

December 18, 2003

Via Facsimile and Electronic Mail

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

Re: Security Holder Director Nominations (68 Fed. Reg. 60,784, October 23, 2003).

Dear Mr. Katz:

We are writing to comment on the U.S. Securities and Exchange Commission's (the Commission) Notice of Proposed Rulemaking, *Security Holder Director Nominations*.¹ The proposed rule would require certain public companies to include shareholder nominations in proxy solicitations for elections to the companies' boards of directors.

The Office of Advocacy (Advocacy) believes the Commission should limit any shareholder director nomination requirement to companies that are accelerated filers, with more than \$75 million of market float (the value of shares available to the public). Advocacy believes that the proposed rule would impose disproportionate costs on small public companies and may discourage small businesses from availing themselves of American capital markets.

Advocacy was established pursuant to Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. Advocacy is an independent office within the U.S. Small Business Administration (SBA), so the views expressed by Advocacy do not necessarily reflect the views of the SBA or the Administration. The RFA, as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA), gives small entities a voice in the rulemaking process. The RFA requires Federal agencies, such as the Commission, to consider alternatives to avoid overly burdensome regulation of small entities.² Advocacy is also required by Section 612 of the RFA to monitor agency compliance with the RFA.³

¹ *Security Holder Director Nominations*, 68 Fed. Reg. 60784 (2003) (to be codified at 17 C.F.R., pts 240, 249, and 274) (proposed October 23, 2003) ("proposed rule").

² Pub. L. No. 96-354, 94 Stat. 1164 (1981) (codified as amended at 5 U.S.C. §§ 601-612).

³ 5 U.S.C. § 612.

On August 13, 2002, President George W. Bush signed Executive Order 13272, requiring Federal agencies to implement policies protecting small businesses when writing new rules and regulations.⁴ Executive Order 13272 instructs Advocacy to provide comment on draft rules to the agency that has proposed a rule, as well as to the Office of Information and Regulatory Affairs of the Office of Management and Budget.⁵ Executive Order 13272 also requires agencies to give every appropriate consideration to any comments provided by Advocacy.⁶ Under the Executive Order, the agency must include, in any explanation or discussion accompanying publication in the *Federal Register* of a final rule, the agency's response to written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.⁷

Under the RFA, when an agency is required to engage in notice-and-comment rulemaking as provided for in the Administrative Procedure Act (APA), the agency is also required to publish an Initial Regulatory Flexibility Analysis (IRFA) with its proposed rule and a Final Regulatory Flexibility Analysis (FRFA) with its final rule unless the agency is able to certify that the rule will not have a significant economic impact on a substantial number of small entities. The IRFA invites comment on a discussion of the impacts of the rule, including "a description of the projected reporting, recordkeeping and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement."⁸ The IRFA also includes a "description of any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities."⁹

I. The Proposed Rule

The Commission proposed the rule with the hopes it would "serve to align the interests of the board and security holders, thereby giving investors greater confidence that the board is serving the interest of security holders."¹⁰ Thus, the Commission proposed a:

mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to 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.¹¹

⁴ Exec. Order No. 13,272 § 1, 67 *Fed. Reg.* 53461 (Aug. 16, 2002) ("E.O. 13272").

⁵ E.O. 13272, at § 2(c), 67 *Fed. Reg.* at 53461.

⁶ *Id.* at § 3(c), 67 *Fed. Reg.* at 53461.

⁷ *Id.*

⁸ 5 U.S.C. § 603(b)(4).

⁹ 5 U.S.C. § 603(c).

¹⁰ 68 *Fed. Reg.* at 60813.

¹¹ 68 *Fed. Reg.* at 60785.

Thus, the Commission’s proposal allows certain shareholders to nominate individuals for election to their company’s board of directors and include that nominee in the company’s proxy solicitation materials.

II. Identification of Small Business Alternatives

The Commission has solicited comment on one alternative to reduce the rule’s impact on small businesses: limiting the new shareholder director nomination requirements to “accelerated filers.” Accelerated filers include those filers with more than \$75 million in market capitalization.¹² Advocacy is not aware of a small public company that can be characterized as an accelerated filer under this definition.

Advocacy recommends that the Commission limit the rule’s applicability to accelerated filers, because of the rule’s potential disproportionate impact on small public companies.

III. Differences in Company Size Complicate Triggers for Events

The Commission’s proposed rule would not automatically grant any shareholder of a company the right to nominate a candidate for election to that company’s board of directors. The Commission proposes several considerations in allowing shareholders to nominate company directors. The Commission balanced the need for shareholders to be able to trigger the nomination procedure against ensuring that “the process is used by security holders who represent a substantial and long-term interest in the subject company.”¹³ To address the potential of the proposed nomination procedure being used by shareholders who do not represent a substantial or long-term interest in the company, the Commission has proposed two triggering requirements which must be fulfilled in order for a shareholder to nominate a director for inclusion in the company’s proxy materials.

First, the Commission set an ownership period requirement for the individual or group who submits the nomination, with shareholders being required to own five percent of the shares of the company for at least two years prior to putting forward a candidate. Second, the nomination could only take place if there was substantial agreement among a large number of shareholders, either by requiring that a director have gotten 35% withhold votes in the last election or a “direct access” shareholder proposal was put forth at the last meeting and was approved by more than 50% of the votes (but not implemented within that year). These two requirements were designed to prevent misuse of the shareholder access provisions to further interests other than special interests not shared by the company’s shareholders.

The ownership requirements proposed by the Commission may not be sufficient to deter abuse of the nomination procedure in smaller public companies. A one percent stake in a small public company with under \$75 million in outstanding shares would require less than a \$750,000 investment. For many small public companies, such as a small public

¹² 68 *Fed. Reg.* at 60788 (“Accelerated filers”).

¹³ 68 *Fed. Reg.* at 60790.

company operating warehouse-style stores with outstanding shareholder equity of around \$16,000,000, the one percent holding requirement would amount to \$160,000.¹⁴ In comparison, in the hypothetical case of a large national grocery chain with more than 400,000,000 shares outstanding worth around \$8,000,000,000, one percent of shares outstanding would amount to \$80,000,000 (an amount far in excess of many small public companies' *entire* market capitalization).

Many institutional shareholders have billions of dollars available for investment.¹⁵ Since the amounts available for investment are so large and the level of investment required to achieve relatively high percentages of ownership in small public companies so low, Advocacy believes that percentage ownership requirements are unlikely to ensure that the shareholders eligible to submit nominations are acting to protect long-term shareholder interests.

IV. Costs

Public company representatives inform Advocacy that the cost of including shareholder nominees in company proxy materials are likely to disproportionately affect small public companies.¹⁶ The majority of proxy costs are represented in due diligence and other background work required to include a nominee for election to the board of directors. A small public company would devote a larger percentage of its earnings to proxy costs than large public companies would. And, because of the lower level of investment required to nominate a director to the board of a small public company, small public companies would likely find themselves engaged in proxy contests more often.

¹⁴ This small amount is important because institutional investors may already have significant holdings in small public companies. Institutional investors are required by law to diversify their investments among industries and firm types. 29 U.S.C. § 1104(a)(1)(c); *Metzler v. Graham*, 112 F. 3d 207, 209 (5th Cir. 1997); *see also*, Restatement (Third) Trusts § 227(b) (“the trustee has a duty to diversify the investments of the trust”). Small cap firms offer high yield investments and opportunities to reduce systemic risk through diversification.

¹⁵ For example, TIAA-CREF's most recent annual financial reports indicated that at the end of 2002, it was holding approximately \$100,000,000,000 in stocks alone. *See* TIAA-CREF, 2002 *Financial Statements*, available at <<http://www.tiaa-cref.org/pubs/html/AR/fin/02.html>> (last visited Dec. 16, 2003).

¹⁶ The Commission estimated that the proposed rule would cost affected small public companies around \$4,200 each. 68 *Fed. Reg.* at 60814. The Commission estimates that the rule will require less than 15 hours of company employee time (at \$75/hr.) and less than 10 hours of outside professional time (at \$300/hr.) to conduct adequate due diligence and clearance. Advocacy generally believes these cost figures greatly underestimate the true cost of conducting due diligence and assessing a nominee's character and qualifications. For example, the Commission has estimated 10 hours of attorney review for what is essentially a proxy fight using the company's solicitation.

V. Conclusion.

In conclusion, Advocacy urges the Commission to adopt a final rule that does not require small public companies to implement the proposed shareholder director nomination procedures. Advocacy appreciates the opportunity to comment on the Commission's proposed shareholder director nomination rule. Thank you for your consideration and please do not hesitate to contact Michael See at (202) 619-0312 or Michael.See@sba.gov.

Sincerely,

Thomas M. Sullivan
Chief Counsel for Advocacy

Michael R. See
Assistant Chief Counsel

Cc: Martin P. Dunn, Deputy Director, Division of Corporation Finance, U.S.
Securities and Exchange Commission
Dr. John D. Graham, Administrator, Office of Information and Regulatory Affairs