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October 22, 1991

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

Re: File No. S7-22-91: Regulation of Securityholder Communications -- Proposed Rules (Exchange Act Release No. 29315).

Dear Mr. Katz:

Although the official comment period for the above-referenced proposal is over, we hope you will consider our response to some of the arguments made in the filings. In particular, we would like to comment on the filings submitted by the Business Roundtable, the American Society of Corporate Secretaries, and the Comptroller of the State of New York. We do not intend to try to counter every argument made against the proposed amendments (and our decision not to respond to any point should not be construed as agreement); but some of the comments filed by the business community require explicit rebuttal, and the suggestion of the Comptroller deserves further consideration.

Preclearance of Solicitation Materials by Disinterested Parties

We must begin by recognizing the purposes of Section 14 of the '34 Act. It is to promote and protect, through proxies or consents, the exercise of shareholder voting rights. It is not to justify restrictions on freedom of speech. Indeed, any prior restraint of speech should be based on the most overwhelming justification. Government review of speech before publication is such a clear infringement of first amendment rights that it is authorized only in the most extreme cases. "Any system of prior restraints of expression comes to this Court bearing a heavy presumption against its constitutional validity." Bantam Books, Inc. v. Sullivan, 372 U.S. 58, 70 (1963). While commercial speech is entitled to less protection than other discussion of economic, political, or social issues can turn even speech about commercial transactions into protected speech.[1]

Prior restraint may possibly be justified for the contestants in proxy battles,where the parties are competing very aggressively, the speech concerns their own transaction, and time is a critical factor.[2] But, even

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[1] The Business Roundtable refers to the Supreme Court's "commendation" of the proxy rules as a legitimate restriction on commercial speech. The cited reference, Motor Vehicle Manufacturer Association v. State Farm, 463 U.S. 29 (1983), provides only the most tangential and insubstantial reference to the proxy rules. To the extent that the courts have "commended" the limitations on speech imposed by the proxy rules, it has not been on point with the proposals currently under consideration. In Pacific Gas and Electric Co. v. Public Utilities Commission of California et al. (475 U.S. 1), for example, the proxy rules are cited as an example of a legitimate infringement of management's speech, when management is required to include shareholder proposals in corporate proxy materials. ("Management has no interest in corporate property except such interest as derives from the shareholders; therefore, regulations that limit management's ability to exclude some shareholders' views from corporate communications do not infringe First Amendment rights." 475 U.S. 1, at 14 (1986)) In Pacific Gas, and several other cases, the issue has been raised in the context of misstatements or omissions by parties, which would still be prohibited and adequately guarded against if this proposal is adopted.

Motor Vehicle does, however, provide some useful thoughts about the requisite basis for reforming rules previously adopted ("we fully recognize that '[r]egulatory agencies do not establish rules of conduct to last forever,' and that an agency must be given ample latitude to adapt their rules and policies to the demands of changing circumstances' [at p. 42, citations omitted]), as long as the agency supplies "a reasoned analysis for the change beyond that which may be required when an agency does not act in the first place." We are confident that the current release and the record on which it and the final rules will be based meet that standard.

[2] We would welcome the opportunity to explore whether there is any justification for the review process, even for parties to a proxy contest. Indeed, it seems to us that the kinds of reforms proposed here provide a strong justification for eliminating that review. If shareholders are permitted to communicate with each other, they will be

where it is justified, government infringement of speech must be interpreted very narrowly. The justification for prior restraint does not extend to those the release describes as "disinterested parties,"[3] including ISS. Contrary to the arguments made by the New York State Bar Association, "disinterested" does not mean that a party plays no part in the process. It means that the party's returns are not dependent on the outcome (beyond the value of any increase in stock price, which applies to all shareholders). This is not based on some finding that shareholders are "more credible" than management, as the Business Roundtable suggests. It is just based on the obvious notion that management, which has the use of the corporate treasury and the other advantages of incumbency, has an interest in its own compensation and tenure that may at times conflict with its duty to disclose. Shareholders and other independent parties, on the other hand, using their own funds, and facing the other obstacles to collective action, do not have these conflicts.

A proxy advisory firm like ISS does not own stock. Our only interest is in producing reports that are of enough value that our clients will continue to buy them. Whether we recommend a vote for the dissident or the incumbents in an election, our income is not affected. Nor is it affected by the outcome of any particular vote. Any justification for prior restraint of the information circulated by the parties to a proxy contest and their agents simply does not apply.

At ISS, our advice on proxies is provided in our publications, which include the ISS Proxy Voting Manual, the Proxy Advisory Service, our newsletter, and special reports. They are sold by subscription, and are similar to the investment newsletters excluded from coverage of the Investment Advisers Act by the Supreme Court in <u>Lowe v. SEC</u>, 105 S. Ct. 2557 (1985). As the Court noted, "The mere fact that a publication contains advice and

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able to protect themselves from inadequate proxy materials, and it becomes more difficult to justify government review of the written materials they receive.

[3] We have no objection to using a different term, if that would clarify what some commenters find difficult to understand, although in fact the term is not used in the proposed amendments.

comment about specific securities does not give it the personalized character that identifies a professional investment adviser." While our subscribers can customize the service, to avoid receiving material that is not useful to them, the individual company reports remain the same. Our advice is not "attuned to any specific portfolio or to any client's particular needs. On the contrary, they circulate for sale to the public in a free, open market," like the newsletter in the Lowe case.

Response to the BRT

We would like to respond specifically to some of the comments made by the Business Roundtable. Of course, it is not surprising that the members of the Business Roundtable (and other representatives of management) argue that the current proxy rules work well; they are the primary beneficiaries of the current impediments to shareholder oversight. Otherwise the usual corporate opposition to government regulation in the marketplace would have them calling for repeal of the rules altogether.

The Business Roundtable keeps insisting that there is no evidence that shareholders are unable to communicate effectively with each other and with issuer companies. We note that of the filings made to the Commission on this subject, every one made by a shareholder expresses concerns about the obstacles to shareholder communication that the current system imposes. The very fact that the members of the Business Roundtable continue to deny the overwhelming message of shareholder dissatisfaction with this system is in itself proof that management either does not hear expressions of shareholder concern or hears them and is free to disregard them.

We note with regret that the Business Roundtable has backslid since its 1978 The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, where it said in discussing "the stubborn practical obstacles," to "enlarging" shareholder involvement: "Even (in the case of large institutional shareholders), however, there are severe policy and practical limitations on the ability of such holders to participate in corporate decision-making." The Business Roundtable recommended "revisions of Rule 14a-8 that would permit share owners to propose amendments of corporate by-laws which would provide for share owner nomination of candidates for election to the board of directors. We also believe corporations should voluntarily adopt procedures to facilitate communication among share owners."[4] But times have changed. Now that shareholders are big enough to have an impact, the Business Roundtable wants to make sure that regulatory obstacles prevent them from doing so.

The irony is that the members of the Business Roundtable themselves represent the largest shareholders in the country, their own employees participating in ERISA benefit plans. We question whether they could make the same claims about the benefits of the current system if they were commenting in their capacity as fiduciary shareholders.

The Business Roundtable's comment begins by arguing that the current proxy rules do not "inhibit effective communication among the stockholders of a company." We believe the record before the Commission and all available academic literature supply ample evidence that they do, in fact, inhibit this communication.[5] The Business Roundtable argues further that "If interested shareholders focus their attention and efforts on poorly performing companies, the current proxy process can be used very effectively to remedy problems without undue cost or burden." While

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[4] See also, the memorandum submitted to the SEC by the Roundtable's Corporate Organization Policy Committee, dated August 1, 1977, with a cover letter from its chairman, J. Paul Austin, CEO of Coca Cola.

[5] See, for example, B. Black, "Shareholder Passivity Reexamined," 89 Michigan Law Review 520 (1990) and sources cited therein, A. Conard, "Beyond Managerialism: Investor Capitalism?" 22 University of Michigan Journal of Law Reform 1 (Fall 1988), J. Pound, "Proxy Contests: The SEC Rewrites the Rules," The American Enterprise, September/October 1991 (enclosed). The record for this rulemaking also includes some compelling examples. Sarah Teslik, Executive Director of the Council of Institutional Investors, notes: "I have personally seen Council members dismiss without further study perhaps 95 percent of the actions that they have contemplated that could require filings under the shareholder communication rules -- precisely <u>because</u> they require such filings." (CII Comment at p. 5, emphasis in the original.) And the comment from Louise Price Parsons discusses the "impenetrable roadblocks" to shareholder activity (at p. 2), with specific examples from her efforts at Jefferson-Pilot.

isolated examples undoubtedly exist to support this argument, the fact remains that the current rules create significant disincentives for shareholders to communicate and to act collectively. The successes by institutions of late have come in spite of, not because of, the existing proxy rules.

The Business Roundtable claims that the market for corporate control gives shareholders the avenue they need for communication with management. To argue that "the tumultuous corporate restructuring which took place in the '80s is strong evidence" of effective shareholder communication is disingenuous, given the (Business Roundtable-supported) changes in state legislation and corporate charters and bylaws that have all but eliminated most aspects of that market. Indeed, corporate management has supported its argument in favor of impediments to the market for corporate control (and restrictions on director liability) by claiming that the proxy system provides the alternative. It is something of a shell game -- the right answer is always under the shell you didn't pick.

Even if there were, in 1991, a real market for corporate control, "tumultuous corporate restructuring" is a poor substitute for the kind of mid-course corrections that a workable proxy system can provide. As Michael Jacobs said, in his thoughtful new book, Short-Term America, "The 1980's takeover wave would not have occurred if the United States had an effective system of corporate governance, and if investors had behaved as owners rather than as speculators. The efficiencies achieved through buy-outs could have been achieved by internally driven changes.... If this had occurred, less money would have been left on the table to enrich an industry of corporate raiders and arbitragers." The current proxy rules are so onerous that shareholders have little choice but to behave as speculators. If they are to behave as owners, the obstacles to exercising their rights as owners must be reduced.

And as Robert A.G. Monks and Nell Minow argue in Power and Accountability, "Coercive bust-up takeovers on the one hand and outrageous compensation and entrenchment tactics on the other have all demonstrated the absence of an effective and constructive relationship between owner and manager." That effective and constructive relationship depends on the proxy rules; without changes like those proposed in this release, it cannot occur. With these changes, we will have an opportunity for the kind of long-term investment that the business community always says that it wants. Without them, the only opportunity to send the message of shareholder concern will be selling out, an option that is all but foreclosed as a practical matter for the biggest category of shareholders, large institutional investors with diversified portfolios.

The Business Roundtable says that "the notion that multi-billion dollar sophisticated institutional investors find themselves overwhelmed by the filing of a short four-page proxy statement is difficult to understand." It is not the original filing that is the real problem. It is the consequences of that filing. John Pound's article in "The American Enterprise" includes several examples of excruciating consequences of the current review process (enclosed). Another good (and highly representative) example is described in a report by Sarah Teslik, Executive Director of the Council of Institutional Investors. In that case, a small group of carpenters submitted a shareholder resolution asking the company to adopt a bylaw that would require a majority of independent directors on the board. Despite the fact that a similar resolution had been upheld by the Commission, the company responded with a twelve-page challenge (see enclosed).

Issuers will always have more resources to devote to stopping shareholder resolutions than shareholders will have to defend them. Issuers have access to the corporate treasury, while shareholders must use their own money. The collective choice problem, in the context of the costs imposed by the current rules, makes shareholder action uneconomic.

The Business Roundtable intentionally uses an inflammatory term when it complains about "secret" speech that will contain "information about a company's destiny."[6] The speech in question is not "secret," but "private."[7]

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[6] This concern is echoed by other commentors, like the American Society of Corporate Secretaries' claim that the "board is charged with exercising its business judgment; it may not abrogate this responsibility by conveniently deferring to shareholder plebiscite." In their haste to paint the darkest possible picture of commercial anarchy, these commentors neglect the limited agenda and precatory impact of shareholder proposals.

Any "information" will be discussion of a particular matter scheduled to be submitted to a shareholder vote. This is hardly determinative of a company's destiny. Shareholder resolutions must fall within the narrow confines of Rule 14a-8. If they relate to matters too close to the company's "destiny," they can be excluded as "ordinary business." If they relate to matters too far from the company's "destiny," they can be excluded as beyond the company's control. In virtually all cases, a majority vote in favor of a shareholder resolution -- even a unanimous vote -- is precatory only, non-binding, and can be utterly disregarded by the company's management. "Destiny" is not at issue.

Even if the matter to be discussed concerns the election of directors, the company's "destiny" is seldom in question. If almost every shareholder withholds the vote from a particular candidate (the proxy, of course, does not provide the option of a vote "against" an unopposed candidate), the candidate will be elected if he gets a single vote. It is impossible for shareholders to change the outcome in an "election" of unopposed directors, so there again the company's "destiny" is not in question. Arguably, a shareholder vote could determine the outcome of certain management proposals, like those asking for approval of amendments to the charter, stock option plans, or auditors, but these matters relate to general structure, and incentives are not so central to the substantive strategic direction of the company that they relate to its "destiny."

The only conceivable "destiny" that could be discussed by shareholder groups would relate to competing director slates in a proxy contest. And even there, any communication between the dissident candidates and the shareholders would be disclosed. The marginal value of making public the private discussions between shareholders on the relative merits of their options is utterly outweighed by the value of a free and open discussion.

The talk about preferring institutional shareholders over the management misses the point. Owners and management have different roles to play,

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[7] We support the proposal that a copy of written solicitation materials exempted by this rulemaking must be filed with the issuer's corporate secretary, as long as the requirement is not overly technical.

and both are important. In order for shareholders to meet their responsibilities, they must be able to communicate, so that ownership as a whole can effectively monitor management, by its nature cohesive.

The Business Roundtable counters an argument that no one has made in suggesting that supporters of the release want to manage companies "on a town hall meeting basis." As noted above, the spacious reach of the "ordinary business" exemption means that shareholders are (appropriately) precluded from submitting shareholder resolutions on matters that concern the company's day to day operations. And the matters management must submit for shareholder approval are also limited to the most basic structural issues. The proposal before the Commission would not in any way expand the topics submitted for shareholder approval. And the SEC's determination about what issues are "basic to the shareholder's interest as an investor" is not at issue here. The whole question of "manag[ing] the company through the proxy" has nothing to do with the proposal currently under consideration.

The Business Roundtable argues that "the shareholders decide whether the directors are doing their job -- either by selling their shares or by electing different directors." If that were true, this undertaking would not be necessary. The "Wall Street Rule" is no longer workable. Large institutional investors are too big to sell out of every company whose performance is disappointing. Furthermore, some actions objected to by shareholders are undertaken by such a wide range of companies that selling out of all of them is simply impossible. And as for electing different directors -- it seems to us that that is precisely what the Business Roundtable is trying to prevent.

We agree with the Business Roundtable that "not all shareholders are alike, nor do they necessarily have the same interests." That is all the more reason that there is little risk of overwhelming shareholder involvement, and all the more reason to allow them to communicate with each other, to develop a shared set of priorities.

But we do not agree with the Business Roundtable's assertion that the shareholders' "strong and material economic interest in the outcome of proxy contests" is "as much as...members of management." That is plainly wrong. Certainly shareholders do have an interest, but the interest of managers is that their own employment is on the line. And it is precisely this interest which can conflict with the interests of shareholders. For this reason, shareholders must have the ability to communicate with each other, to counter the inherent conflict of interest. The Business Roundtable asks, "So why the different rules for management on one hand and shareholders on the other?" The answer is in the conflicts of interest, and in the potential for abuse. If the Business Roundtable is willing to give shareholders the same access to the corporate treasury, shareholder list, and other resources that are available to management, then it would be fair for shareholders to be governed by the same restrictions. Until then, it just does not make sense.

Shareholder Lists

It seems extreme to suggest that the release would make "shareholder lists as freely available to any individual shareholder as today's New York Times." Anyone can buy the Times for fifty cents, but the shareholder lists would only be available to shareholders for considerably more (compounded further by the expenses of any meaningful use of the list to contact the other shareholders). Furthermore, anyone seeking privacy for the "intimate" information of share ownership can do so by registering the securities in nominee name. Predictably, the Business Roundtable prefers to speculate on what the shareholders want, rather than actually putting it to an authentic shareholder vote ("If it were put to a shareholder vote, I am quite sure that a majority would not favor providing the list to one and all upon request and a return, postage-paid envelope"). We would welcome the opportunity to put this question to a shareholder vote, on a level playing field, to see what the outcome would, in fact, be.

We agree entirely with one statement of the Business Roundtable: "It's time we return to the sound management of companies through strong boards of directors." We submit, however, that directors "elected" under the current system cannot be strong.

Response to the ASCS

The American Society of Corporate Secretaries raises concerns utterly outside the scope of the very modest proposals in this release. Proposals for access to the corporate proxy materials are not at issue here. Neither are "attempts to change the business corporation from what it is to something else"; on the contrary, as noted above, the narrow range of substantive concerns permitted to shareholders by the proxy rules, and the non-binding nature of virtually all shareholder proposals are more than adequate protection from the kinds of abuse they suggest. And the fact that ASCS has its own list of agenda items (on which we would welcome Commission consideration, despite the inflammatory language in which they are framed) has little to do with the actual proposal at issue.[8] The ASCS's policy seems to be "divide and conquer," their analysis suggests that if a shareholder or group of shareholders is large enough to have an impact, they must be stopped. But they are unable to come up with one specific example of any shareholder action under the proposal currently under consideration which could even affect, much less determine, much less harm, legitimate corporate decision-making.

[8] Discussion of the questions raised by ASCS in any detail is far beyond the scope of this letter. We will just say for the record that institutional shareholders, with the legal constraints of fiduciary obligation, the commercial constraints of the marketplace, and the practical restraints of substantial shareholder involvement, even if these proposals are adopted, have neither the incentive nor the capacity to undertake action that is in any way harmful to any shareholder, large or small. Furthermore, the consequence of limited liability for shareholders is the limited shareholder agenda. As long as that agenda is limited to (1) meaningful election of directors, (2) resolution of matters in which directors or management have conflicts with the interests of shareholders, and (3) fundamental decisions about the overall direction of the company, limited liability is justified. Indeed, the limitations on liability for directors is based in the notion that directors are elected by shareholders and can be replaced by shareholders. While the "election" is something of a myth, the limitation on liability is not; the list of directors who have ever been held personally liable is almost non-existent. The limitation on liability is based on a legal fiction; if the fiction does not become reality, the limitation on liability will not stand.

Response to New York State Comptroller
The Comptroller of the State of New York has submitted an alternative proposal that has significant merit. The proposal would give substantial, long-term shareholders access to management's proxy to comment (favorably or unfavorably) on the performance of the company's managers. The procedural aspects may require more consideration, but we would be willing to support this kind of alternative to the current proposals.

Conclusion
We believe that the current system discourages shareholder involvement in corporate affairs. This is one reason why, historically, shareholders have preferred "exit" to "voice." The costs of participation are simply too high, relative to the rewards. The emergence of the institutional investor in the 1980s, and the interest that institutions have shown in corporate governance, underscore the need to review and revise the proxy rules. Having recognized these changes in other areas, it would be incredible if the Commission had failed to do so with respect to the proxy rules. Though it has moved slower than we would have liked, the Commission has now thoughtfully come to grips with the changes that have occurred in the ownership structure of American corporations.

At it reviews the current rules, the Commission should remember that disclosure is not an end in itself. It is a means to an end. In the case of the proxy rules, the historical reason for disclosure is to promote and protect the voting rights of shareholders through proxies and consents. Many aspects of the disclosure system continue to function well in respect to voting. We have not advocated dismantling the disclosure system. Nor, we would add, do the proposed changes in the Commission's proxy rules dismantle the disclosure rules. Instead, the proposed changes would simply create a limited safe harbor for purposes of facilitating communication. Such communication, we emphasize, is in furtherance of the statutory purposes set forth in Section 14 of the '34 Act. And to the degree that unfettered communication is false, or misleading, or fails to disclose the true purposes involved, adequate remedies are available under existing rules.

The opponents of proxy reform suggest that the proxy reform proposals at issue here will have dire consequences. As Chairman Breeden noted in his recent testimony,[9] "despite suggestions to the contrary, large institutional shareholders would not be allowed to form secret groups for collective action" (emphasis in the original). Breeden pointed out that "Disclosure is required when shareholders act in concert with respect to voting power. Indeed, disclosure of such action is a primary purpose of the public filing mandated by Section 13(D) of the Exchange Act."

In reading the submission by the Business Roundtable, and, to a lesser degree, the submission of the American Society of Corporate Secretaries, one would think that the entire system of corporate governance -- and with it the ability of American corporations to compete globally -- is about to be destroyed by simply giving shareholders the right to talk with one another without first getting permission from the Securities and Exchange Commission. We hope the Commission is not misled, or intimidated, by this rhetoric.

To us, it seems highly inconsistent for the Business Roundtable to urge shareholders to focus their concerns about corporate governance on the board of directors but then to seek to deny shareholders the effective means to voice their concerns. Other than the Business Roundtable and the American Society of Corporate Secretaries, does anyone seriously believe that the current proxy rules encourage shareholder involvement in corporate governance? With the possible exception of Rule 14a-8 (which at least provides a roadmap in which all obstacles are clearly marked), the existing rules actually discourage such involvement. The comments the Commission has received from shareholders, individuals as well as institutions, bear witness to this truth.

Despite impressive efforts from expensive law firms, the business community has been unable to come up with a single example of a specific problem that the proposed changes would create. There is a lot of "slippery slope" rhetoric, a lot of concerns about "direct and collateral adverse consequences, not all of which can be foreseen today" but little, if any, actual evidence of real problems. We agree with Chairman Breeden

[9] Testimony before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, October 17, 1991.

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adverse consequences, not all of which can be foreseen today" but little, if any, actual evidence of real problems. We agree with Chairman Breeden that with this proposal, "the SEC has been seeking the most fair and balanced approach to reduce the costs and burdens of current proxy rules." The Commission should take seriously the expressions of shareholder dissatisfaction about the current rules, and take the small first step toward leveling the playing field by adopting the proposed changes in the release.

Sincerely,

James E. Heard
President

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