

**Statement of SEC Chairman Christopher Cox Concerning Bylaw Proposals to
Establish Director Nomination Procedures**

Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs
November 14, 2007

Chairman Dodd, Senator Shelby and Members of the Committee:

Thank you for inviting me to testify concerning the Commission's ongoing rulemaking on the subject of bylaw proposals to establish director nomination procedures.

As you know, the current rules do not permit shareholders to offer these bylaw proposals. In July, I voted for a rule proposal to change that. The Commission has published that proposed rule for comment, along with a companion proposal that would essentially ratify the longstanding status quo. The breadth of the territory that was covered between these two proposals, and the extensive questions that we submitted for public comment, gave the Commission plenty of flexibility to address defects in the proposals or areas for possible improvement that might be identified in the comment process. The comment period on those rule proposals has just closed.

I cannot predict exactly what the Commission will do on this subject this year. Obviously, we are currently reviewing the enormous number of comments that we have received, most of them on the last day of the comment period, on October 2. And today I can speak only for myself, since my testimony does not reflect the individual views of the other Commissioners, or of the SEC. But I am happy to explain why I support strengthening the proxy rules to better vindicate the fundamental state law rights of shareholders.

Our free enterprise system is built on a foundation of law. The enforcement of private property rights is an essential ingredient of a successful free market. At bottom, a share of stock is a bundle of private property rights, no more and no less. And the law's enforcement of private property rights is what gives it its value. America's investors in equities currently entrust over \$20 trillion of their assets in exchange for these property rights. It is only the precious few specific rights that the law gives to a common stockholder that undergird this investment. And so it's of the utmost importance that what the stockholder does have is jealously guarded by our legal system.

The stockholder is said to own the company. But he or she cannot direct management or the board to do anything. Indeed, as a legal matter, even 100% of the shareholders acting in concert could not do so – instead they must rely on the directors. Only after every unsecured creditor is taken care of does the common shareholder receive a penny of assets on liquidation. A common stockholder can receive dividends, but only if the board of directors decides to declare them. But the shareholders do have the ironclad legal right to do one thing for themselves – and that's to choose the company's directors.

The federal proxy system should protect and enforce that most important legal right, not stand in its way. After all, we cannot have capitalism without capital.

Not only is protecting the private property rights of America's shareholders important to ensure a continued flow of capital to our companies and industries, but it is the best way to ensure that boards of directors remain accountable to the interests of investors. It is the check and balance on boards and management that is built into the corporate form under state law, and its proper functioning is essential to our free enterprise system.

The issue of protecting investor's ownership rights is not a partisan one. As Chairman John Shad put it during the Reagan Administration, "the Commission has always encouraged shareholder participation in the corporate electoral process." And, he added, the SEC's "responsibilities for regulating proxy solicitation have been premised on the need to assure 'fair corporate suffrage' for every securityholder." More recently, several commentators, from all across the spectrum, have been making the case. The distinguished group of experts that comprised the Committee on Capital Markets, under the direction of Professor Hal Scott of the Harvard Law School, Glenn Hubbard, President Bush's former Chairman of the Council of Economic Advisers, and John Thornton, the former President of Goldman Sachs, devoted an entire section of their recent report to shareholder rights. In their words, "the strength of shareholder rights in publicly traded firms directly affects the health and efficient functioning of U.S. capital markets."

They pointed out that "[o]verall, shareholders of U.S. companies have fewer rights in a number of important areas than do their foreign competitors." And they added that "[t]his difference creates an important potential competitive problem for U.S. companies." As one way of addressing that need, the Committee recommended that the SEC take the opportunity of the court's decision in the *AIG* case to ensure "appropriate access by shareholders to the director nomination process." And that is exactly the initiative we've begun.

But changing the proxy system to address the "collective action" problem while rationalizing the potential input of 45 million shareholders, fulfilling the essential federal role of ensuring disclosure, and guaranteeing them the full protection of the antifraud provisions of the securities laws is a complicated matter. If it were easy, my predecessor, who attempted to do it, would have succeeded over the several years that he tried. Indeed, when the Commission previously considered this issue in the 1990s, it determined not to pursue it. The Commission stated at the time that "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." So despite noting the "difficulty experienced by shareholders in gaining a new voice in determining the composition of the board of directors," they adopted the short slate rules instead.

And as difficult as the basic proxy access problem is, we have another issue on our hands. Last autumn, the U.S. Court of Appeals for the Second Circuit invalidated the SEC's interpretation of our existing proxy access rule that had been applied at least since 1990. Indeed, in the SEC's view, that interpretation had been in effect since 1976. But the court found the SEC's view since 1990 to be inconsistent with its prior interpretation. At the same time, the court said that it would "take no side in the policy debate regarding shareholder access to the corporate ballot," noting that "such issues are appropriately the province of the SEC." This decision applies only in one of the 12 judicial circuits in America. And it has created great uncertainty and danger for every stakeholder in our public markets.

This uncertainty is compounded by a recent decision of the U.S. Supreme Court, which creates doubt about the state of affairs even in the Second Circuit. The Supreme Court reversed another panel of the Second Circuit in a similar case of an agency that changed its interpretation of its rules. Just as in the proxy access case, the Second Circuit rejected the agency's more recent interpretation. Justice Breyer's opinion for the unanimous Court held that the agency's interpretation of its own regulations is controlling unless plainly erroneous. As a result of this decision, it is more likely today that even a Second Circuit court would uphold the agency's longstanding interpretation of our proxy access rule. In this escalating state of confusion, the only rule across America at the moment is every litigant for himself.

And yet the only legal question is what the SEC's rule means – not the new rules that we have proposed, but the rule that is already on the books, and has been for over 30 years. It should be a straightforward matter for the SEC to answer that question. The legal uncertainty does not involve any statutory interpretation, or questions of the agency's authority. But it does involve a great deal of real world risk and litigation. In the wake of the Second Circuit decision, the SEC staff has stopped responding either positively or negatively to inquiries from the public about what our rule means. Officially, the staff has no view on what the rule says or how it applies in any specific case. There can be absolutely no excuse for our continuing to fail to answer that basic question. That is why I have said all year that we are committed to having a clear rule in place for the coming proxy season.

I cannot predict what the Commission will do. It is widely reported that the Commissioners have irrevocably formed their views on what they will do, both now and in the future. But in fact the Commissioners, just like the staff, take this issue very seriously and with an open mind. Though some of my colleagues did not vote to approve the proposed rule to broaden proxy access that we published for comment last summer, it was not because they or any of us thinks the current system could not be improved. Rather, as one of them said, the current framework "is far from perfect," but it has "at least created a framework for dealing with these problems." Another of the Commissioners objected to the proposed rule because it did not consider "other potentially viable alternatives." This bespeaks an open mind and a willingness to seek improvements in the proxy process for the benefit of all investors, which is what I believe each of the members of the Commission brings to this issue. We are still in the process

of evaluating over 34,000 comments from the public on this issue, and we take that job very seriously. The testimony that you will hear today, as well as your own comment that each of you is offering during this hearing, will add very usefully to this public record, and we will be very attentive to it as well.

Our rulemaking is, as I'm sure you know, a work in progress. Even the Commissioners who voted for the broader proposal raised questions about it that were put to the public for comment, and each of us who voted for it explicitly acknowledged the tradeoffs that exist. In the words of one of my colleagues, our challenge is to "balance the rights of shareholders, with the legitimate goal of leaving the management of companies largely to the board and the managers, whose primary focus should be on profit generation."

There is a widespread assumption that having published the two proposals, the Commission has only a binary choice – that we must adopt one of them, or do nothing. But in fact we may also adopt a rule that is different than either of those proposed. The only requirement is that the proposed rule, and the questions the agency has asked, provide fair notice to the public of what the Commission is contemplating and the issues involved. So long as the final rule or rules are a logical outgrowth of what was proposed, we are free to amend the proposals and to consider improvements that the public comment process has brought to our attention.

The "do nothing" alternative is doubly dangerous. Not only will it provoke more needless litigation about the meaning of our rule, which in light of the recent Supreme Court decision might well be resolved in favor of the agency's long standing interpretation in any event, but it will create a law of the jungle for any actual shareholder proposals that are advanced in the meantime. That's because unless we accept the Second Circuit's invitation to clarify the current rule, all of the protections of the proxy contest rules are out the window -- including requirements for disclosure of conflicts of interest, and possibly even the antifraud rules that prevent deliberate lying to investors. It is obvious that many shareholders support the main effect of the Second Circuit decision, which is that the Commission's existing rule concerning proxy access is called into question, because they want to have access to the proxy. You will hear from them on the next panel, and I personally am very attentive to their concerns. But it should be possible to gain the more effective use of the proxy that they seek without abandoning other important shareholder protections, such as our disclosure and antifraud rules.

So whatever the Commission decides to do, we will restore certainty about the application of our rules. That is our fundamental responsibility.

When Hammurabi erected his stone tablets in the city square of Babylon 3800 years ago, civilization made a great advance. From that moment forward, the law was no longer arbitrary. For the first time, citizens could know in advance the standard to which they should conform their conduct. That is the difference between the rule of law and the rule of men.

In our own time, when we highly prize the rule of law, we face the same risk as our ancient forebears, but for a different reason. All of our laws are written down -- thousands of pages of them. On top of that there are hundreds of thousands of pages of regulations, and beyond that an ever-growing case law that interprets both the statutes and the regulations. The uncertainty generated by competing interpretations and so many grey areas creates a 21st century version of the pre-Hammurabian days. Once again, citizens cannot know in advance the rules by which they should arrange their lives and their business affairs.

There is nowhere that certainty in the law is more important than in our markets. Each day, investors in this country and around the world execute make-or-break choices that depend on knowing in advance what the rules are. Businesses large and small need to know how to navigate in a sea of regulation. We owe it to them to provide a clear answer. Each of our rules may not be precisely what a particular player wants, but it should nonetheless be precise. A vague or ambiguous rule can be just as bad as no rule at all.

The rule of law that the SEC enforces has given America the most dynamic and vibrant capital markets in the world. And the rule of law includes both certainty in application, and commitment to enforcement of the fundamental property rights of every shareholder -- above all the right to choose the directors of the companies they own.

So I agree with the many commenters on our two proposals who have said that we should go back to the drawing board and take a fresh look at this issue. We will do that. None of the 22 SEC Chairmen since the agency first looked at this issue in 1942 has successfully taken this step. I nonetheless am committed to serious work on it, and I am intent on bringing it to a successful resolution. And I am happy to take your questions.