise do not rely on government-unique standards. the requirements in this section do not apply,

AGENCY RESPOSSIBILITIES

13. What Are The Responsibilities Of The Secretary Of Commerce?

The Secretary of Commerce:
a. Coordinates and fosters executive branch implementation of this Circular and, as appropriate, provides administrative guidance to assist agencies in implementing this Circular including guidance on identifying voluntary consensus standards bodies and voluntary consensus standards.

b. Sponsors and supports the Interagency Committee on Standards Policy (ICSP), chaired by the National Institute of Standards and Technology. which considers agency views and advises the Secretary and agency heads on the Circular.

c. Reports to the Director of OMB concerning the implementation of the policy provisions of this Circular.

d. Establishes procedures for agencies to use when developing directories described in Section 15b(5) and establish procedures to make these directories available to the public.

e. issues guidance to the agencies to improve coordination on conformity assessment in accordance with section 8.

14. What Are The Responsibilities Of The Heads Of Agencies?

The Heads of Agencies:
a.. Implement the policies of this Circular in accordance with procedures described.

b. Ensure agency compliance with the policies of the Circular.

c. In the case of an agency with significant interest in the use of standards. designate a senior level official as the Standards Executive who will be responsible for the agency's implementation of this Circular and who will represent the agency on the ICSP.

d. Transmit the annual report prepared by the Agency Standards Executive as described in Sections 9 and 15b(6).

15. What Are The Responsibilities Of Agency Standards Executives?

An Agency Standards Executive:
a. Promotes the following goals:

(1) Effective use of agency resources and participation.

(2) The development of agency positions that are in the public interest and that do not conflict with each other.

(3) The development of agency positions that are consistent with administration policy.

(4) The development of agency technical and policy positions that are clearly defined and known in advance to all federal participants on a given committee.

b. Coordinates his or her agency's participation in voluntary consensus standards bodies by:

(1) Establishing procedures to ensure that agency representatives who participate in voluntary consensus standards bodies will. to the extent possible, ascertain the views of the agency on matters of paramount interest and will. at a minimum, express views that are not inconsistent or in conflict with established agency views.

(2) To the extent possible, ensuring that the agency's participation in voluntary consensus standards bodies is consistent with agency missions. authorities, priorities, and budget resources.

(3) Ensuring. when two or more agencies participate in a given voluntary consensus standards activity, that they coordinate their views on matters of paramount importance so as to present, whenever feasible, a single, unified

position and, where not feasible. a mutual recognition of differences.

(4) Cooperating with the Secretary in carrying out his or her responsibilities under this Circular.

(5) Consulting with the Secretary, as necessary, in the development and issuance of internal agency procedures and guidance implementing this Circular. including the development and implementation of an agency-wide directory identifying agency employees participating in voluntary consensus standards bodies and the identification of voluntary consensus standards bodies.

(6) Preparing. as described in Section 9. a report on uses of government-unique standards in lieu of voluntary consensus standards and a report on the status of agency standards policy activities.

(7) Establishing a process for ongoing review of the agency's use of standards for purposes of updating such use.

(8) Coordinating with appropriate agency offices (e.g., budget and legal offices) to ensure that effective processes exist for the review of proposed agency support for. and participation in. voluntary consensus standards bodies, so that agency support and participation will comply with applicable laws and regulations.

SUPPLEMENTARY ISFORMATION

16. When Will This Circular Be Reviewed?

This Circular will be reviewed for effectiveness by the OMB three years from the date of issuance.

17. What Is The Legal Effect Of This Circular?

Authority for this Circular is based on 31 U.S.C. 1111. which gives OMB broad authority to establish policies for the improved management of the Executive Branch. This Circular is intended to implement Section 12(d) of P.L. 104-113 and to establish policies that will improve the internal management of the Executive Branch. This Circuiar is not intended to create delay in the administrative process. provide new grounds for judicial review, or create new rights or benefits, substantive or procedural. enforceable at law or equity by a party against the United States. its agencies or instrumentalities. or its officers or employees.

18. Do You Have Further Questions?

For information concerning this Circular. contact the Office of Management and Budget. Office of Information and Regulatory Affairs: Telephone 202/395-3785.

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Corporate Governance

Publications:

SEC's Proposed Rule on Supplementary Financial Information

BRT response to SEC Concept Release on International Accounting Standards

Release No. 33-8089, Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, File No. S7-08-02

Principles of Corporate Governance

Statement Of The Business Roundtable On Corporate Governance Principles Relating To The Enron Bankruptcy

Testimony of Curtis H Barnette Before SEC Blue Ribbon Committee

SEC SAB 99 Conference Call Possible Questions

Chairman Dillon Lerter to Grasso at NYSE

Selective Disclosure Statement by The Business Roundtable to the SEC

The Business Roundtable Corporate Governance Survey Highlights July 2003

The Business Roundtable, in an effort to measure the corporate governance reforms and improvements undertaken by its member companies since the enactment of last year's Sarbanes-Oxley Act and the proposed New **York** Stock Exchange Listing Standards. commissioned a survey of its 150 members in June 2003.

Highlights

1. **Board Independence:** Eight in 10 of Roundtable companies report that their boards of directors are at least 75 percent independent, and nine in 10 report that at least two-thirds of their directors are independent.

   In the absence of a legal requirement, 55 percent of Roundtable companies have (or will have by the end of 2003) an Independent Chairman, Independent Lead Director or Presiding Outside Director. This represents an increase of **122** percent from 2002.

2. **Director** Education: Ninety percent of Roundtable companies now encourage. require, or have in place director education programs for new (54 percent), and in some cases all (36 percent). directors, compared to 76 percent in 2002.

3. **Director** Evaluation: Over 70 percent of Roundtable companies performed director evaluations in 2003, compared with 44 percent in 2002.

4. **Executive Session:** The outside directors of **97** percent of Roundtable members are meeting in executive session at least once each year, and 55 percent expect to do so at least five times this year

5. **Increased Information and Involvement:** Roundtable companies report that the amount of company-related information sent to the board of directors and members of the Audit, Compensation and Nominating Committees increased in 2003, as did Director involvement in Board and Committee meetings:
   - In the past year, **77** percent increased the amount of information sent to their board of directors. and **88** percent increased the amount sent to members of the Audit. Compensation or Nominating Committees.
   - In the past year. 91 percent reported increased involvement by the board of directors, and **88** percent reported increased involvement by members of the Audit, Compensation, or Nominating Committees.

6. **Shareholder** Communication: In the absence of a legal requirement. Roundtable companies are recognizing the need to have formal processes to address the issue of shareholder communication:

RE: Vote for S. 2673 . Public Company Accounting Reform and Investor Protection Act of 2002

PCAOB-Proposed Auditing Standard-Sec.404 of > Sarbanes-Oxlev

Business Roundtable comments on Sec. 404 of Sarbanes-Oxley Act

Business Roundtable comment letter to OMB re: Proposed rule regarding security holder director nominations

Transcript of Conference Call: Principles of Executive Compensation

The Business Roundtable Hosts Conference Call with SEC on "Fair Disclosure" Regulation

The Business Roundtable Hosts Conference Call with SEC on Auditor Independence

The Business Roundtable - SEC SAB 99 Conference Call Transcript

Re: Release No. 33-8154, Strengthening the Commission's Requirements Regarding Auditor Independence, File No. S7-49-02

Letter to the SEC regarding proposed rules on shareholder access

Comments to the SEC on Proposed Disclosure Rules

The Business Roundtable Corporate Governance Forum "Taking Stock and Looking Ahead"

- Two-thirds (66 percent) of Roundtable companies reported that their Nominating/Governance Committees have a process in place by which to communicate and respond to shareholder nominations of board candidates.
- Two-thirds (66 percent) of Roundtable members have discussed with the Nominating Committee a process to communicate and respond to shareholder proposals and inquiries.

7. **Commitment of Member Companies:** While estimating the cost is difficult, Roundtable member companies who were able to do so report dedicating financial resources between $1 million to over $10 million to ensuring the implementation of the Sarbanes-Oxley Act and proposed NYSE listing standards. Fifty percent of those companies estimate commitments between $1 million and $5 million to satisfactorily meet the criteria of the Sarbanes-Oxley Act.

The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

July 15, 2003

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Enough is enough.

A message to the American people from **America's** CEOs.

Re:Release No. 33-8 186, Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, File No. S7-45-02

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Fluor Will Expense Stock Options Once New Accounting Rules in Effect

May 09,2003

ALISO VIEJO, Calif. – May 9, 2003 – Fluor Corporation's (NYSE:FLR) **board** of directors today announced that the company will commence with the expensing of company stock options once new accounting standards are in place. The board's decision was made following consideration of a non-binding, shareholder proposal to expense the costs of all future **stock** optians in **the** company's earnings statements. The proposal, submitted by the United Brotherhood of Carpenters Pensions Fund, was approved *at* Fluor's annual shareholders meeting.

The Financial Accounting Standards Board recently voted to require companies to expense stock options and is currently studying issues related to the accounting for stock options, including valuation and transition issues. The FASB said it expects to have a new rule in place sometime next year.

"The change to Fluor's current accounting practices will occur when the ongoing uncertainty is resolved by adoption of uniform accounting standards," said Peter J Fluor, lead independent director of Fluor's board "In the meantime, Fluor could be **placed** at a significant competitive disadvantage, if it were to begin recognizing stock option expense in its earntngs statements when most, if not all, of Fluor's competitors do not"

"Fluor's formal consideration of expensing stock options was a positive and prudent response to the shareholder vote," said Ed Durkin, a Carpenters' spokesperson "We want to send a signal to political **and** business leaders, as well as the FASB, that it's time for action on an accounting standard requiring option expensing. But, our proposal was non-binding because we do not believe that an individual company should be compelled to expense options while its industry peers do not."

In accordance with generally accepted accounting practices. Fluor currently discloses what the impact of expensing stock options would be on company earnings in the notes to its financial statements The vast majority of corporations use this method to provide information relating to the impact of the expensing of stock options

Fluor Corporation (NYSE FLR) provides services on a global basis in the fields of engineering, procurement, constructton, operations. maintenance and project management Headquartered in Aliso Viejo Calif, Fluor is a Fortune 500 company with revenues of $10 billion in fiscal year 2002 For more information, visit www.fluor.com

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news release

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HP Board Declares Regular Dividend, Adopts New Policies

PALO ALTO, CALIF., JULY 21, **2003**

The board of directors of HP (NYSE:HPQ) today declared a regular cash dividend. The board also adopted new policies for senior executive severance agreements and shareowner rights plans (also known as poison **pills).**

HP's board declared a regular cash dividend of 8 cents per share on the company's common stock. The dividend, the fourth in HP's fiscal year 2003, is payable on Oct. 8, 2003, to shareholders of record as of the close of business on Sept 17, 2003 HP has approximately 3 billion shares of common stock outstanding.

The **new** policies are a result of a process that began following the company's annual meeting of shareowners held in April. **At** the meeting. advisory shareowner proposals relating to severance agreements and poison pills were approved by **a** majority of shares present and entitled to vote, and HP announced that it would duly consider these recommendations.

Under the new severance policy, HP will **seek** shareowner approval for future severance agreements, if any, with senior executive officers that provide specified benefits in an amount exceeding 2.99 times the sum of the executive's base salary plus bonus.

HP also announced that its board will submit any poison pill to a shareowner vote, unless the Board, exercising its fiduciary duties under Delaware law. determines that such a submission would not be in the interests of shareowners under the circumstances HP does not have a poison pill in place

About HP

HP delivers vital technology for business and life The company's solutions span IT infrastructure, personal computing **and** access devices global services and imaging and printing for consumers, enterprises **and** small and medium **business** For the last four quarters, HP revenue totaled $70 **4** billion More information about HP is available at http //www hp com

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This document contains forward-looking statements that involve risks and uncertainties as well as assumptions that. if they never materialize or prove incorrect could cause the results of HP and **its** consolidated subsidiaries to differ materially from those expressed or implied by such forward-looking statements **All** statements other than statements of historical fact are statements that could **be** deemed forward-looking statements tncluding any statements of the plans. intentions or expectations of the company for future events and any statement of assumptions underlying any of the foregoing The risks, uncertainties and assumptions referred to **above** include future circumstances impacting the board's fiduciary duties and other risks that are described from time to time in HP's Securities **and** Exchange Commission reports. including **but** not limited to HP's quarterly report **on** Form 10-Q for the quarter ended April 30, 2003, and subsequently filed reports If any of these risks or uncertainties materializes or any of these assumptions proves incorrect, results could differ materially from the expectations in these statements HP assumes **no** obligation to update these forward-looking statements

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tyco

General News Releases

TYCO ADOPTS NEW POLICIES ON EXECUTIVE AND DIRECTOR COMPENSATION

Board Limits Executive Severance, Sets Requirements for Stock Ownership and Revises compensation Structure for Directors

PEMBROKE, Bermuda, July 11, 2003 -- Tyco International Ltd. (NYSE: TYC, BSX: TYC, LSE: TYI) today announced that its Board of Directors has adopted limits on severance and change-in-control agreements for senior executives. The Board has also adopted guidelines that require senior executives (e.g., "Section 163 officers" as defined by the Securities and Exchange Commission) to retatn a minimum percentage of shares acquired through equity awards and, over time, to hotd certain amounts of Tyco common stock. In addition, the Board has revised the compensation structure for directors.

Prior to today's action, the Company had no official corporate policy on severance and no requirement for stock ownership by its senior management or Board.

The severance and change-in-control policies will be applied to future severance agreements. The major provisions of these policies include:

- Senior Executives will be limited to cash severance of two times base salary and bonus at the time of termination and payments of 2.99 times base salary and bonus in a change-of-control situation.
- Post-employment benefits will be limited to outplacement services and transitional health benefits, with no provisions for consulting contracts, airplane usage, offices or other perquisites

The new minimum ownership guidelines range from two times base pay for Senior Vice Presidents to ten times base pay for the Chief Executive Officer. These officers will be required to retain at least 75% of vested stock and shares acquired on option exercises (net of taxes) until certain minimum guidelines are met and to retain at least 25% thereafter. Executives may reach this target over a multi-year period.

The princtpal changes in directors' compensation are to move the equity part of their Compensation from stock options to stock units that vest at their retirement from the Board and to recognize the added responsibilittes of certain Board roles. Total cornpensation for non-chair directors will not change. The major provisions of their compensation structure include:

- The cash compensation for individual members will remain at $80,000 per year.
- Directors will also receive $120,000 per year in deferred stock units ("DSU's") that will be paid out in shares onty at the time of a directors retirement from the Board Directors were previously paid a comparable value in the form of stock options.
- Additional retainers will be granted for committee chairs, including $20,000 for Audit Committee Chair, $15,000 for the Compensation or Governance Committee Chair and $20,000 fnr the Lead Director

Chair and $20,000 for the Lead Director.

Chairman and CEO Ed Breen said: "At the time of our Annual Meeting, we told our shareholders that our new Board would develop a severance policy as part of its review of the Company's governance program. We have now fulfilled that commitment. In addition, the Board has adopted guidelines that require Tyco's senior executives and directors to maintain certain levels of Company stock, thereby ensuring that the interests of Tyco's leadership and shareholders are completely aligned. We believe these policies further our goal of establishing clear and transparent standards for all aspects of Tyco's management so that our investors know that we are acting on their behalf."

ABOUT TYCO INTERNATIONAL LTD.

Tyco International Ltd. is a diversified manufacturing and service company. Tyco is the world's largest manufacturer and servicer of electrical and electronic components; the world's largest designer, manufacturer, installer and servicer of undersea telecommunications systems; the world s largest manufacturer, installer and provider of fire protection systems and electronic security services and the world's largest manufacturer of specialty valves Tyco also holds strong leadership positions in medical device products, and plastics and adhesives. Tyco operates in more than 100 countries and had fiscal 2002 revenues from continuing operations of approximately $36 billion.

FORWARD LOOKING STATEMENTS

This release may contain certain "forward- looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. These statements are based on management's current expectations and are subject to risks, uncertainty and changes in circumstances, which may cause actual results, performance or achievements to differ materially from anticipated results, pertormance or achievements. All statements contained herein that are not clearly historical in nature are forward looking and the words "anticipate," "believe," "expect,' ' estimate," "plan," and similar expressions are generally intended to identify forward-looking statements The forward-looking statements in this release include statements addressing the following subjects: future financial condition and operating results Economic, business, competitive and/or regulatory factors affecting Tyco s businesses are examples of factors, among others, that could cause actual results to differ materially from those described in the forward-looking statements.

More detailed information about these and other factors is set forth in Tyco's Annual Report on Form 10-K for the fiscal year ended September 30, 2002, and in Tyco's Quarterly Report on Form 10-Q for the quarter ended March 31, 2003. Tyco is under no obligation to (and expressiy disclaims any such obligation to) update or alter its forward-looking statements whether as a result of new Information, future events or otherwise.

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News Releases
Union Pacific's Board of Directors Restricts Executive Severance

Omaha, NE, Oct. 3, 2003 – The board of directors of Union Pacific Corporation (NYSE: UNP) has adopted a new policy that prohibits severance agreements with senior executives that exceed certain limitations unless such agreements are approved by a vote of the Corporation's shareholders.

The new policy is a result of a review process that began following the Corporation's annual meeting of shareholders in April. At the meeting, a shareholder proposal relating to severance agreements was approved by a majority of shares present and entitled to vote.

Under the new policy, Union Pacific will seek shareholder approval for future severance agreements, if any, with senior executive officers that provide specified benefits in an amount exceeding 2.99 times the sum of the executive's base salary plus bonus. A copy of the policy is available on our Web site at: **http://www.up.com/investors/governance**

Union Pacific Corporation is one of America's leading transportation companies. Its principal operating company, Union Pacific Railroad, is the largest railroad in North America, covering 23 states across the western two-thirds of the United States. A strong focus on quality and a strategically advantageous route structure enable the company to serve customers in critical and fast growing markets. It is a leading carrier of low-sulfur coal used in electrical power generation and has broad coverage of the large chemical-producing areas along the Gulf Coast. With competitive long-haul routes between all major West Coast ports and eastern gateways, and as the only railroad to serve all six gateways to Mexico, Union Pacific has the premier rail franchise in North America. The Corporation's trucking operations include Overnite Corporation, which owns less-than-truckload carriers Overnite Transportation and Motor Cargo.

For more information, contact Kathryn Blackwell at (402) 271-3753.

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Tuesday, October 8, 2002

LABOR-MANAGEMENT RELATIONS IN GLOBAL ECONOMY
CHARLES I. COHEN

Statement of Charles I. Cohen Senior Partner, Morgan, Lewis & Bockius LLP

Employer-Employee Relations Subcommittee Committee on House Education and the Workforce

October 8, 2002

Chairman Boehner, Chairman Johnson, and Members of the Subcommittee, I am pleased and honored to be here today. Thank you for your kind invitation.

By way of introduction, I was appointed by President Clinton and served as a Member of the National Labor Relations Board from March 1994 until my term expired in August 1996. Before becoming a Member of the aoard, I worked for the NLRB in various capacities from 1971 to 1979 and as a labor lawyer representing management in private practice from 1979 to 1994. Since leaving the Board in 1996, I have returned to private practice and am a Senior Partner in the law firm of Morgan, Lewis & Bockius LLP. I am a member of the Labor Relations Committee of the U.S. Chamber of Commerce, and Chair of its NLRB subcommittee, and am testifying today on behalf of the U.S. Chamber of Commerce.

The National Labor Relations Act was enacted in 1935 and has been substantially amended only twice --once in 1947 and once in 1959. Nonetheless, the Act continues to strike the balance in labor relations that its drafters intended The Act guarantees important rights to employees, employers, and unions The fundamental precept in industrial democracy is premised on a majority of employees in a collective bargaining unit freely selecting a union as their bargaining representative. Because all employees in that unit are bound by the decision of the majority, it is especially important that the employees are informed about the possible consequences of their choice, and that their right not to be represented by a union be respected. Once a union is duly designated, the Act provides a framework for both sides to work out, through collective bargaining. the terms and conditions applicable to employees in collective bargaining units.

Recent times, however, have seen a remarkable shift in the labor relations landscape --a shift caused in large part by the need for U.S. corporations to remain competitive in a global economy. Although unions

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remain strong in many traditionally unionized industries (steel, coal, airlines --to name a few), union density has decreased precipitously to the point where only about 9 percent of the American private sector workforce is represented by a union.

Union leadership has been unable to combat this trend through traditional methods --namely, through union organizing campaigns and NLRB-conducted secret ballot elections. Therefore, union leadership has turned to two controversial approaches (or techniques) to bolster their position among working Americans, and to firmly entrench unions in the landscape of American industry. It is a tremendous understatement to state that these techniques have serious implications for the future of labor relations, and they warrant the attention of the U.S. Congress, which is why I have accepted your invitation to appear here today.

The first approach unions have taker. to combat their decreased density in American industry is the use of "corporate campaigns" as a way of obtaining and then exerting their influence over employees and over management. The corporate campaign is an alternative approach to the traditional forms of expression by unions representing employees or by unions seeking recognition --namely, collective bargaining, picketing, and strike activity. Corporate campaigns take many forms, but typically involve unions' attempts to enlist the media and public interest groups to influence public opinion and to rally support for union organizing and other union causes. Corporate campaigns often attempt to have the target company and its officials portrayed as villains by investors, customers, vendors, employees, an5 the public at-large.

It is often observed that although corporate campaigns are by no means new, their use has greatly intensified and has become much more sophisticated over time. Unions have developed innovative strategies to exert pressure on employers. Corporate 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.

The goals and tactics of union corporate campaigns are diametrically opposed to the current regime of federal labor relations laws, which exist to facilitate the equitable balance of the interests of management, employees, and unions When properly aligned, labor relations can result in win-win situations Businesses thrive, jobs are created, and employee satisfaction is high. This prosperous situation is less likely to occur under a corporate campaign regime. One of the principal differences between the traditional forms of union expression and the corporate campaign is that while collective bargaining is premised on labor having some or all of its views adopted voluntarily by management after a perioa of collective bargaining, the corporate campaign often is premised on management either being coerced into accepting a union's demands or potentially being driven out of business. It is no wonder that it has beer. recognized that corporate campaign strategies are divisive, threaten the viability of companies and jobs, and are at odds with the need for employer-employee cooperation in the

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workplace to meet the demands of global competition. And, in this shrinking global environment, corporate campaigns can be utilized internationally, with efforts made to unfairly portray law-abiding companies as international outlaws.

The second approach used by unions to stem the tide of their declining membership is the use of a so-called "bargaining to organize" strategy resulting in neutrality agreements and especially card check agreements. The term "neutrality agreement" is an umbrella term, and like corporate campaigns, generally represents the national labor movement's attempt to jumpstart union organizing by having one-sided organizing campaigns and eliminating secret ballot NLRB elections.

Neutrality agreements contain built-in provisions designed *to* ensure uniori success in organizing, including automatic recognition based on authorization card designations, as well as requirements that the neutrality provisions apply to corporate affiliates of the company that actually enters into the neutrality agreements. In essence, neutrality agreements --although they take many forms and cover a wide range of issues --enable unions to utilize their considerable leverage at the bargaining table with already represented employers, or to utilize their political leverage with state and local governments, to obtain organization tools not provided for in our federal laws. Over the past decade, neutrality agreements have quickly become part of the contemporary labor relations landscape and are an issue of the highest priority to major national unions. Neutrality agreements especially have become prevalent in the telecommunications, steel, auto, hotel, and gaming industries.

There are many kinds of neutrality agreements, and they tend to differ significantly in complexity and level of sophistication. To label a neutrality agreement as requiring only neutrality during an organizing campaign, however, would fail to capture the high degree of complexity, breadth of coverage, or potential intrusiveness into a company's operations that these agreement5 actually involve. Neutrality agreements typically go far beyond a company remaining neutral in the face of a union organizing drive.

The advantages to unions in obtaining neutrality agreements are apparent They help unions increase membership without the need for the lengthy, expensive, and ultimately unpredictable process of industrial democracy culminating in an NLRB-conducted secret ballot election process. In fact, to the extent unions are successful in getting neutrality clauses and card check agreements, the NLRB is almost entirely removed from the process The consequences to the labor relations process, however, car, be startling. Free choice by employees with respect to union representation is a basic tenet of U.S. labor laws. Corporate campaigns conducted with the aim of securing neutrality agreemenrs, card check agreements, or ocher procedural concessions from the employer --with the ultimate goal of obtaining representation status without a fully informed electorate and without a secret ballot election

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--in fact undermine the right of free choice.

Union corporate campaigns and neutrality agreements are thus part of the same disturbing trend in labor relations. Unable to win while playing by the well-established rules of the National Labor Relations Act and the National Labor Relations Board, unions and union organizers and their representatives have turned to corporate campaigns and neutrality agreements to circumvent the federal labor laws. In so doing, unions endeavor to make up for the fact that in today's environment, employees --when given the right to choose of their own accord after being fully informed --choose to reject union representation roughly half the time.

Particularly troublesome is what *is* occurring in the Trico Marine situation. We see there the three legs of the stool of avoiding our established procedures for accepting or rejecting union representation: a corporate campaign, pressure to accept a neutrality agreement and card check recognition, and international pressure including a lawsuit in a Norwegian court to permit a crippling of Trico's international operations. Indeed, I intend to testify next month in a Norwegian court on behalf of Trico Marine to explain to the court our finely balanced labor laws as that court considers whether a boycott of Trico Marine should be sanctioned in Norway because of Trico's actions in Louisiana.

This concludes my prepared oral testimony. I look forward to discussing my comments in more detail during the question and answer period, but before that, I would again like to thank the committee for inviting me here today, and for its attention to these very important developments regarding labor relations in the 21st century.

---- INDEX REFERENCES ----

COMPANY (TICKER): Morgan, Lewis & Bockius (X.MLB)

ORGANIZATION: MORGAN, LEWIS & BOCKIUS LLP $65:EMPLOYER-EMPLOYEE RELATIONS

NEWS SUBJECT: English language content; Transcript, Content Types; Labor/Personnel Issues; Corporate/Industrial News; Labor Issues, Management Issues; Global/World Issues; Political/General News ENGL NTRA NCAT C42 CCAT LAB MNT GGLOBE GCAT

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SUMMARY OF THE NOVEMBER 2003 SURVEYS

In November 2003, members of the Business Roundtable and the American Society of Corporate Secretaries were surveyed regarding the Commission's Proposed Election Contest Rules (the "November 2003 Surveys"). As of December 18, 2003, 137 companies had responded to the November 2003 Surveys.

1. WITHHOLD VOTES

A. 24 out of 135 of the companies that answered, or 17.8%, responded that they had directors who had received greater than 20% withhold votes in at least one of the last two years. (Two of the returned surveys had no response to this question.)

B. Of the 24 companies with greater than 20% withhold votes:

- At 23, or 95.8%, of those receiving greater than 20% withhold votes, Institutional Shareholder Services (ISS) recommended a withhold vote.
- At 1, or 4.2%, of those receiving greater than 20% withhold votes, ISS did not recommend a withhold vote.

2. MAJORITY VOTES

A. 36 out of 132, or 27.3%, of the companies responding to the question on majority votes had received a majority vote on a shareholder proposal. (Four of the returned surveys had no response to this question, and one company responded that it did not receive any shareholder proposals.)

B. Of the 36 companies with majority votes on shareholder proposals, the subjects of the proposals were:

Redeem/shareholder approval of poison pill	22 (41.5% of total majority votes)
De-classify board	12 (22.6%)
Supermajority voting	6 (11.3%)
Expensing stock options	6 (11.3%)
Severance agreements/executive compensation	4 (7.5 %)
Presiding director	1 (1.9 %)
Confidential shareholder voting	1 (1.9%)
unknown	1 (1.9%)

(Note that some companies had more than one majority-vote shareholder proposal.)

C. Of the 36 companies with majority-vote shareholder proposals, 100% of companies' boards considered whether to implement the proposal.

3. NUMBER OF DIRECTORS

Of the **137** companies responding regarding the number of directors on their board of directors:

- **16**, or **11.7%**, have 1-8 directors;
- **121,** or **88.3%**, have 9-19 directors; and
- **0** have 20+ directors.

4. INSTITUTIONAL INVESTOR VOTING PRACTICES

A. Of the **113** companies responding to this question, **108** were able to give a rough estimate **or** range of percentages of shares voted by institutional investors that follow ISS's voting guidelines. The other **5** noted that a majority of shares followed **ISS,** a number of their top institutional holders followed **ISS,** or they were unable to estimate but had few institutional investors. The average percentage **of** shares voted by institutional investors that follow **ISS** is **40%.** Note that some companies giving percentages stated that, although the institutional investors subscribed to **ISS,** they may only partially follow ISS's voting guidelines.

B. **39** companies specifically indicated that one or more of their institutional investors communicated to the company their adherence to ISS voting guidelines or that the company had knowledge that the institutions adhered to **ISS** guidelines **at** least partially. This represents ***65%*** of the **60** companies providing any anecdotal or company-specific information on communicating with institutional investors in connection with **proxy** voting matters.

5. TIME AND COSTS

A. Much of the Commission's cost estimate appears driven by its assumptions about the number of companies affected. **Even** for companies that the Commission assumed to be affected, moreover, it assumed a very low average burden per company. For Paperwork Reduction Act purposes, the Commission assumed an average of ½ hour to 22% hours per form, including time for both company personnel and outside professionals.[1] Based on assumptions such as these, the Commission's cost-benefit analysis assumes a bottom-line total of 130 companies affected, each of which would **be** required to invest an average of approximately 14 hours of time and $1,200 of cost

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[1] 68 Fed. Reg. **60,784, 60,812** (Oct. **23,2003).**

for company personnel at $85 per hour, and 10 hours of time and $3,000 in expense for outside professionals' time at $300 per hour.[2]

Although the Commission's summary does not explain exactly how these estimates were derived, the estimates do not appear to be grounded in empirical data. In fact, the Commission admits that many of its figures "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 would be able to meet the applicable requirements (*e.g.*, minimum ownership threshold)."[3] For three of the eight forms, the Commission assumed that all incremental work could be completed in less than an hour. The Commission furthermore assumed that company personnel would perform 75% of the incremental work with outside professionals performing the remaining 25% of the work on these forms. Accordingly, the Commission assumed that outside professionals would complete their work in an average of 8 to 13 minutes.[4]

To test the reasonableness of the Commission's assumptions, the November 2003 Surveys included a series of questions in which individual companies estimated the time and cost that would be associated with various aspects of compliance with the Proposed Election Contest Rules. The questions and resulting answers are set forth in the chart below.

Several important observations are pertinent to a full understanding of these results. First, the responses to the November 2003 Surveys in many cases required an element of interpretation. These compilations were performed in a conservative manner that, if anything, would understate the respondents' true projected costs. When the respondent provided a range of hours or cost, the midpoint of this range was used to calculate averages. When the respondent stated that hours or costs would be "at least" or "more than" a certain amount, the base amount was included in the average without upward adjustment, but when the respondent stated that hours or costs would be "at most" or "less than" a certain figure, the average was computed based on the midpoint between the given figure and zero. When the response reported time or cost "per person," and the number of relevant individuals could not be easily ascertained, the time or cost was applied to a minimal number of individuals, and in many cases to just one individual.

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[2] 68 Fed. Reg. at 60,814.

[3] 68 Fed. Reg. at 60,811.

[4] *Id.* The 8-13 minute average was derived by multiplying the total allocation for the lowest three of the eight incremental hours/form estimates in Table 1, 68 Fed. Reg. 60,812, by the 25% portion attributed to outside professional work.

As one might expect, estimates varied widely from one respondent to the next. To a great extent, this variance may reflect differences in size, approach, and other factors. Nonetheless, even with this variance, the volume of responses provides a database of sufficient size to establish that the Commission's estimates are severely understated. For example, the average estimated burden for company personnel upon "the occurrence of a trigger (*e.g.*, a shareholder access proposal from a greater than 1% holder or a 35% withhold vote for a director)" was 89.5 hours and **$39,363** per company – many multiples higher than the Commission's assumed average impact for the entire rule. By applying a simple statistical confidence level test to the data, it can be shown with 95% confidence that the actual average falls in an interval between 68-111 hours and $26,000-$53,000 in incremental costs. Even the lowest ends of these ranges are approximately five times higher than the Commission's estimate for company personnel activity – including all aspects of the rule – and more than 20 times higher than the Commission's company personnel cost estimate. Estimates for outside professionals are similarly understated.

The following outline summarizes the responses obtained from the November 2003 Surveys.

B. DETAILED RESULTS FROM THE NOVEMBER 2003 SURVEYS

WHAT WILL BE THE AVERAGE HOURS REQUIRED AND ASSOCIATED COSTS FOR:	HOURS REQUIRED:	ASSOCIATED COSTS:
Preparing and submitting a no-action letter request to the SEC regarding a shareholder proposal?	**30.8 hours** (*3360.5* hours/ **109** companies responding)	**$13,896** ($1,431,282/ 103 companies responding)
Printing and mailing one shareholder proposal in your proxy materials?	**34.0 hours** (3023.5 hours/ **89** companies)	**$15,324** ($1,547,762/ **101** companies)
In connection with opposing the occurrence of a trigger (*e.g.,* a shareholder access proposal from a greater than 1% holder *or* a 35% withhold vote for a director), please estimate the hours and associated costs:		
• Company personnel (including executives)?	**89.5 hours** (8324.5 hours/ 93 companies responding)	**$39,363** ($3,109,700/ 79 companies responding)

WHAT WILL BE THE AVERAGE HOURS REQUIRED AND ASSOCIATED COSTS FOR:	HOURS REQUIRED:	ASSOCIATED COSTS:
• Directors?	**13.4 hours** (1191.5 hours/ 89 companies)	**$11,971** ($706,300/ 59 companies)
• Outside counsel?	**54.2 hours** (4391 hours/ 81 companies)	**$23,138** ($1,989,8501 **86** companies)
• **Proxy** solicitor?	**105.2 hours** **60 companies)**	**$77,864** 79 companies)
• Financial printer?	**9.9 hours** (**426** hours/ **43** companies)	**$16,757** ($1,206,550/ 72 Companies)
• Mailing costs?	**10.7 hours** (171.5 hours/ **16** companies)	**$97,800** (5,867,980/ 60 companies)
• Average total of specified hours and costs:	**192.3 hours** (192.3 hours/ **92** companies)	**$162,299** ($15,256,150/ **94** companies)
• Other: Outside experts	(0 companies)	**$25,000-$100,000** (1 company)
• Other: Follow-up mailings	(0 companies)	**$40,000** (1 company)
• Other: NOBO list (non-objecting beneficial owners)	(0 companies)	**$20,000-$25,000** (1 company)
• Other: Transfer **agent** tabulation services, inspector of election	**150 hours** (1 company)	**$100,000** (1 company)

WHAT WILL BE THE AVERAGE HOURS REQUIRED AND ASSOCIATED COSTS FOR:	HOURS REQUIRED:	ASSOCIATED COSTS:
• Other: Independent tabulator extra charges for contested situations	(0 companies)	**$5,000-$10,000** (1 company)
• Other: Transfer agent/ADP assistance	**5-10** (1 company)	(0 companies)
In connection with opposing a shareholder access nominee and supporting the company's nominees for director (once shareholder access is triggered), please estimate the hours and associated costs:[5]		
• Company personnel (including executives)?	**182.7 hours** (15,527/ 85 companies responding)	**$69,497** ($5,212,260/ 75 companies responding)
• Directors?	**21.6 hours** (1729/ 80 companies)	**$26,239** ($1,416,900/ 54 companies)
• Outside counsel?	**59.4 hours** (4218.5/ 71 companies)	**$44,460** ($3,512,350/ 79 companies)
• Proxy solicitor?	**126.8 hours** (6217.5/ 53 companies)	**$136,292** ($10,767,050/ 79 companies)
• Financial printer?	**16.2 hours** (665/ 41 companies)	**$31,854** (2,420,900/ 76 companies)

[5] In connection with opposing a shareholder access nominee and supporting the company's nominees for director (once shareholder access is triggered), companies that noted that they had experienced a proxy contest within the last two years had a significantly higher average estimate of burdens and costs than those that had not.

WHAT WILL BE THE AWRAGE HOURS REQUIRED AND ASSOCIATED COSTS FOR:	HOURS REQUIRED:	ASSOCIATED COSTS:
• Mailing costs?	**13.9 hours** (236/ 17 companies)	**$168,442** ($10,948,710/ 65 companies)
• Average total of specified hours and costs:	**323.9 hours** (27208.5 hours/ 84 companies)	**$580,321** ($52,809,170/ 91 companies)
• Other: Transfer agent/ADP assistance	**5-10 hours** (1 company)	(0 companies)
• Other: Follow-up mailings	(0 companies)	**$40,000** (1 company)
• Other: Second mailing to shareholders	**160 hours** (I company)	**$1.5 million** (1 company)
• Other: Investigation/background check of shareholder nominee	**17.5 hours** (35 hours/ 2 companies)	**$42,500** ($85,000/ 2 companies)
• Other: NOBO list	(0 companies)	**$20,000-$25,000** (1 company)
• Other: Higher ADP proxy fees	(0 Companies)	**$800,000** (1 company)
• Other: Public relations firm	(0 companies)	**$100,000-$150,000** (1 company)
• Other: Advertising (if circumstances warrant)	(0 companies)	**$283,333** ($850,000/ 3 companies)
• Other: Independent tabulator	(0 companies)	**$10,000-$20,000** (1 company)

WHAT WILL BE THE AVERAGE HOURS REQUIRED AND ASSOCIATED COSTS FOR:	HOURS REQUIRED:	ASSOCIATED COSTS:
• Other: Unspecified	(0 companies)	**$5,000 and $100,000-$1 million** (2 companies)

C. In response to **a** question **asking** for estimates of internal hours and associated costs spent on a **proxy** contest if they had experienced one in the **past** two **years,** only **five** companies responded. Among those responses, estimated internal **costs** were as high **as** $240,000, while estimated total costs of proxy contests exceeded $15 million.

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New York Stock Exchange GUIDE

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Signed proxies for stock in names of other member organizations

A member organization which has in its possession or control stock registered in the name of another member organization, arid which desires to transmit signed proxies pursuant to the provisions of Rule 451(b)(2) [¶ 24511, shall obtain the requisite number of signed proxies from such holder of record.

Amendments.

January 11,1968.

August 25,1994.

● ● ● *Supplementary Material:*

Giving a Proxy To Vote Stock

.10 When member organization may vote without customer instructions.—Rule 452, above, provides that a member organization may give a proxy to vote stock provided that:

(1) It has transmitted proxy soliciting material to the beneficial owner of stock or to the beneficial owner's designated investment adviser in accordance with Rule 451 [¶ 24511, and

(2) it has not received voting instructions from the beneficial owner or from the beneficial owner's designated investment adviser, by the date specified in the statement accompanying such material, and

(3) the person in the member organization giving or authorizing the giving of the proxy has no knowledge of any contest as to the action to be taken at the meeting and provided such action is adequately disclosed to stockholders and does not include authorization for a merger, consolidation of any matter which may affect substantially the rights or privileges of such stock.

Amendments.

January 11,1968.

August 25, 1994.

.11 When member organization may not vote without customer instructions.—In the list of meetings of stockholders appearing in the Weekly Bulletin, after proxy material has been reviewed by the Exchange, each meeting will be designated by an appropriate symbol to indicate either (a) that members may vote a proxy without instructions of beneficial owners, (b) that members may not vote specific matters on the proxy, or (c) that members may not vote the entire proxy.

Generally speaking, a member organization may not give a proxy to vote without instructions from beneficial owners when the matter to be voted upon:

(1) is not submitted to stockholders by means of a proxy statement comparable to that specified in Schedule 14-A of the Securities and Exchange Commission;

(2) 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);

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(3) relates to **a** merger or consolidation (except when the company's proposal is to merge with its own wholly **owned** subsidiary, provided its shareholders dissenting thereto do not have rights **of** appraisal);

(4) involves right of appraisal;

(5) authorizes **mortgaging** of property;

(6) authorizes or creates indebtedness or increases the authorized amount of indebtedness;

(7) authorizes or creates a preferred stock or increases the **author**ized amount of **an** existing preferred stock;

(8) alters the terms or conditions of existing **stock** or indebtedness;

(9) involves waiver or modification of preemptive rights (except when the company's proposal is to waive such rights with respect to shares being offered pursuant to **stock** option or purchase plans involving the additional issuance **of** not more **than** 5% of the company's outstand**ing** common shares (see Item 12));

(10) changes existing **quorum** requirements with respect to stockholder meetings;

(11) alters voting provisions or the proportionate voting power of **a** stock, or the number of its votes per share (except where cumulative voting provisions govern the number of votes per share for election **of** directors and the company's proposal involves **a** change in the number **of** its directors by not more than 10% or not more than one);

(12) authorizes **issuance of** stock, or options to purchase stock, to directors, officers, or employees in an amount which exceeds 5% of the total amount of the **class** outstanding;

(13) authorizes

a. a new profit-sharing or special remuneration plan, or a **new** retirement **plan,** the **annual** cost of which **will** amount to more than 10% of average annual income before taxes **for** the preceding **five** years, or

b. the amendment of an existing plan which would bring its cost above 10% of such average annual income before taxes.

Exceptions may be made in cases of

a. retirement **plans** based on agreement or negotiations with labor unions (or which have been or are to be approved by such unions); and

b. any related retirement **plan** for benefit **of** non-union employees having terms substantially equivalent to the terms of such union-negotiated plan, which is submitted for action of stockholders concurrently with such union-negotiated plan;

(14) changes the **purposes** or powers of **a** company **to** an extent which **would** permit it to change to **a** materially different line of business and it is the company's stated intention to make such **a** change;

(15) authorizes the acquisition **of property, assets, or a** company, where the consideration to be given has **a** fair value approximating 20% or more of the market value **of** the previously outstanding shares;

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(16) authorizes the sale or other disposition of assets or earning power approximating 20% or more of those existing prior to the transaction.

(17) authorizes a transaction not in the ordinary course of business in which an officer, director or substantial security holder has a direct or indirect interest;

(18) reduces earned surplus by 51% or more, or reduces earned surplus to an amount less than the aggregate of three years' common stock dividends computed at the current dividend rate.

Amendment.

January 11,1968.

.12 Proportionate voting for auction rate preferred securities.—

Notwithstanding any other provision of Rule 452, a member organization may vote auction rate preferred securities' with auction reset periods of one year or less in proportion to the voting instructions received from holders of the Same class (or of the same series where the item must be voted upon separately by each series), in accordance with the provisions established below:

(1) It has transmitted proxy soliciting material to the beneficial owner of the auction rate preferred securities or to the beneficial owner's designated investment adviser in accordance with Rule 451 [¶ 2451], and

(2) It has not received voting instructions from the beneficial owner or from the beneficial owner's designated investment adviser, by the date specified in the statement accompanying such material, and

(3) A minimum of *30%* of the outstanding shares of the same class or series (where a series vote may be required) has been voted by preferred security holders, and

(4) Less than 10% of the outstanding shares of the same class or series (where a series vote may be required) voted against the proposal, and

(5) For any proposal as to which both the common and preferred holders vote as a single class. Proportional voting will not be allowed unless common shareholders approve the proposal, and

(6) A majority of the independent directors of the issuer's board of directors approved the matter, and

(7) Adequate disclosure of proportional voting has been provided to beneficial holders.

.13 Discretionary and non-discretionary proposals in one proxy form.—In some cases, a proxy form may contain proposals, some of which may be acted upon at the discretion of the member organization in the absence of instructions, and others which may be voted only in accordance with the directions of the beneficial owner. This should be indicated in the letter of transmittal. In such cases, the member organization may vote the proxy in the absence of instructions if it physically crosses out those portions where it does not have discretion.

*For purposes of this rule, an auction rate preferred which the divided rate is established periodically by