Corporate Governance and Shareholder Empowerment

Hearing before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

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Written Testimony and
Comments for the Record

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Introduction

Business Roundtable www.businessroundtable.org is an association of chief executive officers of leading U.S. companies with more than $6 trillion in annual revenues and more than 12 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and pay more than 60% of all corporate income taxes paid to the federal government. Annually, they return $167 billion in dividends to shareholders and the economy. Business Roundtable companies give more than $7 billion a year in combined charitable contributions, representing nearly 60% of total corporate giving. They are technology innovation leaders, with $111 billion in annual research and development spending – nearly half of the total private R&D spending in the United States.

We appreciate the opportunity to participate in this hearing on "Corporate Governance and Shareholder Empowerment" and to discuss the Shareholder Empowerment Act of 2009, the Corporate Governance Reform Act of 2009 and the Proxy Voting Transparency Act of 2009. Because the three bills contain many similar provisions, this written testimony discusses the provisions of the bills on an issue by issue basis.

Business Roundtable has long been at the forefront of efforts to improve corporate governance. We have been issuing "best practices" statements in this area for three decades, including Principles of Corporate Governance (November 2005), which we currently are revising to reflect recent developments in corporate governance, The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004), Guidelines for Shareholder-Director Communications (May 2005), and Executive Compensation: Principles and Commentary (January 2007). More recently, Business Roundtable was a signatory to Long-Term Value Creation: Guiding Principles for Corporations and Investors, also known as The Aspen Principles, a set of principles drafted in response to concerns about the corrosiveness that short-term pressures exert on companies. The signatories to The Aspen Principles are a group of business organizations, institutional investors and labor unions, including the AFL-CIO, Council of Institutional Investors and TIAA-CREF, who are committed to encouraging and implementing best corporate governance practices and long-term management and value-creation strategies. In addition, Business Roundtable recently published its Principles for Responding to the Financial Markets Crisis (2009).

At the outset, we must respectfully take issue with the premise that corporate governance was a significant cause of the current financial crisis.[1] It likely stemmed from a variety of complex financial factors, including major failures of a regulatory system, over-leveraged financial markets and a real estate bubble.[2] But even experts

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[1] *See* Lawrence Mitchell, *Protect Industry from Predatory Speculators*, FINANCIAL TIMES, July 8, 2009. Professor Mitchell, a George Washington University law professor, argues that it is "hyperbolic" to suggest that inattentive boards had anything significant to do with the current recession.

[2] *See* Robert G. Wilmers, *Where the Crisis Came From*, THE WASHINGTON POST, July 27, 2009.

disagree about the origins of the crisis.[3] Notably, with the support of Business Roundtable, Congress established the Financial Crisis Inquiry Commission which is investigating the causes of the crisis.

Changes to the financial regulatory and corporate governance systems in the United States represent two enormously complex yet distinct subjects. By combining an examination of the two, public anger surrounding the financial crisis becomes a substitute for a fact-based examination of our corporate governance system. In fact, a legitimate concern is that some provisions in the proposed legislation, such as proxy access, could exacerbate factors that many believe contributed to the crisis, such as the emphasis on short-term gains at the expense of long-term, sustainable growth.[4] Thus, we must be cautious that in our zeal to address the financial crisis, we remain focused on the actual causes of the crisis and do not jeopardize companies' ability to create the jobs, products, services and benefits that improve the economic well-being of all Americans by enacting unnecessary corporate governance reforms.

Moreover, mandating federal corporate governance requirements is inconsistent with the traditional enabling approach of state corporate law, as noted in a recent article on the risks to private enterprise from federal preemption of state corporate law

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[3] Ben S. Bernanke, *Four Questions About the Financial Crisis* (Apr. 14, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm (observing that experts disagree about the appropriate weight to give to various explanations for the crisis).

[4] *See* Lawrence Mitchell, *Protect Industry from Predatory Speculators*, FINANCIAL TIMES, July 8, 2009.

(attached as Exhibit I). Corporate governance involves the relationships between shareholders, the board and management of a company, and it traditionally has been governed by state law. The proposed legislation seeks to impose federal requirements that would deprive shareholders and companies of the ability to take advantage of the enabling nature of state corporate law to tailor their company's governance practices to the company's specific characteristics at a given point in time.

We also must consider the sweeping transformation in the corporate governance landscape in the past decade through a combination of legislation, rulemaking by the Securities and Exchange Commission ("SEC") and the securities markets, best practices documents issued by organizations like Business Roundtable and the National Association of Corporate Directors, and voluntary action by companies. The SEC has adopted rules designed to provide that shareholders receive the information they need to make informed voting decisions, including rules requiring that companies provide shareholders with additional information on executive compensation and corporate governance practices. Similarly, state corporate law has been responsive to developments in corporate governance, most recently with respect to majority voting for directors, proxy access and proxy contest reimbursement. Finally, companies have taken a number of steps to improve their corporate governance practices, as illustrated by statistics cited later in this testimony.

For these reasons and the reasons discussed below, Business Roundtable believes that several provisions of the proposed legislation are inappropriate responses to the financial crisis and could exacerbate the focus on short-term gains at the expense of long-term, sustainable growth. Moreover, several of the provisions of the bills are otherwise problematic and out of date. Even if Congress proceeds with considering aspects of the bills, there are a number of ways in which they can be improved as well as several other issues that need to be addressed.

Proxy Access

One of the most problematic provisions in the proposed legislation is the provision in the Shareholder Empowerment Act that would require the SEC to issue proxy access rules that would permit shareholders owning as little as 1% of a company's securities for at least two years to nominate director candidates for inclusion in the company's proxy materials. Business Roundtable believes that director accountability to shareholders is extremely important but that federal rules on proxy access are not the most effective way to achieve this goal and could result in significant adverse consequences. As we have noted in our comment letter on the SEC's proposed proxy access rules in August 2009 (attached as Exhibit II), a proxy access rule could exacerbate the short-term focus that is widely considered to be a contributing factor to the financial crisis. The prospect of frequent election contests could cause directors to focus on short-term stock price rather than invest for the creation of long-term value. This already is evident in the practices of some hedge funds, which have encouraged companies where they invest to engage in practices that increase immediate financial returns to shareholders, but may be harmful to longer-term growth, such as demanding overleveraging, increased dividends and reduced capital expenses.

Proxy access also could lead to the election of "special interest" directors, who may promote their own interests or those of the shareholders nominating them at the expense of the interests of other shareholders or the company as a whole. For example, if a union-nominated or other special interest director candidate obtains a seat on a corporate board, the board could become divided and dysfunctional, thus weakening the company and impeding its long-term growth. Even if their "special interest" directors are not elected, the company and its shareholders will have been forced to bear the costs and suffer the distraction of a time-consuming and expensive proxy contest.

In view of the substantial cost and disruption and other serious consequences that would result from proxy access, we believe a 1% threshold ownership requirement for nominating shareholders is particularly inappropriate. In this regard, a federal proxy access mandate would result in expensive, highly contentious, and distracting proxy contests. At a time when American business is responding to the financial crisis, we question the wisdom of undertaking actions that will distract management and board attention, invite disruption in the boardroom and discourage directors from serving on boards.

Contemporary boards of directors use a variety of tools and processes to see that qualified directors are presented to shareholders for election. They strategically review skills matrixes of current directors, carefully assess forward-looking skills requirements on the board considering specialized needs, such as audit committee financial experts, see that the relevant knowledge is present to provide guidance, counsel and oversight and undertake evaluations of the board and its committees. They then disclose to shareholders their criteria for board membership along with the qualifications and experience of the nominated directors. A federally mandated proxy access regime cannot substitute for this carefully crafted qualification, assessment and skills prioritization process. Furthermore, shareholders who disagree with decisions made by a board of directors elected pursuant to this process can use the mechanisms afforded them under the existing framework by voting against directors or "voting with their feet" by selling their shares. Shareholders also can make their views known through nominating their own director candidates and engaging in election contests. Many companies also provide means for shareholders to communicate with the board about various matters, including recommendations for director candidates and the director election process in general.

Despite these concerns about a federally mandated proxy access regime, Business Roundtable believes that shareholders and companies should be able to consider recent state proxy access enabling statutes and to implement proxy access provisions that are adapted to the distinct characteristics and needs of the individual company or, alternatively, to determine that proxy access is unnecessary or inappropriate at their company. Thus, we support proposed revisions to SEC Rule 14a-8 to allow shareholders to offer customized proxy access proposals with the modifications discussed in our comment letter on the SEC's proposed proxy access rules. In 2009, the Delaware legislature adopted amendments to the Delaware General Corporation Law that expressly permit companies to adopt bylaw provisions allowing shareholders to include director nominees in company proxy materials and provide for the reimbursement of expenses incurred by shareholders in connection with proxy contests.[5] In addition, the American Bar Association recently adopted amendments to the Model Business Corporation Act similar to those enacted in Delaware.[6] The Shareholder Empowerment Act would instead create a federal mandate that would deprive shareholders and their companies from exercising their rights under state law to determine whether or not, and to what degree, they wish to permit shareholders to include director nominees in company proxy materials.

<u>Separation of Chairman and Chief Executive Officer</u>

Both the Shareholder Empowerment Act and the Corporate Governance Reform Act would require that the chairman of the board of directors be an independent director. Business Roundtable recognizes the importance of independent board leadership, as reflected in our Principles of Corporate Governance, but a single method of providing that leadership is not appropriate for all companies at all times.

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[5] Delaware General Corporation Law §§ 112 and 113 (2009).

[6] *See* Press Release, American Bar Association, *Corporate Laws Committee Adopts New Model Business Corporation Act Amendments to Provide for Proxy Access and Expense Reimbursement* (Dec. 17, 2009). Thirty states have adopted all or substantially all of the Model Business Corporation Act. *See* Model Business Corporation Act, Introduction (2008).

Thus, while some companies have separated the positions of chairman of the board and chief executive officer, and at some of these companies the chairman is independent, others have voluntarily established lead independent or presiding director positions. These lead or presiding directors generally are responsible for approving the agenda for board meetings, as well as the information to be provided for the meeting, calling and chairing executive sessions of the board and performing other functions. Recent studies indicate that companies have been implementing changes to their board leadership structures to enhance board independence. According to the RiskMetrics Group 2010 Board Practices survey, from 2003 to 2009, the number of S&P 1,500 companies with separate chairmen of the board increased from 30% to 43%. In addition, a 2007 Business Roundtable survey of member companies indicated that 91% of member companies have an independent chairman or an independent lead or presiding director, up from 55% in 2003. Finally, according to the 2008 Spencer Stuart Board Index, by mid-2008, 95% of S&P 500 companies had a lead or presiding director, up from 36% in 2003.

Companies need the ability to adapt their leadership structures to their individual circumstances depending on the needs of the company at any particular time in its evolution. For example, a company may determine that separating the roles of chairman and chief executive officer will weaken its ability to develop and implement its strategy and that combining the roles would provide the most efficient and effective leadership model. On the other hand, during the transition to a new chief executive officer, some companies may determine it is appropriate to have a separate chairman to allow the new chief executive officer to focus primarily on management responsibilities. This illustrates the need for, and advantages of, being able to determine the approach to independent board leadership that will work most effectively for them at different points in time. Our Principles of Corporate Governance reflect this concept that a company's board leadership structure should not be static, but rather should be considered as part of the succession planning process in light of the company's facts and circumstances.

Shareholders today are being provided with more information about their companies' board leadership structures. While many companies have addressed this issue in their corporate governance principles for quite some time, the SEC recently required companies to provide disclosure to shareholders about board leadership.[7] Specifically, companies are required to discuss whether they combine or separate the positions of chairman and chief executive officer and describe why their leadership structure is appropriate for the company. As a result of these new disclosures, shareholders now have more information to assess whether their company's leadership structure is appropriate. Shareholders also have the ability to use the SEC's shareholder proposal process under Rule 14a-8 to seek a particular leadership structure at the

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[7] *See* Proxy Disclosure Enhancements, SEC Release No. 33-9089, 34-61175, 74 Fed. Reg. 68,334 (Dec. 23, 2009).

companies in which they invest. Indeed, RiskMetrics statistics indicate that in 2009 companies held votes on 39 independent chairman shareholder proposals.[8]

Mandating a board leadership structure for the more than 10,000 public companies, regardless of their size, organizational structure, location, business, industry or shareholder base, simply will not work. Dictating a particular board leadership structure could seriously impact companies' ability to operate effectively, thereby jeopardizing job creation and the creation of shareholder value.

Say on Pay

All three proposed bills would require companies to hold an annual shareholder advisory vote to approve the compensation of executives, as disclosed in the proxy statement. While Business Roundtable supports choice for shareholders, including the choice to hold an advisory vote on compensation, we are concerned with a one-size-fits all approach to a say on pay requirement that is applicable to all public companies.

The SEC's shareholder proposal process under Rule 14a-8 affords shareholders the ability to request that companies implement say on pay. In this regard, since 2007, shareholder proposals requesting that companies provide for an advisory vote on executive compensation have become increasingly popular. According to RiskMetrics

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[8] RiskMetrics 2009 Proxy Season Scorecard (Dec. 15, 2009), *available at* http://www.riskmetrics.com/knowledge/proxy_season_watchlist_2009.

statistics, in 2009 companies held votes on 79 shareholder proposals seeking an advisory vote on executive compensation.[9]

Moreover, some companies already have adopted advisory votes in response to shareholder proposals or voluntarily, but in ways they consider most meaningful for their shareholders and most beneficial for the particular company. For example, several companies, including Pfizer Inc. and Colgate-Palmolive Co., have opted for biennial advisory votes, and others like Microsoft Corp. have opted for triennial advisory votes. These alternative approaches are more appropriate for many companies because they are more consistent with the time horizon of many companies' compensation programs.

Broker Discretionary Voting in Uncontested Director Elections

The Shareholder Empowerment Act would prevent brokers from voting securities on an uncontested director election without specific instructions from the beneficial owner of those securities. However, this provision is unnecessary as broker discretionary voting in uncontested director elections was eliminated for all shareholder meetings held after January 1, 2010 under a New York Stock Exchange ("NYSE") rule change approved by the SEC in July 2009. Because the NYSE rule applies to brokers, the amendment applies not only to companies listed on the NYSE, but also to companies listed on other exchanges such as NASDAQ or NYSE Amex.

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[9] *Id.*

Majority Voting

The Shareholder Empowerment Act would require majority voting in uncontested director elections and require companies to adopt director resignation policies relating to director elections. A federal mandate applicable to all public companies is not warranted in this area.

A number of states have adopted legislation to clarify or ease the adoption of some form of majority voting in director elections. For example, Delaware amended its corporate law to provide that, if shareholders approve a bylaw amendment providing for a majority vote standard in the election of directors, a company's board of directors may not amend or repeal the shareholder-approved bylaw.[10] Other states have also amended their corporations statutes to address majority voting as well, including California, Nevada, North Dakota, Ohio, Utah and others.[11] In addition, the American Bar Association approved amendments to the Model Business Corporation Act permitting a company's board or shareholders to adopt majority voting in director elections through bylaw amendments rather than through a more cumbersome process.[12]

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[10] Delaware General Corporation Law § 216.

[11] *See* California Corporations Code § 708.5 (2009); Nevada General Corporation Law § 330 (2009); North Dakota Century Code § 10-35-09 (2009); Ohio General Corporation Law § 1701.55 (2009); Utah Revised Business Corporation Act § 728 (2009).

[12] Model Business Corporation Act § 10.22.

These enabling statutes have facilitated the rapid response of companies and their shareholders to the majority voting movement, which began in 2004 when several labor unions and other shareholder groups began to advocate that companies adopt a majority voting standard in uncontested director elections in order to improve directors' accountability to shareholders. Companies and shareholders alike recognized the merits of a majority voting standard, and this corporate governance enhancement was swiftly adopted by many companies. Research indicates that, as of late 2008, more than 70% of S&P 500 companies had adopted a form of majority voting, up from less than 20% in 2006,[13] and mid- and small-cap companies increasingly are adopting majority voting as well.[14]

Nevertheless, while majority voting is appropriate for many companies, there are circumstances at some companies that make plurality voting a better alternative; for example, at companies where shares are held by only a few large shareholders. Further, voluntary company action, combined with the SEC's shareholder proposal process under Rule 14a-8, has proven to be an effective means for shareholders to seek to implement majority voting. Once again, this should be an issue for shareholder choice.

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13 Melissa Klein Aguilar, *Shareholder Voices Getting Louder, Stronger*, COMPLIANCE WEEK, Oct. 21, 2008, *available at* http://www.complianceweek.com/article/5113/shareholder-voices-getting-louder-stronger.

14 Claudia H. Allen, *Study of Majority Voting in Director Elections* (Nov. 12, 2007), *available at* http://www.ngelaw.com/files/upload/majoritystudy111207.pdf.

Performance Target Disclosure

The Shareholder Empowerment Act would require disclosure of "specific performance targets that are used by issuers to determine a senior executive officer's eligibility for bonuses, equity and incentive compensation." This provision is largely duplicative of SEC rules that already require the disclosure of performance targets in the Compensation and Discussion Analysis of a company's proxy statement, unless this disclosure involves confidential trade secrets or confidential commercial or financial information that, if disclosed, would result in competitive harm. The standard to establish that disclosure of performance targets would cause competitive harm to the company is a strict one,[15] as the SEC staff has emphasized in comment letters to companies seeking revisions to their filings. Accordingly, the performance target disclosure requirement in the Shareholder Empowerment Act is not necessary.

Independent Compensation Consultants

The Shareholder Empowerment Act would require that any compensation advisor engaged by a company be independent of the company and its executives and

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15 The instructions to Item 402(b) of Regulation S-K provide that the standard for determining whether disclosure would cause competitive harm is the same standard that would apply when a company requests confidential treatment pursuant to Rule 406 under the Securities Act of 1933 and Rule 24b-2 under the Securities Exchange Act of 1934 (the "Exchange Act"), each of which incorporates the criteria for non-disclosure under section 552(b)(4) under the Freedom of Information Act. Section 552(b)(4) provides an exemption from disclosure for matters that are "trade secrets and commercial or financial information obtained from a person and privileged or confidential."

directors. New SEC disclosure rules require companies to disclose additional information about the fees paid to their compensation consultants and affiliates of the compensation consultant when such consultant provides other non-compensation related services to the company.[16] This additional disclosure requirement informs shareholders of any possible conflicts of interest and encourages companies to establish practices to avoid even the appearance of a conflict of interest. Business Roundtable believes that requiring compensation consultant independence is unnecessary as shareholders now have information about services provided by compensation consultants and can express their views if they have concerns. Moreover, as a result of the focus on the issue of compensation consultant conflicts of interest, a number of boards have reviewed, and others are reviewing, their practices with regard to the services provided by compensation consultants, and some executive compensation consultants are breaking away from full service consulting firms. Accordingly, legislation in this area is unnecessary.

Severance Agreements Tied to Performance and Advisory Vote on Golden Parachute Compensation

The Shareholder Empowerment Act would prevent companies from entering into agreements providing for severance payments to executives who are terminated for poor performance, and the Proxy Voting Transparency Act would require a separate shareholder advisory vote on "golden parachute compensation" (*i.e.*, any compensation, whether present, deferred or contingent, based on or related to a merger, acquisition or

[16] *See* Proxy Disclosure Enhancements, *supra* note 7.

sale of assets). The advisory vote on executive compensation proposal included in both the Shareholder Empowerment Act and the Proxy Voting Transparency Act and discussed above affords shareholders an advisory vote on all compensation discussed in the company's proxy statement. In this regard, current SEC rules require extensive disclosure about potential termination payments to executives, including any severance or "golden parachute" arrangements. Thus, shareholders already have information about agreements providing for potential severance payments to executives and would have the ability to express their approval or disapproval of such agreements through the say on pay vote. Given this mechanism for shareholder feedback, a separate prohibition or vote on termination payments is unnecessary.

Independent Risk and Compensation Committees

The Corporate Governance Reform Act appears to require that risk management at public companies be overseen by an independent board committee or the full board. Such a requirement is unnecessary since under both NYSE listing standards[17] and state corporate law,[18] boards of directors already have the responsibility for overseeing risk management. Most recently, the SEC has adopted rules requiring disclosure of the

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[17] *See* NYSE Listed Company Manual, Rule 303A.07(c)(iii)(D). The NYSE listing standards require that the audit committee "discuss policies with respect to risk assessment and risk management." The commentary to the listing standards states that the audit committee "is not required to be the sole body responsible for risk assessment and management, but . . . must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken."

[18] *See In re Caremark Int'l Inc. Derivative Litig.,* 698 A.2d 959 (Del. Ch. 1996).

board's role in risk oversight.[19] While some boards currently address risk through their audit committees, other boards have placed responsibility for some aspects of risk oversight to other board committees while still others address risk at the full board level.[20] Our 2010 Principles of Corporate Governance will emphasize the importance of the board of directors taking a proactive role in overseeing the company's risk assessment and risk management processes.

The Corporate Governance Reform Act also appears to require that a company's compensation practices and structure be overseen by an independent board committee or the full board. This provision also is unnecessary as both NYSE and NASDAQ listing standards require independent oversight of compensation decisions.[21] Moreover, due to SEC rules and the Internal Revenue Code, other companies also have compensation decisions made by committees composed of independent directors.[22] According to the RiskMetrics 2010 Board Practices survey, the compensation committees of S&P 500 companies maintained a 99% independence level in 2009, up from 94% in 2003.

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[19] *See* Proxy Disclosure Enhancements, *supra* note 7.

[20] For example, environmental risks may be overseen by the environment, health and safety committee and compensation-related risks may be overseen by the compensation committee.

[21] *See* NYSE Listed Company Manual, Rule 303A.05(c); NASDAQ Marketplace Rules, Rule 5605(d).

[22] *See* Exchange Act Rule 16b-3; Internal Revenue Code § 162(m).

Chief Risk Officer

The Corporate Governance Reform Act would require companies to appoint a chief risk officer. As reflected in our Principles of Corporate Governance, management plays an important role in identifying and managing the risks that a company undertakes in the course of carrying out its business as well as the company's overall risk profile. Nevertheless, companies take a variety of approaches in implementing a management-level risk management structure that is appropriate for the needs of the particular company. For example, many companies in the financial services industry have a chief risk officer, while at companies in other industries the chief risk management role may be held by a different individual or responsibility for risk management may be shared by several individuals. The types of risks companies face vary tremendously according to a variety of factors, including a company's industry, size and business. Consequently, companies must be able to tailor their risk management structure to their business and their overall management structure.

Clawback Policies

The Shareholder Empowerment Act would require company boards or board committees to develop a policy for reviewing any "unearned bonus payments, incentive payments or equity payments that were awarded to executive officers owing to fraud, financial results that require restatement, or some other cause," for the purpose of recovering or cancelling any unearned payments. The SEC already has the authority under the Sarbanes-Oxley Act of 2002 to recoup certain cash and equity incentive compensation paid to the chief executive officer and chief financial officer in the event of an accounting restatement as a result of misconduct. In addition, many companies have voluntarily adopted clawback policies with broader coverage. According to a 2009 Equilar study, 72.9% of Fortune 100 companies have publicly disclosed that they maintain a clawback policy, up significantly from 17.6% in 2006.[23] Companies with existing clawback policies also are modifying them to expand their coverage.[24] In adopting clawback policies companies recognize, as any legislation should, the importance of giving some discretion to a company's board of directors in administering the policy to address the myriad circumstances that may occur.

Director Certification

The Corporate Governance Reform Act would require the SEC to conduct a study on the feasibility of requiring, and the logistics of implementing, a certification process under which director candidates would be required to obtain certification by the SEC. The SEC's primary role is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The SEC does not have any particular expertise in evaluating the background and experience of individuals to determine

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23 Press Release, Equilar Inc., *Clawback Policies Get More Clarity in 2009* (Nov. 18, 2009), *available at* http://www.equilar.com/press_20091118.php.

24 *See* Katie Wagner, *PepsiCo Expands Clawback Policy Following Risk Review*, AGENDA (Mar. 29, 2010), *available at* http://www.agendaweek.com/articles/20100329/pepsico_expands_clawback_policy_following_risk_review.

whether they are qualified to serve as directors. Instead, the SEC recently adopted rules requiring expanded disclosure of the skills and experience of each director nominee that led to the conclusion that the nominee is qualified to serve as a director of the company.[25] As a result of these new disclosures, shareholders now have more information on which to make a judgment with respect to director nominees. Many private organizations provide director education and training and some, such as the National Association of Corporate Directors, provide a certification program for directors. This is not an appropriate role for the federal government.

Other Related Issues That Should Be Considered

Before adopting legislation that would make sweeping corporate governance changes, is important to considers a number of related areas. For example, concerns about the current shareholder communications system, the integrity of the proxy voting system and the influence of the proxy advisory services have been raised by many groups in recent years, including the Business Roundtable and the Council of Institutional Investors. We are pleased that SEC Chairman Mary Schapiro has indicated that the Commission is beginning its study of these issues, but they must be resolved prior to or at least in conjunction with the implementation of some of the changes in the proposed legislation.

[25] *See* Proxy Disclosure Enhancements, *supra* note 7.

Fixing the Shareholder Communications System

The shareholder communications system in the United States is complex and integrated, involving companies, directors, shareholders, proxy solicitors, proxy voting services and others. Rules administered by the SEC make it difficult and expensive for companies to communicate with the beneficial owners of their securities held in street name, as described by the Shareholder Communications Coalition, of which Business Roundtable is a member (see Exhibit III), and in a recent white paper commissioned by the Council of Institutional Investors (attached as Exhibit IV).

Problems with the current shareholder communications system need to be resolved before the adoption of corporate governance legislation as certain provisions will increase the need for companies to communicate with their shareholders. More frequent proxy contests brought about by proxy access would result in additional communications between companies and their shareholders in order to solicit support for candidates. Proxy access would add to the already-increasing need for companies to communicate with their shareholders, which has resulted from greater activism by institutional shareholders, the prevalence of majority voting and the elimination of broker discretionary voting in uncontested director elections.

While companies have been increasing their engagement efforts through meetings with their large shareholders to discuss governance issues, as well as using surveys, blogs, webcasts and other forms of electronic communication, the current shareholder communications system stands in the way of these efforts.

Voting Integrity

It is also critical that concerns related to the integrity of the current proxy voting system be addressed. Numerous commentators have noted that the proxy voting system in the United States is antiquated, byzantine and inadequate.[26] Complexities in the proxy voting system can lead to problems such as empty-voting (voting with no economic interest due to hedging or derivatives) and over-voting (in the case of loaned shares), which raise concerns regarding the integrity of the proxy voting process.[27] An increase in the frequency of contested elections, which would likely stem from any federal proxy access mandate, will place additional demands on an already over-burdened and ill-functioning system. Accordingly, it is important that such issues be considered before any federal proxy access right is mandated.

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[26] *See, e.g.*, *Voting Integrity: Practices for Investors and the Global Proxy Advisory Industry*, The Millstein Center for Corporate Governance and Performance (2009), *available at* http://millstein.som.yale.edu/Voting%20Integrity%20Policy%20Briefing%2002%2027%20 09.pdf; John C. Wilcox, *Shareholder Nominations of Corporate Directors: Unintended Consequences and the Case for Reform of the U.S. Proxy System*, Comment, SEC File No. 4-537 (May 13, 2007); Charles Nathan, *"Empty Voting" and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds*, THE CORPORATE GOVERNANCE ADVISOR (Jan./Feb. 2007).

[27] *See, e.g.*, Henry T.C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

Undue Influence of Proxy Advisory Services

The role of proxy advisory services and the processes used by these firms in generating voting recommendations and making voting decisions needs to be addressed, including considerations of increased regulatory oversight and transparency. Current laws impose fiduciary responsibilities on investment advisors, investment companies, and most retirement and pension plans in voting their proxies. Because many institutional investors and their third-party investment managers do not have sufficient staff to review and vote on proxy items, they outsource their voting decisions to proxy advisory firms, which frequently apply a one-size-fits-all approach to their voting recommendations. Widespread use of proxy advisory services by institutional investors has resulted in proxy advisory firms having a significant impact on shareholder voting and corporate governance. As noted earlier, a federal proxy access mandate will increase the frequency of director election contests, and, accordingly, increase the influence of proxy advisory firms.

Despite their significant influence, proxy advisory firms remain largely unregulated and provide limited and varied transparency about their methodologies and decision-making processes. Consideration should be given to more robust oversight of proxy advisory services by the SEC, including conflict of interest disclosure, standards for professional and ethical conduct and disclosure of the methodology used by proxy advisory firms. Moreover, consideration should be given to the oversight by institutional investors with respect to any delegation, either expressly or implicitly, of their voting rights to a proxy advisory firm.

Conclusion

Business Roundtable is committed to corporate governance practices that enable U.S. companies to compete globally, create jobs and generate long-term economic growth. We believe in corporate boards and management holding themselves to high standards of accountability and making changes in their governance practices as necessary and appropriate, taking into account the circumstances and shareholder wishes at individual companies. We are concerned that the proposed legislation would take these choices away from companies and their shareholders and endanger the engine of economic growth that is the American corporation.

The Risks to Private Enterprise from Federal Preemption of State Corporate Law

Peter Atkins, Skadden, Arps, Slate, Meagher & Flom LLP, 2009/12/18 09:27 Eastern Standard Time

Editor's Note: Peter Atkins is a Partner for Corporate and Securities Law Matters at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden client memorandum, and follows up on matters raised by Mr. Atkins in this post on the Forum regarding his article entitled *Raising the Bar*.

The current multi-pronged effort for U.S. federal preemption of state corporate law, particularly in the area of corporate governance, is largely predicated on the view that it is necessary to forestall excessive risk-taking in the private sector. However, the federal preemption "cure" is a carrier of its own systemic disease. Before imposing this "cure," it is essential to make a responsible assessment of its need and consequences.

State Regulation of Public Business Corporations: A Cornerstone of Capitalism

The modern U.S economic system — variously called capitalism, free enterprise or private enterprise — is centered around the publicly traded business corporation organized under state law. It is the principal vehicle for gathering non-government capital, investing it and managing the businesses in which it is invested. Historically, the governance of these companies has been regulated by their states of incorporation, with limited exceptions. And, in general, the state law-based corporate governance model has been very respectful — indeed protective — of the core concepts of the U.S. private enterprise system: freedom, capital raising, risk-taking, experimentation, innovation and value maximization. The model recognizes that publicly traded business corporations, as key enablers of the U.S. capitalist system, should be regulated in a manner which permits these core private enterprise concepts to operate with minimal interference.

The Price of Free Enterprise Is Eternal Vigilance

Economic systems can crash and burn — as we recently almost witnessed. Fortunately, the mechanisms in place and those that were quickly added permitted a rescue operation that averted the abyss.

However, economic systems also can die due to changes imposed on them and the vitality-sapping effects of such changes over time. The U.S. private enterprise system has worked remarkably well for more than 200 years. The fundamental productivity, creativity, adaptability, growth capacity, power and global leadership of our economic system cannot be denied. Like all systems, however, America's free enterprise economy faces the constant danger of systemic erosion due to (1) the failure of vigilance in continuing to recognize its importance and what makes it tick and (2) the desire to "improve" the system without identifying and carefully weighing the downside to the system of the improvements. Systemic erosion is a creeping phenomenon, without red flags flashing danger signals. Moreover, such erosion is susceptible to acceleration when systemic speed bumps occur (as is inevitable) and, in response, a heightened sense of the need for repair takes over (augmented, often, by political and special group agendas).

The Current Danger Zone

The U.S. appears to be in that danger zone right now. However, before examining that zone in greater detail, it needs to be noted that the thrust of this article is *not* a rant against government intervention in economic matters. The U.S. free enterprise system has never been perfectly free, nor should it be. Clearly there is a role for government regulation and oversight. And times of crisis can point out areas where a larger role is appropriate on a temporary basis and, in some cases, longer term.

That said, today's reality is not about the need for federal preemption of corporate governance regulation under state law. Yet, here is what seems to be happening. In the aftermath of the financial system crisis of 2008, the publicly traded business corporation has come under siege by the federal government. The main assertion is that the near collapse of the financial system was the product of excessive risk-taking by corporate America, permitted by lax directorial oversight and incentivized by excessive compensation practices. The proposed cure is federal preemption of corporate governance by enacting in Washington a raft of uniform federal "good governance" requirements for U.S. publicly traded business corporations. What seems to be missing is adequate identification and a true appreciation of the near and longer term adverse effects that could flow from these requirements.

It is not difficult to ask many questions that need to be answered before federal preemption is implemented — and the answers to these questions should have a direct bearing on whether any steps are taken in that direction and, if so, which ones. These questions include:

- Did U.S public company boards and businesspersons really cause the financial crisis of 2008? What about all of the companies that were not part of the financial sector — were their directors and executives even involved? And what about the failure to regulate the financial markets in order to guard against "excessive risk" — was that a failure of private enterprise or of the federal government, including existing oversight agencies?
- Is there any demonstrable correlation between any of the proposed federally-imposed corporate governance "fixes" and reining in "excessive risk-taking" — or even, for that matter, producing significantly better governance for all public companies? [1] Even if so, is such improvement necessary to avoid material systemic risk to the U.S. free enterprise system?
- In the absence of a clear showing that it will result in the avoidance of material systemic harm, what is the justification for federal government preemption of corporate governance under state law?
- Have the proposed "fixes" been individually critiqued for the possibility of causing harm to the private enterprise system? If so, what is the assessment? For example, what is the potential negative effect of the increased empowerment of shareholders vis-à-vis directors on the need for risk-taking by directors as an essential element of capitalism and on the willingness of directors to serve on public company boards?

The Need for and Meaning of Responsible Assessment

The basic message is this: In assessing the need for and nature of governmental intervention to effect reforms today in our economic system, the federal government (both the executive and legislative branch) has a special duty to act responsibly. Acting responsibly should mean at least the following:

- Understanding — and placing a high priority on — the critical importance of the U.S. private enterprise system to America and all of its people.
- Understanding — and guarding against unnecessary damage to — the core concepts on which the U.S. private enterprise system rests: freedom, capital raising, risk-taking, experimentation, innovation and value maximization over time.
- Requiring (except for emergency actions in a time of crisis, which clearly is not present now) that every act of government intervention intended to affect the existing U.S. economic system undergo a rigorous economic impact assessment.
- Applying in such assessments a principle of restraint in the form of a presumption against intervention unless it is shown:
    - (a) that the harm to be mitigated by the intervention is systemic and substantial,

- (b) by credible evidence, that the intended mitigation is very likely to be achieved, and
- (c) that the adverse effects, if any, of the intervention are not likely to have as great or greater systemic impact than the benefit to be obtained by the intervention.

A Final Word

The message from Washington to corporate America appears to be: “You have a responsibility to stay alert, make informed decisions and not put at risk the system on which we all rely.” If there was ever a time when Washington — the White House, the Senate, the House of Representatives, the Securities and Exchange Commission and other federal agencies — should heed its own advice, it is right now in relation to the attack by Washington on a cornerstone of capitalism, state regulation of public business corporations. And when Washington considers applying its medicinal powers to “cure” systemic ills, it should pay close attention to the medical aphorism, “First, do no harm.”

Endnote:

[1] These proposed “fixes” were summarized in *Raising the Bar* as follows:

- *greater empowerment of shareholders vis-à-vis directors* (*e.g.*, mandatory majority voting in the election of directors, requiring shareholder access to company proxy statements in the election of directors, eliminating classified boards, granting shareholders the right to call special meetings, requiring cumulative voting and mandating annual “say-on-pay” votes by shareholders);
- *increased public disclosure about directors* (*e.g.*, regarding their experience, qualifications attributes and skills), *about pay practices* (*e.g.*, disclosure of specific performance targets for incentive compensation, and disclosure regarding compensation paid to the lowest and highest paid employees and related matters) and *about risk-taking* (*e.g.*, discussion and analysis of risk-related overall compensation policies and practices for employees generally, if the risks arising from those policies and practices” may have” a material affect on the company, and disclosing the relationship of a company’s overall compensation practices to risk management);
- *mandating certain board structural requirements* (*e.g.*, that every board have a risk committee, and that every board separate the board chair and CEO positions, and that the chair be independent); and
- *mandating certain specific pay practices* (*e.g.*, barring severance agreements for executives terminated for poor performance, requiring that executives hold equity awards until retirement, and requiring companies to develop and disclose claw-back policies).

Business Roundtable

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August 17, 2009

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: *File No. S7-10-09*
Facilitating Shareholder Director Nominations

Dear Ms. Murphy:

This letter is submitted on behalf of Business Roundtable, an association of chief executive officers of leading U.S. companies with more than $5 trillion in annual revenues and nearly 10 million employees. We appreciate the opportunity to once again provide our views on Commission rulemaking to require companies to include shareholder nominees for director in company proxy materials under certain circumstances. Due to the importance with which we view these proposals and the significant number of questions raised in the Commission's proposing release, we provide below general comments on the proposals and submit more detailed comments in an attachment to this letter. Our detailed comments reflect the results of surveys of our members. To facilitate the Commission's review of our comments, the subheadings in the attachment include references to the question numbers in the proposing release.

Business Roundtable has long been at the forefront of efforts to improve corporate governance. We have been issuing "best practices" statements in this area for three decades, including *Principles of Corporate Governance* (November 2005), *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004), *Guidelines for Shareholder-Director Communications* (May 2005), and *Executive Compensation: Principles and Commentary* (January 2007). All of these best practices statements have been driven by one principle: to guide corporate governance practices and further U.S. companies' ability to create jobs, products and services for the economic well-being of all Americans. We also strongly supported enactment of the Sarbanes-Oxley Act of 2002, the Commission's implementing rules and the revisions to the corporate governance listing standards of the securities markets. And our member companies, as well as other publicly-traded companies, voluntarily have adopted numerous corporate governance enhancements over the past several years, including majority voting in uncontested director elections. Recently, we published our principles for addressing the current economic crisis and avoiding future crises. In sum, we share the Commission's belief that corporate boards and management must hold themselves to high standards of corporate governance and that steps must be taken to see that an appropriate regulatory framework is established to forestall another economic crisis.

As the Commission is well aware, this is the third time in the past six years that it has issued proposed rules addressing the ability of shareholders to include their director nominees in company proxy materials, so-called "proxy access." Commentators raised substantial concerns about prior proposals, and the Commission determined each time not to move forward. Now, the Commission has proposed its most expansive approach to proxy access, stating that the proposals are warranted "in light of one of the most serious economic crises of the past century." We must take issue with this proposition as the Commission has been debating the issue of proxy access for decades. Even if there is some nexus to the economic crisis, the proposed proxy access regime will, in the words of Commissioner Casey, "be imposed not only [on] the country's largest banks and Wall Street firms, but also on thousands of other large and small public companies across the country." Most troubling is the fact that the Commission's proposals may well exacerbate one of the agreed-upon causes of the crisis—the emphasis on short-term gains at the expense of long-term, sustainable growth.

Further, while the Commission indicates that proposed Rule 14a-11 is intended to remove impediments to shareholders exercising their *state* law rights, it would instead create a *federal* mandate that would deprive shareholders and their companies from exercising their rights under state law to vary the terms of any proxy access procedure. This "one size fits all" federal mandate does not facilitate shareholder rights but instead supplants the shareholder choice that is provided under state law. State law, as evidenced by the recent amendments to Delaware law addressing proxy access and proxy reimbursement (which are described in our detailed comments), provides shareholders and boards of directors with the opportunity to deal effectively with the myriad of different circumstances applicable to their companies in designing a proxy access and/or proxy reimbursement regime. This enabling approach of state law has worked well in recent years as hundreds of companies have amended their bylaws to adopt a majority voting standard in uncontested director elections voluntarily and in response to votes on shareholder proposals. We believe that a similar approach is warranted here, rather than have the Commission impose a "one size fits all" federal mandate.

In addition, proposed Rule 14a-11 and related proposals, referred to in our detailed comments as the "Proposed Election Contest Rules," would result in expensive, highly contentious, and distracting proxy contests. At a time when American business is responding to "one of the most serious economic crises in the past century," we question the wisdom of undertaking actions that will distract management and board attention, invite disruption in the boardroom and discourage directors from serving. The prospect of having to run for election in a highly charged, political atmosphere and serve on a board with "special interest" directors is sure to deter the very qualified and experienced individuals we want to serve as members of corporate boards. This is especially true given the Commission's recent approval of amendments to New York Stock Exchange Rule 452, which will eliminate broker discretionary voting in director elections at shareholder meetings held after January 1, 2010.

We also believe that the Commission has grossly underestimated the staff resources necessary to administer the procedure to be created under proposed Rule 14a-11 at a time when the Commission is seeking, and being given, greater responsibilities to oversee the nation's capital markets. It also has underestimated the resources that companies will have to expend under the Proposed Election Contest Rules as described in our more detailed comments. Finally, the Commission has not addressed the fact that proposed Rule 14a-11 will increase the influence of unregulated proxy advisory services, which frequently apply a "one size fits all" approach to their recommendations.

Given the substantial problems presented by proposed Rule 14a-11, the Commission's questionable authority to enact it, and other infirmities in the rulemaking process, we believe that a far better alternative would be for the Commission to defer any action on proposed Rule 14a-11 and instead adopt revised amendments to Rule 14a-8(i)(8) to permit shareholders to include proxy access shareholder proposals in company proxy materials. While in 2007 we did not support the Commission's proposal to amend

Rule 14a-8(i)(8) to permit such shareholder proposals, we believe that recent state law developments and the addition of certain disclosure provisions to the Commission's current proposals warrant a different position today. As noted above, several states (including Delaware) have amended, or are in the process of considering amendments to, their corporate laws to permit boards and shareholders to adopt bylaw amendments addressing the ability of shareholders to have their director nominees included in company proxy materials and providing for reimbursement of expenses in proxy contests. Moreover, we note that one of our primary concerns about the Commission's 2007 proposal was that it would have permitted shareholders to include their nominees in company proxy materials without the attendant disclosures mandated by the Commission's rules governing proxy contests. In contrast, the current proposals include disclosure requirements when a shareholder nominee is included in a company's proxy materials pursuant to state law or a company's governing documents.

If the Commission were nevertheless to proceed with adopting proposed Rule 14a-11 despite the serious problems identified above, our detailed comments set forth significant modifications that, if not included, would make the rule particularly problematic. Most importantly, any final rule should not preempt the proxy access procedures established or authorized by state law or a company's governing documents. Accordingly, proposed Rule 14a-11 should not apply where a company's shareholders or board have adopted a proxy access or proxy reimbursement bylaw or where a company is incorporated in a state whose law includes a proxy access right or the right to reimbursement of expenses that shareholders incur in connection with proxy contests. In addition, companies should be exempt from proposed Rule 14a-11 if they have adopted majority voting in uncontested director elections because majority voting increases shareholder influence and results in greater board accountability, thereby making proxy access unnecessary. Any final rule also must contain: (1) triggers such that proposed Rule 14a-11 would only be applicable when certain events have occurred indicating that greater director accountability is necessary at a particular company; and (2) revised thresholds that satisfy the Commission's objective of limiting the proposed rules to "holders of a significant, long-term interest." Such measures are necessary to ameliorate the significant cost and disruption that will result from proposed Rule 14a-11. In addition, we suggest limiting the number of directors that can be nominated under proposed Rule 14a-11. Our detailed comments contain a number of other recommendations that we believe should be implemented if the Commission moves forward with proposed Rule 14a-11, a course of action which we strenuously oppose. Importantly, we recommend that there be at least a one-year transition period before the effective date of any rule creating a federal proxy access mandate.

In conclusion, we believe that a federal proxy access right is unnecessary, has serious adverse consequences, and is beyond the Commission's authority to adopt. Most importantly, it has the potential to exacerbate one of the causes—short-termism—of the very economic crisis that the Commission says it seeks to address in its proposed rules. Instead, the Commission should adopt revised amendments to Rule 14a-8(i)(8) to provide shareholders and boards of directors the opportunity to develop company-specific approaches to proxy access. In addition, it should adopt proposed Rule 14a-19 to provide shareholders with essential disclosures if a shareholder nomination is included in a company's proxy materials pursuant to state law or the company's governing documents.

Thank you for considering our comments. We would be happy to discuss our concerns or any other matters that you believe would be helpful. Please contact Larry Burton, Executive Director of Business Roundtable, at (202) 872-1260.

Sincerely,

Alexander M. Cutler

Alexander M. Cutler
Chairman and Chief Executive Officer of Eaton Corporation
Chair, Corporate Leadership Initiative, Business Roundtable

Enclosures

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
Ms. Meredith B. Cross, Director, Division of Corporation Finance
Mr. David M. Becker, General Counsel and Senior Policy Director
Ms. Kayla J. Gillan, Senior Advisor to the Chairman

Detailed Comments
of
Business Roundtable
on
the Proposed Election Contest Rules and
the Proposed Amendment to the Shareholder Proposal Rules
of the
U.S. Securities and Exchange Commission

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DETAILED COMMENTS OF BUSINESS ROUNDTABLE ON THE PROPOSED ELECTION CONTEST RULES AND THE PROPOSED AMENDMENT TO THE SHAREHOLDER PROPOSAL RULES

These comments are divided into four sections. Section I demonstrates why proposed Rule 14a-11 and certain related proposed rule amendments (the "Proposed Election Contest Rules") are not necessary, would have serious adverse consequences and are beyond the authority of the Securities and Exchange Commission (the "Commission" or "SEC") to adopt. Section II discusses why the Commission should consider a revised amendment to Rule 14a-8 as an alternative to the Proposed Election Contest Rules. Section III discusses the substantial revisions that would be necessary if the Commission nevertheless determines to adopt the Proposed Election Contest Rules. Section IV demonstrates that this rulemaking, particularly as it relates to the Proposed Election Contest Rules, is substantively and procedurally flawed in violation of the Administrative Procedure Act and numerous other requirements applicable to agency rulemaking. We do not address in these comments the applicability of the rules proposed by the Commission to investment companies. References in the headings are to the numbered requests for comment in the Commission's proposing release (the "Proposing Release").[1] Attached also is an economic analysis prepared by NERA Economic Consulting and Professor Jonathan Macey demonstrating that the Proposed Election Contest Rules would impose substantial costs on all public companies, impair their efficiency and competitiveness, and further undermine the attractiveness of U.S. equity markets, while, at best, amounting to only modest savings for shareholders engaging in proxy contests at a handful of companies.[2]

I. The Proposed Election Contest Rules

A. The Proposed Election Contest Rules Are Not Necessary [A.1.]

A significant regulatory change should be adopted only in response to a significant need for regulation. Yet, the Commission has issued proposals that would bring about a sweeping transformation of the director election process without an adequate explanation of why they are necessary. At the outset, the Commission's assertion that the Proposed Election Contest Rules are a necessary response to the current economic crisis has no basis in fact. Moreover, state legislatures are already addressing the issue of proxy access. Further, the dramatic corporate governance reforms of the past six years, such as the widespread adoption of majority voting in uncontested director elections, obviate the need for the Proposed Election

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[1] Facilitating Shareholder Director Nominations, SEC Release No. 33-9046, 34-60089, 74 Fed. Reg. 29,024 (June 18, 2009).

[2] See NERA Economic Consulting (Elaine Buckberg, Ph.D., Senior Vice President) & Jonathan Macey (Sam Harris Professor of Corporate Law, Corporate Finance & Securities Law, Yale Law School), *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation* (Aug. 17, 2009) (attached as an exhibit).

Contest Rules. In addition, the traditional proxy contest (the cost of which has been reduced as a result of the Commission's "notice and access" rules and will not be further reduced significantly by the Proposed Election Contest Rules) provides shareholders with a viable alternative means to affect membership on corporate boards. Finally, shareholders have the ability to bring about change in board composition through other avenues, such as the Commission's shareholder proposal process and "vote no" campaigns, a further indication that the Proposed Election Contest Rules are unnecessary.

1. The Economic Crisis Does Not Necessitate The Adoption Of The Proposed Election Contest Rules [A.7.]

The premise upon which the Commission's proposals rest is deeply flawed. As its principal justification for the proposals, the Commission cites the current economic crisis and draws the sweeping conclusion that a loss of investor confidence resulting from the crisis necessitates the adoption of the Proposed Election Contest Rules. However, the purported link between the Proposed Election Contest Rules and the economic crisis is unsubstantiated.[3] The crisis likely stemmed from a variety of complex financial factors, and even experts disagree about its origins.[4] Notably, Congress recently established the Financial Crisis Inquiry Commission to investigate the causes of the crisis.[5] Given that the roots of the crisis are still being debated and explored, the Commission's attempt to establish a causal relationship between proxy access and the crisis is premature. In fact, the Proposed Election Contest Rules could exacerbate factors that may have contributed to the crisis, such as the emphasis on short-term gains at the expense of long-term, sustainable growth.[6] As explained in Section I.B.1 below, the Proposed Election Contest Rules will increase the focus on short-termism.

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3 *See* Lawrence Mitchell, *Protect Industry from Predatory Speculators*, FINANCIAL TIMES, July 8, 2009. Professor Mitchell, a George Washington University law professor, argues that it is "hyperbolic" to suggest that inattentive boards had anything significant to do with the current recession.

4 *See* Chairman Ben S. Bernanke, Four Questions About the Financial Crisis (Apr. 14, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm (observing that experts disagree about appropriate weight to assign to various explanations for the crisis).

5 *See* Stephen Labaton, *A Panel Is Named to Examine Causes of the Economic Crisis*, N.Y. TIMES, July 16, 2009, at B3.

6 *See* Mitchell, *supra* note 3.

The Proposed Election Contest Rules also will apply to almost all public companies—not only to those financial institutions that may have played a key role in the crisis—thus further undermining the assertion that the proposals are a necessary response to the economic crisis.[7] In addition, the Commission has proposed similar proxy access rules twice before in the past six years, which suggests that the economic crisis does not provide a justification for the Proposed Election Contest Rules.[8]

Nor does the Commission explain how the Proposed Election Contest Rules will increase investor confidence. Rather, the Proposed Election Contest Rules could easily harm investor confidence.[9] As detailed in Section I.B below, numerous serious consequences, such as the enhanced influence of proxy advisory firms, the difficulty of satisfying board composition requirements and the possible election of "special interest" directors, could occur if the Commission adopts the Proposed Election Contest Rules. These deleterious effects may actually diminish investor confidence, thus frustrating the Commission's stated objective for proposing the Proposed Election Contest Rules.

2. **State Law Developments Regarding Proxy Access Render The Proposed Election Contest Rules Unnecessary** [A.2., A.12.]

State corporate law is not static but, rather, adjusts to changing circumstances. Over the past several years, state corporate law has adapted to address new corporate governance issues. This recent activity at the state level makes it clear that Commission action to address proxy access is unnecessary.[10]

In 2009, the Delaware legislature adopted amendments to the Delaware General Corporation Law that took effect August 1 that expressly permit companies to adopt bylaw

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7 *See* SEC Commissioner Kathleen L. Casey, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009klc.htm.

8 *See id*. Indeed, the Commission has considered amendments to the proxy rules and regulations to address proxy access in 1942, 1977, 1980, 1992, 2003 and 2007. *See* Security Holder Director Nominations, SEC Release No. 34-48626, 68 Fed. Reg. 60,784, 60,785-86 (Oct. 23, 2003); *see also* 74 Fed. Reg. at 29,029-31.

9 *See* SEC Commissioner Troy A. Paredes, Remarks at Conference on "Shareholder Rights, the 2009 Proxy Season, and the Impact of Shareholder Activism" (June 23, 2009), *available at* http://www.sec.gov./news/speech/2009/spch062309tap.htm ("Here, it is worth observing that subjecting shareholders to an access regime they do not want is unlikely to restore investor confidence and actually may erode it.").

10 *See also infra* Section III.A.

provisions allowing shareholders to include director nominees in company proxy materials,[11] and provide for the reimbursement of expenses incurred by shareholders in connection with proxy contests.[12] New Section 112 of the Delaware General Corporation Law permits a company to amend its bylaws to provide that shareholders may include director nominees in the company's proxy materials "to the extent and subject to such procedures or conditions as may be provided in the bylaws."[13] Among other things, these procedures or conditions may include:

- minimum record or beneficial ownership thresholds, including a definition of "beneficial ownership" that addresses options or other rights related to stock ownership;
- minimum requirements on duration of stock ownership;
- requirements governing the submission of background information about the nominee and the nominating shareholder(s);
- parameters governing the number of directors that shareholders can nominate under the proxy access bylaw and shareholders' ability to make repeat nominations;
- restrictions on a shareholder's ability to nominate directors if the shareholder has acquired a specified percentage of the company's voting stock within a certain time period prior to the election of directors;
- a requirement that shareholders indemnify the company for losses arising from any false or misleading information submitted in connection with a nomination; and
- "[a]ny other lawful condition."[14]

These criteria, as Commissioner Casey observed, are "the exact same matters" that the Proposed Election Contest Rules address.[15] Indeed, the Proposed Election Contest Rules incorporate a number of the elements that appear in Section 112 of the Delaware General Corporation Law. Consistent with the Delaware General Corporation Law and the charters of

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11 8 DEL. CODE ANN. § 112 (2009).

12 8 DEL. CODE ANN. § 113 (2009).

13 8 DEL. CODE ANN. § 112 (2009).

14 8 DEL. CODE ANN. § 112(1)-(6) (2009).

15 Commissioner Casey, Statement at Open Meeting (May 20, 2009), *supra* note 7.

nearly all companies,[16] both shareholders and the board of directors can adopt a proxy access bylaw authorized by Section 112. Further, new Section 113 of the Delaware General Corporation Law permits shareholders and boards to adopt bylaws providing for the reimbursement of expenses incurred by shareholders in connection with a proxy contest.[17]

In addition, the American Bar Association is considering amendments to the Model Business Corporation Act similar to those recently enacted in Delaware.[18] Likewise, the Corporations Committee of the Business Law Section of the State Bar of California currently is evaluating the Commission's Proposed Election Contest Rules and whether to recommend making changes to California's Corporations Code to provide some form of mechanism for shareholders to access company proxy materials. Finally, we note that the North Dakota Publicly Traded Corporations Act, which took effect July 1, 2007, enables shareholders of companies subject to the statute to nominate directors for inclusion in company proxy materials if they have beneficially owned more than 5% of the company's shares for at least two years.[19]

3. **Sweeping Corporate Governance Reforms Obviate The Need For The Proposed Election Contest Rules** [A.2.]

The corporate governance landscape has undergone sweeping changes since the enactment of the Sarbanes-Oxley Act of 2002, thus rendering the Proposed Election Contest Rules unnecessary. A combination of state and federal legislation, rulemaking by the Commission and the securities markets, and voluntary action by companies has resulted in dramatic reforms to corporate governance in the past six years. A number of these reforms, described below, have directly affected the director election process and obviate the need for the Proposed Election Contest Rules.

Majority Voting and Annual Elections. As the Proposing Release acknowledges, the past six years have witnessed the growth of a significant movement by large companies toward a

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16 Section 109(a) of the Delaware General Corporation Law vests the power to adopt, amend or repeal bylaws in a company's shareholders and permits companies to confer this power on the board of directors in their certificates of incorporation. 8 DEL. CODE ANN. § 109(a) (2009).

17 8 DEL. CODE ANN. § 113 (2009).

18 *See* Press Release, American Bar Association, Corporate Laws Committee Takes Steps to Provide for Shareholder Access to the Nomination Process (June 29, 2009). Thirty states have adopted all or substantially all of the Model Business Corporation Act. *See* MODEL BUSINESS CORPORATION ACT, Introduction (2008).

19 N.D. CENT. CODE §§ 10-35-02(8) & 10-35-08 (2009).

majority voting standard in uncontested director elections.[20] Historically, companies have generally elected directors using a plurality voting standard. Under this standard, a candidate will be elected regardless of the number of "withheld" votes he or she receives, as long as the candidate receives one affirmative vote. Under a majority voting regime, a candidate must receive a majority of votes cast in order to be elected. Majority voting thus increases shareholder influence and encourages greater board accountability.[21]

Both state legislatures and companies have responded positively to the majority voting movement. A number of states, including Delaware, have adopted legislation to clarify or ease the adoption of some form of majority voting in director elections.[22] In addition, the American Bar Association's Committee on Corporate Laws similarly amended the Model Business Corporation Act to facilitate majority voting standards.[23] As is generally the case with state corporation laws, these majority voting provisions have been drafted as "enabling" statutes, rather than as "mandatory" statutes. Enabling statutes permit companies and their shareholders to tailor the internal organization of a company to account for the company's individual characteristics.[24] Where a company's board of directors or its shareholders determine that a particular governance structure—such as a majority voting regime—is appropriate, enabling statutes permit, but do not mandate, its adoption.

These enabling statutes have facilitated the rapid response of companies and their shareholders to the majority voting movement, which began in 2004 when several labor unions and other shareholder groups began to advocate that companies adopt a majority voting standard in uncontested director elections in order to improve directors' accountability to shareholders. Companies and shareholders alike recognized the merits of a majority voting

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20 *See* 74 Fed. Reg. at 29,029.

21 *See* Joseph A. Grundfest, Stanford Law School, Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law (May 7, 2007) ("May 7th Roundtable"), at 201 (noting the prevalence of majority voting among S&P 500 companies and stating that majority voting is acting "very powerfully . . . to increase shareholder influence").

22 *See, e.g.*, CAL. CORP. CODE § 708.5 (West 2009); DEL. CODE ANN. tit. 8, § 216 (2009); FLA. STAT. ANN. § 607.0728 (West 2009); N.J. STAT. ANN. § 14A:5-24 (West 2009); N.Y. BUS. CORP. LAW § 614 (McKinney 2009); OHIO REV. CODE ANN. § 1701.55 (West 2009); UTAH CODE ANN. § 16-10a-1023 (West 2009); VA. CODE ANN. § 13.1-669 (West 2009); WASH. REV. CODE ANN. § 23B.10.205 (West 2009).

23 *See* MODEL BUSINESS CORPORATION ACT, §§ 8.07, 10.22 (2008).

24 *See* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS G-15 (3d ed. 2009) (describing modern corporation laws as "enabling"); *see also* Commissioner Paredes, Remarks at Conference (June 23, 2009), *supra* note 9.

standard, and this corporate governance enhancement was swiftly adopted by many companies. A 2008 Business Roundtable survey of member companies indicated that 75% of companies have voluntarily adopted some form of majority voting for directors.[25] Other research indicates that, as of late 2008, more than 70% of S&P 500 companies had adopted a form of majority voting, up from less than 20% in 2006,[26] and mid- and small-cap companies increasingly are adopting majority voting as well.[27]

In addition, a growing number of companies have moved to annual director elections. According to the RiskMetrics Group 2009 Board Practices survey, 64% of S&P 500 companies held annual director elections in 2008 as compared to only 44% in 2004.[28] Likewise, the number of S&P 1,500 companies with classified boards had decreased to 50% in 2008 from 61% in 2004.[29]

Board Independence. Public companies have taken a number of steps to enhance board independence in the past several years. First, there has been a significant increase in the number of independent directors serving on boards. A 2008 Business Roundtable survey of member companies indicated that 90% of our member companies' boards are at least 80% independent.[30] According to the RiskMetrics Group 2009 Board Practices survey, average board independence at S&P 1,500 companies increased from 69% in 2003 to 78% in 2008.[31] According to the same study, in 2008, 85% of S&P 1,500 companies, and 91% of S&P 500 companies, had boards that were at least two-thirds independent.[32]

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25 Business Roundtable Corporate Governance Survey Trends (Dec. 2008), *available at* http://www.businessroundtable.org/sites/default/files/2008%20Corp%20Gov%20Survey%20Trends.pdf.

26 Melissa Klein Aguilar, *Shareholder Voices Getting Louder, Stronger*, COMPLIANCE WEEK, Oct. 21, 2008, *available at* http://www.complianceweek.com/article/5113/shareholder-voices-getting-louder-stronger. The Proposing Release similarly notes that nearly 70% of the corporations in the S&P 500 have adopted some form of majority voting. *See* 74 Fed. Reg. at 29,029 n.69.

27 Claudia H. Allen, *Study of Majority Voting in Director Elections* (Nov. 12, 2007), *available at* http://www.ngelaw.com/files/upload/majoritystudy111207.pdf.

28 RiskMetrics Group, Board Practices: The Structure of Boards of Directors at S&P 1,500 Companies, at 9 (2009).

29 *Id.*

30 Business Roundtable Corporate Governance Survey Trends (Dec. 2008), *supra* note 25.

31 RiskMetrics Group, Board Practices, *supra* note 28, at 11.

32 *Id.* at 12.

In addition, directors increasingly meet in regular "executive sessions" outside the presence of management and 75% of our member companies hold executive sessions at every regular board meeting, compared to 55% in 2003. Moreover, the New York Stock Exchange ("NYSE") listing standards require a non-management director to preside over these executive sessions and require companies to disclose in their proxy materials how interested parties may communicate directly with the presiding director or the non-management directors as a group.

Companies also have made changes to their board leadership structures to enhance board independence. First, there has been a steady increase in the number of companies that have appointed a separate chairman of the board. According to the RiskMetrics Group 2009 Board Practices survey, from 2003 to 2008, the number of S&P 1,500 companies with separate chairmen of the board increased from 30% to 46%.[33] Second, many companies without an independent chair have appointed a lead or presiding director. A 2007 Business Roundtable survey of member companies indicated that 91% of companies have an independent chairman or an independent lead or presiding director, up from 55% in 2003. According to the 2008 Spencer Stuart Board Index, 95% of surveyed S&P 500 companies had a lead or presiding director by mid-2008, up from 36% in 2003.[34] Lead directors' duties are often similar to those of an independent chairman and may include: presiding at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors; serving as liaison between the chairman and independent directors; reviewing or advising on information sent to the board; reviewing or advising on meeting agendas for the board; reviewing or advising on meeting schedules to assure that there is sufficient time for discussion of all agenda items; having authority to call meetings of the independent directors; being available for consultation and direct communication with major shareholders; and providing interim leadership in the event of an emergency succession situation. Many companies provide information about their board leadership structures in their corporate governance guidelines, their proxy statements, or both, and the Commission recently has proposed to require proxy statement disclosure about a company's leadership structure and why that structure is appropriate for the company.[35]

Finally, various organizations are focusing on voluntary steps that companies can take to enhance independent board leadership. In the spring of 2009, the National Association of Corporate Directors, with the support of Business Roundtable, issued the *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies*. One "key agreed principle" states that boards should have independent leadership, either through an

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33 *Id.* at 22.

34 Spencer Stuart Board Index, at 21 (2008), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf.

35 *See* Proxy Disclosure and Solicitation Enhancements, SEC Release No. 33-9052, 74 Fed. Reg. 35,076, 35,082-83 (July 17, 2009).

independent chairman or a lead/presiding director, as determined by the independent directors.[36] The principles further recommend that boards evaluate their independent leadership annually. In March 2009, the Chairman's Forum, an organization of non-executive chairmen of U.S. and Canadian public companies, issued a policy briefing calling on companies to appoint an independent chairman upon the succession of any combined chairman/chief executive officer. The policy briefing recognizes, however, that particular circumstances may warrant a different leadership structure and recommends, in these instances, that companies explain to shareholders why combining the positions of chairman and chief executive officer represents a superior approach.[37]

Communications with Shareholders. Many companies provide means for shareholders to communicate with the board about various matters, including recommendations for director candidates and the director election process in general. In this regard, in 2003 the Commission adopted rules requiring enhanced disclosure about companies' procedures for shareholder communication with the board and for shareholders' recommendations of director candidates.[38] In addition, companies listed on the NYSE must have publicized mechanisms for interested parties, including shareholders, to make their concerns known to the company's non-management directors.[39] The Commission's 2008 rules regarding electronic shareholder forums also provided additional mechanisms for communications between the board and shareholders.[40] According to a 2008 Spencer Stuart survey, board members or members of

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36 National Association of Corporate Directors, *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies*, at 11 (2009), *available at* https://secure.nacdonline.org/StaticContent/StaticPages/DM/NACDKeyAgreedPrinciples.pdf.

37 *See Chairing the Board: The Case for Independent Leadership in Corporate North America*, Millstein Center for Corporate Governance and Performance, at 20, *available at* http://millstein.som.yale.edu/2009%2003%2030%20Chairing%20The%20Board.pdf.

38 *See* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, SEC Release No. 33-8340, 68 Fed. Reg. 69,204 (Dec. 11, 2003).

39 *See* NYSE Listed Company Manual § 303A.03.

40 *See* Electronic Shareholder Forums, SEC Release No. 34-57172, 73 Fed. Reg. 4450 (Jan. 25, 2008). *See also* Jaclyn Jaeger, *The Rise of Online Shareholder Activism*, COMPLIANCE WEEK (Mar. 11, 2008), *available at* http://www.complianceweek.com/article/4007/the-rise-of-online-shareholder-activism (providing examples of successful online shareholder activism).

management of nearly 45% of surveyed S&P 500 companies reached out to shareholders proactively.[41]

Other Changes. In addition, the following data from our member companies illustrates the additional changes in corporate governance that have taken place over the past several years:

- 76% of chief executive officers serve on no more than one other board, and 36% do not serve on any other boards;
- 92% of compensation committees meet in executive session, and 75% meet in executive session at every meeting; and
- the average tenure of a Business Roundtable chief executive officer is down to just five years, demonstrating effective board oversight of management.[42]

As the discussion above indicates, the corporate governance landscape has undergone a sea change over the past six years and continues to evolve. Significantly, many of these corporate governance transformations have occurred as a result of voluntary reforms implemented by companies and their shareholders under the auspices of enabling state corporate law provisions, rather than through legislative or regulatory fiat.

4. Sufficient Means For The Nomination Of Shareholder Director Candidates Already Exist [A.2.]

Currently, shareholders already have a viable avenue for the nomination of director candidates: the proxy contest, in which shareholders seek the election of director candidates by soliciting their own proxies.[43] We note that recent years have seen an increase in the

41 Spencer Stuart Board Index, at 28 (2008), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf.

42 Business Roundtable Corporate Governance Survey Trends (Dec. 2008), *supra* note 25.

43 We also note that shareholders can recommend director candidates to a board's nominating/governance committee. According to a July 2009 survey of Business Roundtable member companies (the "July 2009 Survey"), 100% of responding companies consider such recommendations, and 97% apply the same standards and qualifications to board nominees and shareholder-recommended nominees. The July 2009 Survey was sent to Business Roundtable member companies to gauge their views and opinions regarding the Proposed Election Contest Rules, and 67 companies responded to the Survey.

number of proxy contents.[44] Moreover, short slate proxy contests, in which dissidents seek board representation but not full board control, are far from futile; most short slate proxy contests in recent years have been successful. According to a recent study conducted by the Investor Responsibility Research Center Institute, during a four-year period, short slate proxy contest dissidents were able to gain representation at approximately 75% of the companies they targeted.[45] Significantly, in the majority of these cases, dissidents found it unnecessary to pursue the contest to a shareholder vote; instead, they gained board seats through settlement agreements with the target companies.[46]

Further, we respectfully disagree with the Commission's assertion that the Proposed Election Contest Rules are necessary to address the high cost of proxy contests. Significantly, the Proposed Election Contest Rules will not eliminate some of the most significant costs associated with waging a proxy contest: the cost of legal counsel,[47] proxy solicitors, public relations firms, other advisors, and other proxy solicitation costs, such as advertising. Due to potential liability under the current federal securities laws, legal counsel must be consulted with respect to the required disclosures and solicitation issues that arise in a proxy contest, and additional legal fees arise in connection with litigation.[48] These legal fees will still need to be incurred under the Proposed Election Contest Rules. Nominating shareholders will need to prepare the disclosures required by new Schedule 14N and are likely to need additional legal counseling just as in a traditional proxy contest. Moreover, in a traditional proxy contest, dissidents typically engage other types of advisors, in addition to legal counsel, such as proxy solicitors and public relations experts.[49] The Proposed Election Contest Rules will not reduce the cost of such advisors and other proxy solicitation costs, and instead will address primarily the issues of printing and mailing costs, which have already been addressed by the Commission's "notice and access" rules permitting the electronic delivery of proxy materials in lieu of the delivery of paper proxy materials. To be sure, the availability of "notice and access" reduces the cost of printing and distributing proxy materials, which benefits shareholders that

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44 *See* RiskMetrics Group 2008 Post-Season Report, at 28 (Oct. 2008).

45 Chris Cernich et al., Investor Responsibility Research Center Institute, *Effectiveness of Hybrid Boards*, at 4 (May 2009), *available at* http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf.

46 *Id.* at 4, 13 (noting that 76% of dissidents gaining representation were able to do so through settlement).

47 *See* Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 475-76 (2008).

48 *Id.* at 476.

49 *See* C. William Baxley & Mark E. Thompson, *Corporate Governance*, THE NAT'L LAW J., Mar. 2, 1998, at B5 (describing the logistics of a proxy contest).

nominate director candidates in a traditional proxy contest.[50] However, like the Proposed Election Contest Rules, the "notice and access" rules do not reduce many of the other costs associated with a proxy contest.

5. **Shareholders Already Have The Power To Effect Change In Board Composition Through Other Means** [A.2., A.8.]

Finally, shareholders already have significant power to bring about change in the composition of a company's board through other means—most notably through the shareholder proposal process and "vote no" campaigns against the company's director nominees.

Both binding and precatory shareholder proposals can effect change in board composition. Importantly, shareholder proposals afford shareholders with a choice regarding the governance issues that they wish to raise for consideration by other shareholders. For example, after shareholders approved by a majority of votes cast a binding bylaw amendment requiring an independent chair for the company's board this year, the chief executive officer of Bank of America stepped down as chairman of the board.[51] In addition, precatory shareholder proposals frequently prompt company boards and management to discuss corporate governance issues, including director elections, with shareholder proponents.[52] Precatory shareholder proposals receiving shareholder support may thus encourage companies to adopt governance polices affecting the election of directors. For example, we note that an advisory vote on executive compensation has been implemented at a number of companies where shareholder proposals on this topic received substantial votes.[53]

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50 *See* Shareholder Choice Regarding Proxy Materials, SEC Release No. 34-56135, 72 Fed. Reg. 42,222, 42,231 (Aug. 1, 2007) (noting that the new rules reduce the cost of proxy contests).

51 *See* Dan Fitzpatrick & Marshall Eckblad, *Lewis Ousted as BofA Chairman*, WALL ST. J., Apr. 30, 2009, at A1. In contrast, similar proposals were voted down at other companies, including CVS Caremark Corp., Ashford Hospitality Trust Inc., Wells Fargo & Co. and Exxon Mobil Corp.

52 *See* Edward Iwata, *Boardrooms Open Up to Investors' Input*, USA TODAY, Sept. 7, 2007, *available at* http://www.usatoday.com/money/companies/management/2007-09-06-shareholders-fight_N.htm.

53 As of August 1, 2009, RiskMetrics reports that 82 proposals requesting an advisory vote on executive compensation have been voted on or are pending for 2009 annual meetings. *See* RiskMetrics Group, Inc. 2009 Proxy Season Scorecard (Aug. 1, 2009), *available at* http://www.riskmetrics.com/knowledge/proxy_season_scorecard_2009. At least 25 companies have agreed to hold an advisory vote voluntarily or in response to such a

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In addition, the proliferation of "vote no" campaigns in recent years has provided shareholders with another method for effecting change in board composition. In these low-cost, often well-organized campaigns, shareholder activists encourage other shareholders to withhold votes from, or vote against, certain directors, with such aims as pressuring a company to make corporate governance changes or forcing a director to step down. Although "vote no" campaigns do not have a legally binding effect where the targeted company uses a plurality voting regime in an uncontested election, evidence indicates that such campaigns are nonetheless successful in producing corporate governance reform.[54] Moreover, at companies that have adopted majority voting in director elections, "vote no" campaigns have an even greater impact, as they may result in the removal of directors who do not receive a majority of affirmative votes.

Shareholder proposals and shareholder-sponsored campaigns against directors provide an opportunity for shareholders to address governance issues on a company-by-company basis. Much like the state law enabling statutes regarding majority voting and proxy access described above, shareholder proposals and shareholder "vote no" campaigns allow shareholders to address their concerns at a particular company. Accordingly, in view of shareholders' already-significant influence over the composition of a company's board through other avenues, the Proposed Election Contest Rules are unnecessary.

B. The Proposed Election Contest Rules Will Have Serious Adverse Consequences [A.4.]

Besides being unnecessary for the reasons set forth above, the Proposed Election Contest Rules will have harmful consequences that the Commission has failed adequately to consider and address.[55] We and other commentators have warned the Commission of these consequences in connection with its previous rulemakings addressing this topic.[56] Widespread

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shareholder proposal, including Intel Corp., Motorola, Inc., RiskMetrics Group, Inc., Aflac Inc., H&R Block, Inc., Jackson Hewitt Tax Service, Inc., Zale Corp. and Verizon Communications, Inc.

54 *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

55 *See also infra* Section IV.A. for a detailed analysis regarding how the Proposed Election Contest Rules will reduce efficiency, stifle competition and deter capital formation.

56 *See, e.g.*, Letter from the U.S. Chamber of Commerce to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, SEC File Nos. S7-16-07 and S7-17-07 (Oct. 2, 2007); Letter from Business Roundtable to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, SEC File Nos. S7-16-07 and S7-17-07 (Oct. 1, 2007); Division of Corporation Finance, Supplemental Summary of Comments Received on or After February

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shareholder access to company proxy materials will promote short-termism at the expense of long-term value creation and encourage the election of "special interest" directors. The Proposed Election Contest Rules also will enhance the influence of proxy advisory firms. The addition of shareholder-nominated directors to a corporate board, moreover, could frustrate a company's ability to satisfy the myriad requirements applicable to the composition of corporate boards. Meanwhile, the increased likelihood of divisive and time-consuming annual election contests could deter qualified directors from serving on public company boards of directors. Finally, serious questions have been raised about the ability of the current proxy voting system to handle the increasing number of proxy contests that would result from the implementation of the Proposed Election Contest Rules.

1. The Proposed Election Contest Rules Will Promote Short-Termism And Encourage The Election Of "Special Interest" Directors [A.4., D.13.]

We are concerned that the Proposed Election Contest Rules will promote an unhealthy emphasis on short-termism at the expense of long-term value creation. Business Roundtable is a signatory to *Long-Term Value Creation: Guiding Principles for Corporations and Investors*, also known as the Aspen Principles, a set of principles drafted in response to concerns about excessive short-term pressures in the capital markets. The signatories to the Aspen Principles are a group of business organizations, institutional investors and labor unions, including the AFL-CIO, Council of Institutional Investors and TIAA-CREF, which are committed to encouraging and implementing corporate governance best practices and long-term management and value-creation strategies. As the Aspen Principles recognize, short-termism "constrains the ability of business to . . . create valuable goods and services, invest in innovation, take risks, and develop human capital."[57] To combat the negative repercussions of short-termism, the Aspen Principles recommend that companies and investors should, among other things, make an effort to de-emphasize short-term financial metrics, such as quarterly earnings per share. We note that the Aspen Principles are particularly critical at this juncture, given that, as discussed

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6, 2004 in Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations (May 25, 2004); Division of Corporation Finance, Summary of Comments in Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations (Mar. 5, 2004); Letter from Business Roundtable to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-19-03 (Dec. 22, 2003); Letter from the U.S. Chamber of Commerce to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-19-03 (Dec. 19, 2003).

57 The Aspen Institute, Long-Term Value Creation: Guiding Principles for Corporations and Investors (Apr. 2009), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf.

above, an emphasis on short-term gains at the expense of long-term, sustainable growth is often identified as a contributor to the current financial crisis.

Yet, the Proposed Election Contest Rules may exacerbate short-termism. In particular, we are concerned that the threat of a director election contest could place unnecessary pressure on a company to improve short-term financial performance, in the interest of appeasing its shareholders at the price of capital expenditures, for example.[58] In addition, we are concerned that the Proposed Election Contest Rules will increase the influence of hedge funds, which may use proxy access to advance their own short-term interests and investment strategies.[59] These funds are likely to support policies that increase short-term gains in stock prices, such as stock repurchases, asset sales, increased reliance on debt and distribution of cash on hand.[60] If the Proposed Election Contest Rules are adopted, hedge funds could use a director nomination as leverage in pressuring a company to make decisions to promote such short-term gains.

Other aspects of the Proposed Election Contest Rules also will encourage short-termism and inhibit long-term value creation. Notably, the Proposed Election Contest Rules do not require shareholder nominators to retain stock in the company *after* the director election.[61] Thus, investors oriented towards short-term gains could simply withdraw their investments from the company after their objectives had been achieved through the use of the Proposed Election Contest Rules.[62] Similarly, we are concerned that the low ownership and holding period thresholds proposed by the Commission may also encourage the submission of nominations by shareholders with a short-term focus. Contrary to the Commission's

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[58] Several respondents to our July 2009 Survey expressed concern that the Proposed Election Contest Rules will increase the emphasis on short-termism. One respondent specifically remarked that the rules would "pressure management to emphasize short term results over creating long term value."

[59] According to Professor Iman Anabtawi, hedge funds generally are not concerned with the long-term success of the companies in which they invest. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579 (2006).

[60] *See id.* at 564, 582 (describing aggressive efforts of hedge fund investors to influence the board of directors of MCI to sell the company to Qwest Communications, rather than Verizon Communications, in order to maximize short-term shareholder gains).

[61] *See infra* Section III.D.2.

[62] *See* Mitchell, *supra* note 3 (noting that the Proposed Election Contest Rules "create[] incentives for institutions to strong-arm management to increase share prices and then sell out as soon as they are done, regardless of the long-term effects on the business").

assertion,[63] the current low thresholds do *not* limit proxy access to only those shareholders with a "significant, long-term interest" in a company, as described further in Section III.D.1 below.

In addition, the Proposed Election Contest Rules could lead to the election of "special interest" directors, who may promote their own interests or those of the shareholders nominating them at the expense of the interests of other shareholders or the company as a whole, and the Proposed Election Contest Rules may also hinder long-term value creation. For example, the Proposed Election Contest Rules may be used as a "bargaining chip" by union-controlled pension funds, many of which are active and influential institutional investors. Unions previously have used the shareholder proposal process to obtain results in "corporate campaigns" against companies.[64] With the Proposed Election Contest Rules, a union could more easily use the threat of board representation as leverage in bargaining with the company. Moreover, if a union-nominated or other special interest director candidate[65] obtains a seat on a corporate board, the board could become divided and dysfunctional, thus weakening the company and impeding its long-term growth.[66] Regardless of whether a shareholder nominee is ultimately elected, the cost and disturbances of a contest initiated by shareholders nominating special interest candidates with no fiduciary duties to other shareholders will undermine the board's ability to act in the best interests of shareholders.

As discussed further in Section III.E.1 below, we are concerned that, unlike the proxy access rules proposed by the Commission in 2003 (the "2003 Proposal"), the Proposed Election Contest Rules do not restrict certain relationships between nominees and nominating

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63 *See* 74 Fed. Reg. at 29,035.

64 *See* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1755 (2006).

65 We also note that state employee pension funds often are overseen by elected officials, who may use the Proposed Election Contest Rules to advance political objectives. *See id.* (observing that "[p]ublic employee pension funds are especially vulnerable to being used as a vehicle for advancing political or social goals unrelated to shareholder interests").

66 Some industry experts attributed past financial crises at United Airlines to union representation on the company's board and to those directors placing union aims ahead of the company's interests. *See* Marilyn Adams & David Kiley, *United vows no disruptions*, USA TODAY, Dec. 10, 2002. *See also* Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* 15-16 (UCLA School of Law, Law & Econ. Research Paper No. 03-22, Nov. 14, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=470121 (noting that "introduction of a shareholder representative [on a corporate board] is likely to trigger a reduction in board effectiveness" and citing evidence from the experience of German firms).

shareholders that are designed to help address the issue of "special interest" and "single issue" directors. Such restrictions are of particular importance because a nominating shareholder, unlike a member of a board's nominating/governance committee, is not bound by a fiduciary duty to act in the best interests of the company and its shareholders. Without the constraints of this fiduciary duty, nominating shareholders may be more likely to nominate "special interest" or "single issue" candidates. While restrictions on relationships between nominees and nominating shareholders would not wholly eliminate the potential harm posed by such directors, the absence of any such restrictions only increases the likelihood that such directors would be elected and pursue their narrow interests at the expense of other shareholders and the long-term growth of the company.

2. The Proposed Election Contest Rules Will Hinder The Ability Of Companies To Satisfy Board Composition Requirements [A.4., A.5., B.1., D.1., D.2., D.8.]

Numerous legal standards are applicable to the composition of corporate boards, and the addition of shareholder-nominated directors to a company's board will complicate the board's ability to satisfy these requirements. For example, NYSE Listed Company Manual requires that a company's audit committee have at least three independent director members, all of whom must be financially literate.[67] The Commission's rules require disclosure as to whether at least one member of a company's audit committee is an "audit committee financial expert."[68] In addition, all audit committee members must satisfy the heightened independence standards in the Commission's Rule 10A-3.[69] Similar requirements also apply to a company's compensation committee. The NYSE Listed Company Manual requires that the compensation committee consist entirely of independent directors.[70] Moreover, in order to qualify for the exemption under the Commission's Rule 16b-3, equity awards must be approved by a committee composed solely of "non-employee directors,"[71] and under Section 162(m) of the Internal Revenue Code, in order for executive compensation to be deductible, it must be approved by a committee of "outside directors."[72] If a shareholder-nominated director does not possess some or all of the above-described qualifications, and displaces a company-nominated director who does satisfy these requirements, the company may not be in compliance with the applicable legal requirements following the election.

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67 *See* NYSE Listed Company Manual, § 303A.07.

68 *See* Regulation S-K, Item 407(d)(5).

69 *See* 17 C.F.R. § 240.10A-3 (2009).

70 *See* NYSE Listed Company Manual, § 303A.05.

71 17 C.F.R. § 240.16b-3 (2009).

72 26 U.S.C. § 162(m) (2009).

Moreover, many boards of directors have established additional board and committee membership requirements for their directors and director nominees. Some boards have adopted more rigorous independence standards than those required by the securities markets (for example, some companies apply the heightened audit committee standards of the NYSE to all board members). Boards also have established independence standards that address a director's affiliation with nonprofit organizations receiving contributions from the company, as well as other requirements for directors, such as mandatory retirement ages and limitations on the number of other boards on which a director may serve. Companies in certain industries also are subject to board composition requirements. For example, for companies in the gaming industry, directors must undergo a subjective "suitability" review by state gaming regulators.[73] Similarly, defense contractors may require board members to possess security clearances.[74] Shareholder-nominated directors may not have the necessary qualifications.

In addition, in the past several years, boards and nominating/governance committees have become increasingly focused and deliberate in assessing board composition and seeking director candidates who possess specific expertise that they believe their boards should have. In identifying potential candidates, many nominating/governance committees now routinely engage in a process that involves assessing the skills and expertise that are already represented on the board and identifying additional qualifications that are necessary or desirable. Nominating/governance committees can then conduct targeted efforts to identify and recruit individuals who have these qualifications. Moreover, nominating/governance committees often seek director candidates with experience specific to the industries in which their companies operate. As one respondent to our July 2009 Survey explained:

> Our Nominating and Governance Committee actively searches for qualified candidates with deep expertise in areas relevant to the nature of our business operations and industry . . . . In our industry . . . deep, relevant business experience is crucial to an ability to function as a contributing director who can serve to the benefit of shareholders.

Similarly, we note that in the wake of the current financial crisis, financial institutions have sought directors with extensive financial and regulatory experience.[75] In a recent rulemaking

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[73] *See, e.g.*, Nevada Gaming Commission and State Gaming Control Board Reg. 16.415 (requiring a "finding of suitability" for certain directors of gaming companies).

[74] *See, e.g.*, Northrop Grumman Corp., Proxy Statement (Schedule 14A), at 12 (Apr. 17, 2009) (noting that "[e]ach [director] candidate must be willing to submit to the background check necessary for obtaining a top secret clearance, which is a requirement for continued Board membership").

[75] *See, e.g.*, Robin Sidel, *Citi Taps Directors With Fix-It Expertise*, WALL ST. J., July 25, 2009, at B1 (noting that Citigroup, Inc. recently appointed "three directors with résumés that

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proposal, the Commission itself has pointed to the necessity of finding board members with particular skill sets and qualifications:

> As recent market events have demonstrated, the capacity to assess risk and respond to complex financial and operational challenges can be important attributes for directors of public companies. Moreover, developments such as the enactment of the Sarbanes-Oxley Act of 2002 and corporate-governance related listing standards of the major stock exchanges also have brought about significant changes in the structure and composition of corporate boards, such as requiring directors to have particular knowledge in areas such as finance and accounting.[76]

Yet, according to the Proposing Release, a shareholder-nominated director candidate would not be required to comply with a board's membership requirements or other qualifications and criteria, even if these are contained in the company's governing documents.[77] Accordingly, there can be no assurance that the shareholders nominated under the Proposed Election Contest Rules would meet membership requirements established by a company's board of directors or possess the skills and qualifications that have been identified by the board as necessary for a director to have. We respectfully contend that a company's board and nominating/governance committee are best suited to determine the skills and qualities desirable in new directors in order to maximize the board's effectiveness, and the Proposed Election Contest Rules will stymie these efforts.

3. Frequent, Time-Consuming And Politicized Director Elections Will Deter Qualified Directors From Serving On Boards Of Directors [A.4.]

The Proposed Election Contest Rules will increase the frequency of contested elections and divert corporate resources to address such elections. Faced with the prospect of divisive, time-consuming and politicized annual election contests, qualified independent directors may be reluctant to serve on corporate boards. As noted above, the past six years have seen dramatic changes in the corporate governance landscape, and the cumulative effect of these reforms and directors' potential increased exposure to personal liability has made it more

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reflect experience in turning around troubled financial institutions and a deep understanding of regulatory issues").

76 Proxy Disclosure and Solicitation Enhancements, SEC Release No. 33-9052, 74 Fed. Reg. 35,076, 35,082-83 (July 17, 2009).

77 *See* 74 Fed. Reg. at 29,040 n.152 & 29,041.

difficult for companies to recruit and retain qualified directors.[78] In response to our July 2009 Survey, one company remarked:

> The directors have expressed general concern about the effect of the rule and the [Commission's] increasingly activist shareholder stance. One director has advised us that, partly as a result of this new climate, he would like to retire from the Board rather than stand for reelection at our next annual meeting.

Moreover, the costs and disruption that will result from election contests under the Proposed Election Contest Rules will likely deter directors from serving on boards. As another July 2009 Survey respondent noted, "[o]ur directors have indicated that they will be disinclined to serve if every election is a contested election." The Proposed Election Contest Rules will only exacerbate these director recruitment and retention issues. If qualified director candidates are deterred from serving, the quality of corporate boards could suffer.[79]

4. **The Proposed Election Contest Rules Will Increase The Influence Of Proxy Advisory Firms** [B.8., A.4.]

With the adoption of the Proposed Election Contest Rules, the frequency of director election contests will increase dramatically, and so too will the influence of proxy advisory firms. Such firms, which develop proxy voting recommendations for institutional investors, have significant influence over the voting decisions of institutional investors that rely on the firms' voting guidelines.[80] In our July 2009 Survey, the respondents reported that 15.0% of their institutional investors follow the proxy voting guidelines of RiskMetrics Group, Inc. ("RiskMetrics") without deviation, while 27.4% of their institutional investors follow the RiskMetrics guidelines but are willing to change their votes based on dialogue with the company. In addition, the respondents reported that 6% of their institutional investors

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78 *See* Press Release, Grant Thornton, 65% of Senior Financial Officers of Public Companies Say It's Harder Today to Recruit Directors, Citing Sarbanes-Oxley Act, Increased Director Liability (Aug. 26, 2005); *see also What Directors Think*, CORPORATE BOARD MEMBER, at 14 (2008) (reporting that 33% of directors surveyed stated that they had turned down a board seat because they felt the risk of shareholder withhold-vote campaigns was too great).

79 The Commission acknowledges in the Proposing Release that the Proposed Election Contest Rules could result in "lower quality boards." 74 Fed. Reg. at 29,075.

80 *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 [now RiskMetrics] 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."

followed the proxy voting guidelines of Glass, Lewis & Co. without deviation, while 9.1% of their institutional investors follow the Glass, Lewis & Co. guidelines but are willing to change their votes based on dialogue with the company. Respondents to our July 2009 Survey also provided numerous specific examples of the influence of proxy advisory firms on the proxy voting decisions of institutional investors. Survey respondents remarked:

- "[C]ertain institutions have indicated to us in the solicitation process that they completely outsource the proxy voting decision-making process to [RiskMetrics] or [Glass, Lewis & Co.] and are not willing to meet with, or discuss proxy voting issues with us."

- "We have seen institutions follow a rigid application of policy on a proxy voting matter without regard to a company's performance, overall good governance practices or other information relevant to the proxy voting matter. We were told—'we agree with you and note your good record but it would take an act of god to change the vote.'"

- "When we contacted our institutional investors, several of them admitted to us that they 'outsource' (their term) their voting decisions to RiskMetrics and therefore would not discuss any proxy voting issues with us."

- "Of [our institutional shareholders] who follow [RiskMetrics] or [Glass, Lewis & Co.] lockstep, a number will not speak or meet with us or don't have staff to do so."

- "Of [our] top 50 shareholders, most (45%) state that they follow their own in-house guidelines, but consult with proxy advisors [RiskMetrics] and Glass Lewis, or both. However, most in-house voting guidelines are very close to [RiskMetrics'] published policies. Thus, the institutional shareholders typically vote in a manner consistent with [RiskMetrics'] recommendations.

- "On certain issues (e.g. stock plans, director votes and certain shareholder proposals) the voting recommendations of RiskMetrics determine the outcome. In these instances, *shareholder will has been replaced to a significant degree by the policies and views of a single organization that has no ownership interest in our company*. RiskMetrics' growing influence has made it increasingly difficult to influence shareholders through direct communication and engagement." (*emphasis added*).

These examples and statistics indicate that proxy advisory firms exert a strong influence on the proxy voting decisions of institutional investors, and, further, that some institutional investors are unwilling to deviate from the recommendations of such firms, even in light of a company's individual circumstances. If institutional investors rely heavily on the recommendations of proxy advisory firms in election contests, the Proposed Election Contest Rules will not function in the manner intended by the Commission. The Commission has stated that it seeks to "structure the proxy rules to better facilitate the exercise of *shareholders*' rights to nominate and elect directors."[81] Yet, if the Commission adopts the Proposed Election Contest Rules, election contest results will reflect the recommendations of *proxy advisory firms*, rather than the will of the shareholders.

In addition, the increased influence of proxy advisory firms is troubling for a number of other reasons. As Commissioner Casey stated at the Commission's July 1, 2009 open meeting, proxy advisory firms have no economic interest in the companies for which they issue voting recommendations.[82] Moreover, conflicts of interest may be present at certain firms that both create voting guidelines for institutional investors and advise the companies to which these voting guidelines are applied.[83] Similarly, a recent report published by the Millstein Center for Corporate Governance and Performance at the Yale School of Management emphasized the need to address certain issues, such as conflicts of interest, with respect to the voting recommendations of proxy advisory firms.[84] The Millstein Center report recommended the adoption of a professional code of ethics for the proxy voting and governance advisory industry. Also recognizing the problems posed by proxy advisory firms, the NYSE Proxy Working Group report recommended that the Commission study the increasing role and influence of such firms.[85] Finally, we note that other recent regulatory changes, such as the amendments to NYSE Rule 452, are likely to elevate further the influence of proxy advisory firms.[86]

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81 74 Fed. Reg. at 29,027 (emphasis added).

82 *See* SEC Commissioner Kathleen L. Casey, Statement at SEC Open Meeting (July 1, 2009), *available at* http://www.sec.gov/news/speech/2009/spch070109klc.htm.

83 *See* Robert D. Hershey, Jr., *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. TIMES, June 18, 2006.

84 *See Voting Integrity: Practices for Investors and the Global Proxy Advisory Industry*, The Millstein Center for Corporate Governance and Performance (2009), *available at* http://millstein.som.yale.edu/Voting%20Integrity%20Policy%20Briefing%2002%2027%2009.pdf.

85 *See* Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, June 5, 2006, at 29, *available at* http://www.nyse.com/pdfs/PWG_REPORT.pdf.

86 *See* Commissioner Casey, Open Meeting (July 1, 2009), *supra* note 82 (observing that "[i]t is also virtually certain that this rule change [to NYSE Rule 452] will significantly increase the power and influence of the proxy advisory firms that make voting recommendations to . . . institutional shareholders.").

5. The Proposed Election Contest Rules Will Exacerbate Voting Integrity Issues [A.4.]

As discussed above, the Proposed Election Contest Rules will result in an increased number of director election contests, which raises concerns regarding the integrity of the proxy voting process. Numerous commentators have noted that the proxy voting system in the United States is antiquated, byzantine and inadequate,[87] and various Commission officials have acknowledged the flaws of the system on several occasions.[88] An increase in the frequency of contested elections will place additional demands on an already over-burdened and ill-functioning system. Yet, the Proposing Release does not address how the current proxy voting system will be able to handle the increase in election contests.

The deficiencies of the current proxy voting system stem, in part, from the manner in which securities are held in the United States. Most investors hold their shares in "street name" through intermediaries, such as broker-dealers and banks. In turn, the securities held by broker-dealers and banks are deposited with the Depository Trust Corporation (the "DTC"), which holds the securities in "fungible bulk."[89] Intermediaries own a pro-rata share in the securities held by the DTC, and investors own an interest in their brokers' pro-rata share. A separate entity, the National Securities Clearing Corporation (the "NSCC"), clears and settles securities transactions between brokers and the DTC. However, if a broker fails to deliver securities owed in the course of a transaction, the NSCC's system of allocation may result in an over- or under-representation of the number of shares that should be properly credited to a

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[87] *See, e.g.*, *Voting Integrity*, *supra* note 84; John C. Wilcox, *Shareholder Nominations of Corporate Directors: Unintended Consequences and the Case for Reform of the U.S. Proxy System*, Comment, SEC File No. 4-537 (May 13, 2007); Charles Nathan, *"Empty Voting" and Other Fault Lines Undermining Shareholder Democracy: The New Hunting Ground for Hedge Funds*, THE CORPORATE GOVERNANCE ADVISOR (Jan./Feb. 2007); Henry T.C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

[88] *See* Commissioner Casey, Statement at Open Meeting (July 1, 2009), *supra* note 82; SEC Commissioner Troy A. Paredes, Statement at SEC Open Meeting (July 1, 2009), *available at* http://www.sec.gov/news/speech/2009/spch070109tap.htm; Erik R. Sirri, Director, Division of Market Regulation, Remarks Before the SIFMA Proxy Symposium (Oct. 16, 2007), *available at* http://www.sec.gov/news/speech/2007/spch101607ers.htm; SEC Briefing Paper: Roundtable on Proxy Voting Mechanics (May 23, 2007), *available at* http://www.sec.gov/spotlight/proxyprocess/proxyvotingbrief.htm.

[89] SEC Briefing Paper, *supra* note 88.

broker's DTC account.[90] Such discrepancies many result in over-voting.[91] Over-voting also can occur when a broker-dealer loans an investor's shares. Standard lending contracts allocate shares' voting rights to the borrower; however, if share records are not reconciled and beneficial owners are not notified of the transfer, both the original investor and the borrower may ultimately vote the same shares in a corporate election.[92] When over-voting occurs, broker-dealers sometimes reduce the number of votes proportionately, which may result in the counting of ineligible votes at the expense of eligible votes.[93] Such errors will take on greater significance as the number of contested elections increases, as inaccurate proxy voting caused by over-voting, for example, could alter the results in close elections.

Other issues plague the current proxy voting system. The structure of the proxy voting system is complex, and the "dizzying array of intermediaries standing between the beneficial owner and the issuer" may result in lost or miscast votes.[94] The complexity of the proxy voting system also hinders communications between companies and their shareholders, as discussed in further detail in Section III.L below. Further, commentators have expressed concern that hedge funds are increasingly using share lending, and the concomitant voting rights that are transferred with borrowed shares, to advance their economic interests.[95] While we recognize that the Commission has indicated it will consider some of these voting integrity issues later this year, they must be addressed and resolved *before* the Commission increases the prevalence of director election contests through the adoption of the Proposed Election Contest Rules.

C. The Proposed Election Contest Rules Exceed The Commission's Statutory Authority [B.1.]

A fundamental question the Commission should ask before regulating in a particular area is whether Congress has delegated authority to do so. In the Proposing Release, the Commission relies on Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act")

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90 SEC Briefing Paper, *supra* note 88; *see also* Wilcox, *supra* note 87 (describing lax record-keeping practices in the proxy voting system).

91 SEC Briefing Paper, *supra* note 88.

92 *See* Sirri, Remarks Before the SIFMA Proxy Symposium (Oct. 16, 2007), *supra* note 88.

93 *See* Bob Drummond, *Double Voting in Proxy Contests Threatens Shareholder Democracy*, Feb. 27, 2006, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4OuCsU8r2Yg.

94 *Voting Integrity*, *supra* note 84, at 11.

95 *See* Nathan, *supra* note 87, at 5.

as the primary basis for the Proposed Election Contest Rules.[96] The Commission also relies summarily on various other provisions of the Exchange Act.[97]

We cannot agree that either Section 14(a) or any of the other cited provisions supplies the necessary authority. For its part, "[t]he 1934 Act cannot be read 'more broadly than its language and the statutory scheme reasonably permit,'" as the Supreme Court explained in *Chiarella v. United States* in rejecting an argument to extend insider trading liability.[98] 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*."[99] 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."[100] "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."[101] Thus, for example, in *American Bankers Association v. SEC*, the District of Columbia Circuit invalidated a rule of the Commission that it found had redefined improperly 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

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96 *Compare* Proposing Release, 74 Fed. Reg. at 29,025, *with* 2003 Proposal, 68 Fed. Reg. at 60,786.

97 *See* 74 Fed. Reg. at 29,078 (identifying "Legal Basis" for the Commission's proposals as required by 5 U.S.C. § 603).

98 445 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))).

99 511 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 the Commission to prosecute an officer of a broker-dealer firm for disclosing information during a securities-fraud investigation of a publicly-traded company).

100 *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977).

101 *Id.* at 472-73 (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.*, *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."); *MCI Telecomms. 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").

direct conflict with the language of the Exchange Act.[102] Moreover, absent a basis in statutory text, the federal securities laws do not apply to conduct "already governed by functioning and effective state-law guarantees."[103]

In her statement on May 20, 2009, Commissioner Casey voiced concern about the legal basis for the Proposed Election Contest Rules, noting that "[t]he Commission's authority to enact these rules is subject to significant doubt."[104] Concerns about the Commission's authority predate the recent Proposing Release. For example the July 15, 2003 Commission staff report (the "2003 Staff Report") noted that "some commenters . . . questioned the Commission's authority to adopt shareholder access rules under Exchange Act Section 14(a)."[105] Apparently in response to these comments, the 2003 Staff Report expressly raised the issue of the Commission's statutory authority: "Is a shareholder access rule consistent with Congressional intent regarding Exchange Act Section 14(a)?"[106] The Proposing Release here does not repeat that question, but it should have done so, and we believe the answer remains no.

1. **The Proposed Election Contest Rules Extend Beyond Procedural Regulation Of Proxy Communication And Thus Exceed The Commission's Section 14(a) Authority** [B.1.]

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"[107] Thus, as the Supreme Court has explained, Section 14(a) "authorizes the [Commission] to adopt rules for the solicitation of proxies, and prohibits their violation."[108]

Section 14(a) expressly limits the Commission's rulemaking authority to proxy solicitation. 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

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102 804 F.2d 739, 755 (D.C. Cir. 1986).

103 *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770-71 (2008).

104 Commissioner Casey, Statement at Open Meeting (May 20, 2009), *supra* note 7.

105 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).

106 *Id.* at 16.

107 15 U.S.C. § 78n(a) (2009).

108 *Va. Bankshares v. Sandberg*, 501 U.S. 1083, 1086 (1991).

by means of deceptive or inadequate disclosure in proxy solicitation."[109] 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."[110]

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 company taking any "corporate action, with the effect of nullifying, restricting or disparately reducing the per share voting rights" of existing common shareholders.[111] The court held that the rule was beyond the Commission's authority because it "directly" controlled "the substantive allocation of powers among classes of shareholders."[112]

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."[113] 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."[114] In reaching that conclusion—and ultimately invalidating the rule—the court considered and rejected a number of arguments that the Commission relies on in the Proposing Release here.

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109 *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) of the Exchange Act was enacted by the Congress 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.").

110 *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.").

111 Voting Rights Listing Standards; Disenfranchisement Rule, SEC Release No. 34-25891, 53 Fed. Reg. 26,376, 26,394 (July 12, 1988) (codified at 17 C.F.R. § 240.19c-4).

112 905 F.2d at 407.

113 *Id.* at 410.

114 *Id.* at 408.

The Commission argued in the *Business Roundtable* case that Rule 19c-4 advanced the statutory purpose of promoting "fair corporate suffrage."[115] It makes the same contention in the Proposing Release: "Section 14(a) of the Exchange Act stemmed from a Congressional belief that '[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange.'"[116]

As the District of Columbia 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."[117]

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*."[118] It was *not* intended to allow the Commission to dictate the subjects that proxy

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115 *Id.* at 410.

116 74 Fed. Reg. at 29,025 (quoting H.R. REP. NO. 73-1383, at 13-14 ("1934 House Report")).

117 905 F.2d at 410 (internal citations omitted) (alterations in original).

118 *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970) (internal quotations omitted; emphasis added).

solicitations would address.[119] The "[s]ubstance of corporate voting rights was left to the states."[120]

Furthermore, in the *Business Roundtable* case, the Commission attempted to rely on its authority to "protect investors and the public interest."[121] The Commission takes the same approach in the Proposing Release.[122] As the District of Columbia Circuit explained, however, "a vague 'public interest' standard cannot be interpreted without some confining principle."[123] In this rulemaking, the statute itself provides the confining principle: the Commission's rules must relate to proxy *solicitation*. It follows "as a matter of necessity from the nature of proxies" that "proxy regulation bears almost exclusively on disclosure."[124] The Commission thus is authorized to regulate proxy disclosures, including concomitant procedures, to protect investors and further the public interest, but its authorization extends no further.[125]

The Proposed Election Contest Rules cross the line separating permissible procedural regulation of proxy communication from impermissible substantive regulation of corporate governance. The justification for the Proposed Election Contest Rules uses procedural terms.[126] Yet the Proposed Election Contest Rules would create a federal substantive right, empowering nominating shareholders to compel a company to include their director nominations in the company's proxy materials.

Indeed, we believe Commissioner Casey was correct in reasoning that the substantive as opposed to procedural character of the Proposed Election Contest Rules is confirmed by the extent of overlap between the detailed provisions of the Proposed Election Contest Rules and

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119 Section 14(a) was not created "to regulate the stockholders' choices." *Business Roundtable*, 905 F.2d at 411.

120 Stephen Bainbridge, Professor, University of California—Los Angeles, May 7th Roundtable, at 57.

121 *Id.* at 412 (internal quotations omitted).

122 74 Fed. Reg. at 29,025 & n.26 (quoting 15 U.S.C. § 78n(a)).

123 905 F.2d at 414.

124 *Id.* at 410.

125 More recent cases likewise have emphasized the importance of adherence to limits on statutory authority. *See, e.g.*, *Fin. Planning Ass'n v. SEC*, 482 F.3d 481, 488 (D.C. Cir. 2007); *Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006).

126 *See, e.g.*, 74 Fed. Reg. at 29,078 (describing Proposed Election Contest Rules as seeking to "remove impediments to shareholders' ability to participate meaningfully in the nomination and election of directors").

recent state law initiatives on point. (Displacement of state law is, of course, an independent problem with the Proposed Election Contest Rules, as we explain below.) In particular, Commissioner Casey recognized that the Proposed Election Contest Rules spell out "the conditions under which a company will be obligated to provide proxy access"; "the eligibility requirements for nominees and proponents of nominees, such as minimum share ownership and holding period requirements"; and "the required procedures for proponents seeking proxy access."[127] Commissioner Casey found that the similarity between those proposed requirements and recent statutory amendments in Delaware and North Dakota addressing those same details "strongly suggests that" the Proposed Election Contest Rules "[are] not merely 'procedural,' but rather go[] to the heart of the policy considerations properly left to state legislatures or, where legislatures so provide, to the companies and their shareholders."[128]

Put another way, the Proposed Election Contest Rules reinvent the concept of the company "proxy" that is contained though not defined in Section 14(a) itself. 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."[129] 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,[130] and a proxy contest, accordingly, is a contest in which rival groups compete to see who will receive

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[127] Commissioner Casey, Statement at Open Meeting (May 20, 2009), *supra* note 7.

[128] *Id.*

[129] 18A AM. JUR. 2D *Corporations* § 1069 (1985); *see also* BLACK'S LAW DICTIONARY 1241 (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").

[130] *See* 15 U.S.C. § 78n(a) (2009) ("It shall be unlawful . . . to solicit any proxy or *consent* or *authorization*. . .") (emphases added); 17 C.F.R. § 240.14a-1 (2009) (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").

shareholders' proxies to be able to vote those proxies as they see fit.[131] In soliciting a proxy, so long as the company has properly explained to the shareholder "the real nature of the questions for which authority to cast his vote is sought," the Congressional objective for federal oversight of proxy communications is met.[132]

A company's proxy materials are property of the company. The Proposed Election Contest Rules carve out a slice of that property and reserve it for use by shareholders that have no fiduciary duty to the company and shareholders, whether or not the company's board otherwise would deem it appropriate to solicit shareholder proxies on the matter. When a shareholder nominating a candidate uses the company's proxy to put forth the candidate to compete for a board seat against a candidate nominated by the company's board of directors in the exercise of their fiduciary duties, the shareholder is in effect using the company's resources to fund an attack on the company—so the company's proxy no longer belongs to the company. In soliciting what the Commission calls "proxies" a company would in fact be soliciting authority to vote on a nominee that the company would not seek authorization to vote for, so that the company proxy solicitation would no longer be a request that the shareholder authorize the *company* to vote on matters over which it has determined to seek proxy authority. The Commission of course cannot redefine "proxy" to mean something it does not, much less—as in this instance—something that is the opposite of its plain and intended meaning.

That the Commission cannot convert proxies to binding general "ballots" is evident in the *structure* of the Exchange Act, as well as in the plain meaning of the statutory terms. The Exchange Act already recognizes a mechanism for shareholders to seek votes against companies' nominees for director—by soliciting their own proxies accompanied by their own proxy statement.[133] 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.[134]

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[131] 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 (2009).

[132] *Mills*, 396 U.S. at 381 (internal quotations omitted).

[133] *See generally* 17 C.F.R. § 240.14a-1 *et seq.* (2009).

[134] In this sense the Proposed Election Contest Rules go farther than Rule 14a-8, which does not use the proxy to force a company to "solicit" votes on a matter that conflicts with the company's own solicitation. Rule 14a-8 uses the proxy to serve a communicative function—to allow shareholder voting on a matter that another shareholder has stated it intends to introduce at a shareholder meeting. However, even Rule 14a-8 contains an exception when a proposal "directly conflicts with one of the company's own proposals to

[Footnote continued on next page]

In short, the Proposed Election Contest Rules regulate substance, not mere procedure, and thus fall outside the authority conferred by Section 14(a).

2. **Section 14(a) Does Not License The Commission To Displace State Legislative Choices Regarding Internal Corporate Affairs** [B.1.]

A Commission regulation requiring companies to include shareholder nominations for director in companies' proxy materials interferes in the internal affairs of companies by redrawing the boundary between shareholder and board authority. Such interference would be contrary to the basic principle that, as the Supreme Court stated in *Santa Fe Industries v. Green*, "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 corporations."[135] Indeed, the Supreme Court has emphasized that the internal affairs doctrine applies with particular force where shareholder voting rights are concerned: "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."[136]

The Court confirmed that understanding as recently as last year in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[137] The Court reasoned that its "precedents counsel[ed] against th[e] extension" of the "implied cause of action" under Section 10(b) of the Exchange Act to reach beyond the "realm of financing business" (a realm subject to the federal securities laws) into the "realm of ordinary business operations," which is "governed, for the most part, by state law."[138] The Court concluded that, absent a basis for doing so in the text of the Exchange Act, it would not presume that the Exchange Act applies to conduct "already governed by functioning and effective state-law guarantees."[139]

Nothing in the Exchange Act purports to authorize the Commission to regulate the nomination and election of corporate directors. There is no textual basis for taking the

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[Footnote continued from previous page]

be submitted to shareholders at the same meeting." 17 C.F.R. § 240.14a-8(i)(9) (2009). The Proposed Election Contest Rules step over the line between using the proxy to force a contest, and using it to bind in precisely the manner of a general binding "ballot."

135 430 U.S. at 479 (internal quotation marks and emphasis omitted).

136 *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987).

137 128 S. Ct. 761 (2008).

138 *Id*. at 770-71.

139 *Id*.

Exchange Act as an authorization to create a federal substantive right to nominate and elect directors using company proxy materials, and the nomination and election system for corporate governance is "already governed by functioning and effective state-law guarantees."[140]

The legislative history of the Exchange Act confirms that the statute does not silently provide such authorization. That history indicates that Congress's intent was not "to regiment business in any way."[141] 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.[142]

The 1934 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."[143] 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."[144] Clearly, requiring companies to include shareholder nominees in their proxy materials would be "interference" with corporate governance, as set forth at greater length below. As the District of Columbia Circuit noted in similar 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."[145] That is not allowed.

The reason that the Exchange Act does not authorize the Commission to "regiment business" is that corporate governance involves internal allocation of authority within a company that has traditionally and, for the most part, exclusively, been reserved to the

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140 *Id.*

141 1934 House Report at 3.

142 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).

143 S. REP. NO. 73-792, at 10 (1934) ("1934 Senate Report").

144 *Id.* at 35.

145 *Business Roundtable*, 905 F.2d at 411.

states.[146] State corporate law governs the director nomination and election process.[147] The Proposed Election Contest Rules certainly would supplant state law in this regard, creating a novel federal framework regulating director elections in state-chartered corporations. Again, as the District of Columbia 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."[148]

In his statement on May 20, 2009 regarding the Proposed Election Contest Rules, Commissioner Paredes summarized the controlling principle: "[S]tate corporate law determines the powers, rights, and duties of corporate actors and constituencies. The federalism balance has been struck with state corporate law governing internal corporate affairs."[149] As Commissioners Paredes and Casey recognized, the Proposed Election Contest Rules do not adhere to that principle.

To be sure, the Proposing Release contains language indicating that the Commission views its proposals as enhancing enforcement of shareholders' state-law rights. Thus, the Proposing Release states that one of the rationales for the Proposed Election Contest Rules is that the Commission "believe[s] that parts of the federal proxy process may unintentionally frustrate voting rights arising under state law, and thereby fail to provide fair corporate suffrage."[150] However, the Proposed Election Contest Rules actually disenfranchise shareholders by removing rights that they possess under state law. As we explain below in Section III.A, the Proposed Election Contest Rules eliminate shareholders' rights to decide whether to adopt proxy access, and how to implement proxy access if they choose to adopt it. Because no evidence substantiates the "unintentional[] frustrat[ion]" notion, it does not rationally support the rule.[151] And *even if* that were a demonstrated problem, we believe the

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146 *See Santa Fe Indus.*, 430 U.S. at 479.

147 *See, e.g.*, 8 DEL. CODE ANN. §§ 141, 211, 214 (2009) (governing nomination and election of directors).

148 *Business Roundtable*, 905 F.2d at 413 (quoting *CTS Corp.*, 481 U.S. at 89).

149 SEC Commissioner Troy A. Paredes, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009tap.htm.

150 74 Fed. Reg. at 29,027.

151 *See, e.g.*, *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839-45 (D.C. Cir. 2006) (vacating and remanding FERC order purportedly justified by record evidence of abuse warranting restraints on regulated-entity conduct, where record "provided zero evidence of actual abuse" by regulated entities subject to that order).

Proposed Election Contest Rules' response is far out of reasonable proportion to that problem by interfering with state policy in at least three ways.

First, the Proposed Election Contest Rules create shareholder nominating rights where none exist. The Proposed Election Contest Rules would "require companies to include shareholder nominees for director in the companies' proxy materials . . . unless state law or [companies'] governing documents prohibit[]" such nominations.[152] As the preamble acknowledges, no state currently has such a prohibition.[153] That is, one indicator that the Proposed Election Contest Rules would disrupt state policy choices is that states would have to act affirmatively to deactivate the right the Proposed Election Contest Rules would create.

Second, the Proposed Election Contest Rules would establish a new allocation of rights between boards of companies, which owe fiduciary duties to shareholders, and minority shareholders that are not bound by such duties—an allocation that is properly left for the states, not the Commission.

Third, as Commissioners Casey and Paredes pointed out in declining to support the Proposed Election Contest Rules, recent developments demonstrate that, as states continue to play their traditional role in regulating corporate internal affairs, they have been "innovative and responsive" to shareholder sentiment regarding the proper scope of director nomination rights.[154] In particular, developments in the laws of Delaware and North Dakota and in the Model Business Corporation Act are persuasive evidence that the Proposed Election Contest Rules would improperly interfere with evolving state law.

While the Proposing Release asserts an interest in enforcing state-law rights, the Proposed Election Contest Rules would actually override the policy choices of states such as Delaware and North Dakota, requiring companies to include shareholder nominations in corporate proxy materials on terms and under conditions different from those contained in or allowed under the recently adopted laws.[155] Indeed, the only situation in which the Proposed

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152 74 Fed. Reg. at 29,031.

153 *Id.* at 29,031 n.99.

154 Commissioner Casey, Statement at Open Meeting (May 20, 2009), *supra* note 7; *see also* Commissioner Paredes, Statement at Open Meeting (May 20, 2009), *supra* note 149.

155 *See* Joseph A. Grundfest, *Internal Contradictions in the SEC's Proposed Proxy Access Rules* 3 (Rock Ctr. for Corporate Governance at Stanford Univ. Working Paper No. 60, 2009) ("Nothing in state law sets a minimum standard for proxy access, defines the contours of any proxy access proposal that must be considered by the shareholders, or prohibits a majority of the shareholders from amending a proxy access standard to make it more

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Election Contest Rules would not apply is when the incorporating state has affirmatively prohibited shareholders from nominating director candidates.[156]

In addition, the Proposed Election Contest Rules interfere with state law governing the fiduciary obligations that the board owes to shareholders. The Proposed Election Contest Rules would countermand a board's determination that a particular shareholder nomination should not go forward because it would not be in the best interests of the company and the shareholders at large, which the board is obligated to protect under state-law fiduciary duties. The Proposed Election Contest Rules thus would disrupt the existing balance between shareholders and directors maintained by state law, because state law does not permit shareholders to elect to supplant directors' fiduciary duties, as a recent case makes clear. In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court noted that it has recognized a "prohibition . . . derived from [Section 141(a) of the Delaware General Corporation Law], against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[157] On that basis, the court invalidated a proposed bylaw that would have "committ[ed] the corporation to reimburse the election expenses of shareholders whose candidates are successfully elected" and left the directors no flexibility to determine that their fiduciary duties foreclosed them from awarding reimbursement in a particular instance.[158] The Proposed Election Contest Rules similarly strip directors of the fiduciary function that, under Delaware law, they must retain.

The Proposed Election Contest Rules leave no room for the exercise of the board's fiduciary duties with respect to shareholder nominations. Such nominations will now be put forth and financed by the company, which curtails the board's ability to carry out its fiduciary responsibilities. That, again, is an improper intrusion into state law's domain.

In *Santa Fe Industries*, the Supreme Court rejected an interpretation of the Exchange Act that would impose liability under Rule 10b-5 for "a wide variety of corporate conduct traditionally left to state regulation."[159] In the Court's judgment, there was sufficient reason to reject the proffered interpretation where it was an "extension of the federal securities laws"

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stringent while forbidding the same majority to make it more relaxed."), *available at* http://ssrn.com/abstract=1438308.

156 *See* proposed Rule 14a-11(a)(1) (74 Fed. Reg. at 29,082).

157 953 A.2d 227, 238 (Del. 2008).

158 *Id.* at 237.

159 430 U.S. at 478.

that "would overlap and *possibly* interfere with state corporate law."[160] 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. For these reasons, the Proposed Election Contest Rules exceed the Commission's authority and should not be adopted.

3. **The Remaining Exchange Act Provisions Cited Do Not Authorize The Proposed Election Contest Rules** [B.1.]

Apart from Section 14(a), the Commission identifies Sections 3(b), 13, 15, 23(a), and 36 of the Exchange Act as providing a legal basis for the Proposed Election Contest Rules, as required by the Regulatory Flexibility Act.[161] As we explain below, those provisions should not be relied on to sustain the Proposed Election Contest Rules.

a. **Section 3(b) Of The Exchange Act** [B.1.]

Section 3(b) vests the Commission with the authority to define certain terms used in the Exchange Act.[162] 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."[163] This is clearly not the type of broad authority that would support the Proposed Election Contest Rules.

b. **Section 13 Of The Exchange Act** [B.1.]

Section 13, entitled "Periodical 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."[164] This is particularly

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160 *Id.* at 478-79 (emphasis added).

161 74 Fed. Reg. at 29,078.

162 15 U.S.C. § 78c(b) (2009) ("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.

163 1934 House Report at 18.

164 *Kalvex*, 425 F. Supp. at 316. *See also Gallagher v. Abbott Labs.*, 269 F.3d 806, 809 (7th Cir. 2001) (Section 13 authorizes SEC to "require issuers to file annual and other periodic reports—with the emphasis on *periodic* rather than continuous. Section 13 and the implementing regulations contemplate that these reports will be snapshots of the

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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 create shareholder rights to nominate directors using company proxy materials. For example, Section 13(b) includes books-and-records and internal accounting controls provisions added by the Foreign Corrupt Practices Act of 1977.[165] Other subsections of Section 13 added over time include: (i) 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;[166] (ii) Section 13(e), which imposes restrictions on certain stock repurchases by companies;[167] (iii) Section 13(f), which requires institutional investment managers to file certain reports on their holdings and transactions in registered equity securities;[168] and (iv) Sections 13(i), (j), (k) and (l), which, respectively, 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 changes in a company's financial condition or company operations as specified by Commission rulemaking.[169]

Section 13 thus remains concerned with issues wholly unrelated to requiring public companies to allow shareholders' director nominees to be placed in the companies' proxy materials. The section does not vest the Commission with the authority to promulgate the Proposed Election Contest Rules.

c. Section 15 Of The Exchange Act [B.1.]

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

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corporation's status on or near the filing date, with updates due not when something 'material' happens, but on the next prescribed filing date.").

165 15 U.S.C. § 78m(b) (2009).

166 15 U.S.C. § 78m(d) (2009); 15 U.S.C. § 78m(g) (2009).

167 15 U.S.C. § 78m(e) (2009).

168 15 U.S.C. § 78m(f) (2009).

169 15 U.S.C. § 78m(i)-(l) (2009). These sections were added in 2002 as part of the Sarbanes-Oxley Act.

restrictions on rulemaking regarding certain hybrid products.[170] Moreover, Section 15 authorizes the Commission to prescribe rules that address the requirements for the registration and conduct of brokers and dealers.[171] Section 15 also requires certain public companies to file supplementary and periodic information, documents, and reports[172] and requires certain disclosures with respect to transactions in penny stocks.[173] The section, however, does not even remotely address proxy matters or the nomination of director candidates.

d. **Section 23(a) Of The Exchange Act** [B.1.]

Section 23(a) vests the Commission 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."[174] 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."[175] There is no provision in the Exchange Act requiring companies to include shareholder nominees in company proxy materials, and indeed, as stated above, Congress never contemplated such interference into corporate governance to be encompassed within the Exchange Act.[176] As the Proposed Election Contest Rules do not implement any section in the Exchange Act, they cannot be properly authorized under Section 23(a). This section, therefore, does not authorize the Commission to promulgate the Proposed Election Contest Rules.

e. **Section 36 Of The Exchange Act** [B.1.]

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.[177] Section 36 has two subparts. Subsection (a)

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170 15 U.S.C. § 78o (2009). 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.

171 *See id.* § 78o(b)(1).

172 *See id.* § 78o(d).

173 *See id.* § 78o(g).

174 15 U.S.C. § 78w(a)(1) (2009). 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.*

175 *Id.*

176 *See, e.g.*, 1934 Senate Report at 10; 1934 House Report at 3.

177 Pub. L. 104-290, Title I, § 105(b), 110 Stat. 3416, 3424 (Oct. 11, 1996).

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.[178] Subsection (b) prohibits the Commission from exempting anyone from the definitions in paragraphs (42), (43), (44) or (45) of Section 3(a).[179]

The legislative history of this section makes clear that Section 36 allows the Commission to *exempt* people and securities from Commission rules, not to adopt regulations imposing affirmative obligations on companies.[180] 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 include shareholder nominees in company proxy materials. Like the other statutory provisions cited in the Proposing Release, Section 36 thus provides no support for the Proposed Election Contest Rules.

f. **Section 19(c) Of The Exchange Act And The Sarbanes-Oxley Act** [B.23.]

We believe that the Commission was correct in not identifying either Section 19(c) of the Exchange Act or the Sarbanes-Oxley Act as authorizing the Proposed Election Contest Rules.

We note that Question B.23 of the Proposing Release asks whether the Commission should "consider rulemaking under Section 19(c) of the Exchange Act to amend the listing standards of registered exchanges to require that shareholders have access to the company's proxy materials to nominate directors under the requirements and procedures described in connection with proposed Rule 14a-11, to reflect, for example, changes the Sarbanes-Oxley Act made to director and independence requirements, among other matters?"[181]

It is true that the Sarbanes-Oxley Act[182] 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 the statute nowhere addresses the question of director nominations. Indeed, the Sarbanes-Oxley Act serves to confirm that, in the absence of express congressional authorization, the Commission lacks statutory authority to regulate corporate governance.

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178 15 U.S.C. § 78mm(a) (2009).

179 *Id.* at § 78mm(b).

180 H.R. REP. NO. 104-622, at 38 (1996).

181 74 Fed. Reg. at 29,034-35.

182 The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

As for Section 19(c), it is obvious from the District of Columbia Circuit's decision in *Business Roundtable* that the Commission cannot use that provision's authority to make rules for registered exchanges as a means to impose requirements that the Commission otherwise lacks authority to impose under other parts of the Exchange Act.[183] Accordingly, the Commission should not consider further rulemaking under Section 19(c) as a means for imposing the requirements set forth in the Proposed Election Contest Rules.

4. The Proposed Election Contest Rules Raise Serious Constitutional Concerns [B.1.]

The Constitution's First Amendment secures freedom of speech and its Fifth Amendment prohibits deprivations of property without the payment of just compensation. Adoption of the Proposed Election Contest Rules as drafted would violate those constitutional provisions. It is evident from their text and context that Section 14(a) and the other statutory provisions cited do not confer authority to adopt the Proposed Election Contest Rules. At a minimum, however, to the extent any of those statutes are unclear on the question, they should be construed not to confer such authority so as to avoid the need to decide grave constitutional questions, under the canon of constitutional avoidance. That canon "is a tool for choosing between competing plausible interpretations of a statutory text, resting on the reasonable presumption that Congress did not intend the alternative which raises serious constitutional doubts."[184]

a. First Amendment Concerns [B.1.]

It is a "fundamental rule of protection under the First Amendment[] that a speaker has the autonomy to choose the content of his own message."[185] The right to free speech forecloses a government agency from requiring that a speaker convey a particular message against the speaker's will, regardless of whether the speaker is an individual or a legal entity such as a corporation. Put simply, the First Amendment protects businesses from being compelled by the government to speak.[186]

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183 905 F.2d at 410.

184 *Hawaii v. Office of Hawaiian Affairs*, 129 S. Ct. 1436, 1445 (2009) (internal quotation marks omitted).

185 *Hurley v. Irish-American Gay, Lesbian and Bisexual Group of Boston, Inc.*, 515 U.S. 557, 573 (1995).

186 *See, e.g.*, *Riley v. Nat'l Fed'n of the Blind, Inc.*, 487 U.S. 781, 784, 786-87 (1988) (invalidating statute requiring potential fundraisers to disclose various facts in appealing for funds); *Pac. Gas & Elec. Co. v. Pub. Utils. Comm'n*, 475 U.S. 1, 20-21 (1986)

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The Proposed Election Contest Rules are inconsistent with that teaching, because the Commission proposes to deprive companies of their "autonomy to choose the content" of their proxy materials, instead demanding that the corporate proxy materials include shareholder nominations. The content of a company's proxy materials, distributed to its shareholders in advance of a shareholder meeting and seeking shareholder approval of corporate actions—including in connection with director elections—goes to the very heart of corporate governance and policymaking.[187]

The First Amendment secures a company's right to use that corporate property to advance a message concerning director elections approved by the company's chief policymaking body—namely, the board of directors, which is charged with a fiduciary duty to safeguard the best interests of the company (and thus the shareholders at large). Absent the most compelling circumstances the government cannot require companies to "use their private property as a 'mobile billboard,'" whether "for the [government]'s ideological message," or for the message of a third person favored by the government, such as the selected class of shareholders that would be entitled to place nominations in the company's proxy materials under the Proposed Election Contest Rules.[188]

Compounding the compelled speech problem here is the lack of content neutrality in the Proposed Election Contest Rules. The reasoning of a plurality of the Supreme Court in the 1986 case *Pacific Gas & Electric Co. v. Public Utility Commission* is instructive.[189] In that case, the state regulatory agency order that the Court invalidated had required that a utility enclose in its customer billing envelope the message of a third party, specifically selected for inclusion

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(invalidating state agency order requiring privately-owned utility to allow third party's message in utility's billing envelope).

187 The Supreme Court has made clear that "speech need not be characterized as political before it receives First Amendment protection." *United States v. United Foods, Inc.*, 533 U.S. 405, 413 (2001). Nevertheless, we note that by analogy to communications in connection with a campaign for political office, statements made by the board in corporate proxy materials are properly classified as political speech—and burdens on political speech are subject to strict scrutiny. *See, e.g.*, *Austin v. Mich. State Chamber of Commerce*, 494 U.S. 652, 658 (1990). Indeed, if the Commission is correct that the shareholder's right to vote in corporate elections is analogous to the voter's right to vote in an election for public office (74 Fed. Reg. at 29,027 n.47), then the Commission has conceded that corporate statements in connection with director elections are analogous to political speech.

188 *Wooley v. Maynard*, 430 U.S. 705, 715 (1977).

189 475 U.S. 1 (1986).

because the third party "disagree[d] with [the corporation's] views."[190] The third party "[a]ccess" to the billing envelope was "limited to persons or groups . . . who disagree with [the utility's] views . . . and who oppose [the utility] in" certain proceedings before the agency.[191] The plurality concluded that the agency's access requirement impermissibly burdened the utility's "right to be free from government restrictions that abridge its own rights in order to 'enhance the relative voice' of its opponents."[192] Forcing the utility "to assist in disseminating the [third party's] message . . . necessarily burden[ed] the expression of the disfavored speaker"—namely, the utility.[193]

The *PG&E* plurality's rationale is readily applicable to a First Amendment analysis of the Proposed Election Contest Rules. When the board of directors includes a nominee for director in the company's proxy materials, the board on behalf of the company as a whole is expressing the company's view that the nominee should be elected. By mandating that the company also include the nominations of certain shareholders, the Commission proposes to abridge the company's right "in order to enhance the relative voice" of the shareholders with opposing views, thereby "burden[ing] the expression of the disfavored speaker"—the company itself, as represented by the board of directors.

To be sure, in responding to the dissenting opinion by Justice Stevens, the *PG&E* plurality issued some dicta suggesting that its own reasoning could not be extended beyond the state public utility regulation context. Analogy to the Commission's Rule 14a-8 for shareholder proposals was "inappropriate," the plurality remarked, because "[m]anagement has no interest in corporate property except such interest as derives from the shareholders," and because "[r]ules that define how corporations govern themselves do not limit the range of information that the corporation may contribute to the public debate."[194] Yet the plurality's discussion of those two points is incorrect. On the first point, the plurality overlooked the fiduciary role of the board of directors, which, as we have emphasized, is an obligation under state law to see that corporate assets are used in the best interests of the company, and thus all of the shareholders—not merely the interests of a vocal minority that may seek to use the proxy

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190 *Id.* at 13.

191 *Id.*

192 *Id.* at 14.

193 *Id.* at 15. Concurring in the judgment, Justice Marshall provided the fifth vote for invalidation of the challenged order, but on grounds distinct from those of the plurality. Justice Marshall was concerned with the fact that the State has "taken from [the company] the right to deny access to its property—its billing envelope—to a group that wishes to use that envelope for expressive purposes." *Id.* at 22.

194 *Id.* at 15 n.10.

materials to convey their own message. On the second point, the *PG&E* plurality overlooked not only the established understanding that companies act through their boards rather than through insurgent shareholders, but also that companies file their proxy materials with the Commission for public disclosure—thereby making the company's proxy materials a means for communication with the equities markets, news media and the public at large. As a result, the plurality's observations in dicta distinguishing *Rule 14a-8* from the agency order at issue in *PG&E* would not persuade contemporary courts that the *Proposed Election Contest Rules* are valid under the First Amendment.

Furthermore, even if company proxy materials were not viewed as corporate property subject to the board of directors' oversight, the Supreme Court's precedents governing compelled subsidization of speech would apply. "First Amendment values are at serious risk if the government can compel a particular citizen, or a discrete group of citizens, to pay special subsidies for speech on the side that it favors."[195] When an insurgent shareholder uses the company proxy materials rather than independently-prepared and distributed materials to advocate for a nomination of a candidate in opposition to the company's nominee, the remaining shareholders are effectively forced to subsidize the insurgent shareholder's speech because the government favors that speech. Although the First Amendment tolerates situations where the "mandated participation in an advertising program with a particular message" is "the logical concomitant of a valid scheme of economic regulation,"[196] that narrow exception would not apply here. As we have explained above, a subsidized right to nominate directors using corporate proxy materials, rather than independent materials, is *not* a "logical concomitant" of the procedurally-focused disclosure regime that the federal securities laws have established.

b. **Fifth Amendment Concerns** [B.1.]

The Takings Clause of the Fifth Amendment states that "private property" shall not "be taken for public use, without just compensation." Regulatory takings arise from the consequences of government regulatory actions that affect private property. Here, because a company's proxy materials are the private property of the company, the Proposed Election Contest Rules implicate the clause. The Proposing Release does not explain how the Commission's commandeering of corporate proxy materials is consistent with the limitations on the government's takings power.[197]

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195 *United Foods*, 533 U.S. at 411.

196 *Id.* at 412 (distinguishing *Glickman v. Wileman Bros. & Elliott, Inc.*, 521 U.S. 457 (1997)).

197 *See generally Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency*, 535 U.S. 302 (2002).

II. The Proposed Amendment To The Shareholder Proposal Rules

A. The Commission Should Not Adopt Proposed Rule 14a-11 And Should Instead Adopt A Modified Version Of Its Proposed Amendment To Rule 14a-8(i)(8) [A.10., A.11., I.1., I.2., I.4.]

We believe that rather than adopting the Proposed Election Contest Rules, the Commission should adopt a modified version of its proposed amendment to Rule 14a-8(i)(8) to permit shareholders to propose amendments to a company's bylaws to facilitate proxy access without the constraints set forth in the Proposed Election Contest Rules and revise its other rules to accommodate these amendments.[198] In contrast with a federally mandated proxy access regime, as proposed in Rule 14a-11, permitting shareholders to propose amendments to a company's bylaws to facilitate proxy access would allow shareholders to take advantage of the opportunity that state law affords to tailor a system of proxy access to the needs of the individual company. For example, as discussed in further detail in Section I.A.2 above, recent amendments to Delaware law expressly permit companies to adopt bylaws that require the company to include shareholder nominees for director in the company's proxy materials and provide for the reimbursement of expenses incurred by shareholders in connection with the solicitation of proxies for the election of directors.

The Commission's Proposed Election Contest Rules would effectively deprive shareholders and companies of the ability to fully take advantage of the flexibility that state law provides and would impede their ability under state law to adopt a proxy access and/or proxy reimbursement regime that suits the unique circumstances of the company at any particular point in the company's evolution.[199] In contrast, the proposed amendment to Rule 14a-8

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198 We note that at the Commission's May 20, 2009 open meeting, Commissioner Paredes suggested an alternative under which Rule 14a-8(i)(8) would be amended to permit proxy access shareholder proposals only if the law of the company's state of incorporation expressly authorizes a company to have a proxy access provision in its governing documents. *See* Commissioner Paredes, Statement at Open Meeting (May 20, 2009), *supra* note 149. This alternative would eliminate the need for the Commission to decide complicated issues of state law regarding whether a Rule 14a-8 proxy access shareholder proposal is permissible under state law. Several participants in the Commission's 2007 Proxy Process Roundtables supported relieving the Commission of the responsibility of deciding state law issues. *See, e.g.*, Leo E. Strine, Jr., Delaware Court of Chancery, Transcript of Roundtable on Proposals of Shareholders May 25, 2007, at 127 ("May 25th Roundtable"); Joseph A. Grundfest, Stanford Law School, May 25th Roundtable, at 101. We would be supportive of such an alternative.

199 Importantly, in a comment letter to the Proposed Election Contest Rules submitted on July 24, 2009, the Delaware State Bar Association expressed similar views, stating that "a

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would enable shareholders and companies to implement proxy access provisions that are adapted to the distinct characteristics and needs of the individual company. Thus, allowing proxy access shareholder proposals facilitates shareholder choice or private ordering, thereby giving better effect to investors' state law rights than the federally mandated "one size fits all" approach the Commission proposes to impose under Rule 14a-11.

While in 2007, we did not support the Commission's proposal to allow shareholder proposals under Rule 14a-8(i)(8) that would amend a company's bylaws to permit proxy access (the "2007 Proposal"),[200] we believe that recent state law developments as well as certain differences between the Commission's 2007 Proposal and the current proposal make a modified version of the proposed Rule 14a-8(i)(8) amendment a realistic alternative to the Proposed Election Contest Rules. As discussed above, several states, including Delaware, have amended or are in the process of amending their corporate laws to explicitly permit companies and shareholders to adopt bylaw amendments addressing the ability of shareholders to have their director nominees included in company proxy materials and providing for reimbursement of expenses in proxy contests.[201] In addition, one of our primary concerns with respect to the Commission's 2007 Proposal was that it would have allowed shareholders to place their nominees in a company's proxy materials without the attendant disclosures mandated by Commission rules governing contested solicitations.[202] As stated in our 2007 comment letter, these rules serve the fundamental goal of providing shareholders with full and accurate disclosure so they have an opportunity to make informed decisions in voting for directors. The concerns we noted with respect to the lack of a disclosure requirement in the Commission's

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single [proxy access] rule would unnecessarily deprive Delaware corporations of the flexibility state law confers to deal effectively with myriad different circumstances that legislators and rulemakers cannot anticipate, and would thereby undermine a key element of the state system of corporate governance that has been largely successful for decades." The Delaware State Bar Association's comment letter further noted that "Rule 14a-11, if adopted, would actually impede the exercise of important stockholder rights available under existing state law." Letter from the Delaware State Bar Association to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-10-09, at 2, 10 (July 24, 2009).

[200] Shareholder Proposals, SEC Release No. 34-56160, 72 Fed. Reg. 43,466, 43,472 (Aug. 3, 2007).

[201] *See* Section I.A.2 *supra* for a more detailed discussion of the actions that are being taken by state governments to facilitate proxy access.

[202] *See* Letter from Business Roundtable to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, SEC File Nos. S7-16-07 and S7-17-07, at 1-2 (Oct. 1, 2007).

2007 Proposal generally have been allayed by the disclosure regime for shareholder nominees that the Commission has established under proposed Rule 14a-19.[203]

Thus, in light of state law amendments permitting companies and shareholders to adopt proxy access and proxy reimbursement bylaws and in light of the proposed disclosure requirements for shareholder nominees, we support, as an alternative to the Proposed Election Contest Rules, the proposed amendment to Rule 14a-8(i)(8) that would permit shareholders to amend, or request an amendment to, a company's bylaws regarding nomination procedures or disclosures related to shareholder nominations of directors, with the changes outlined below.[204]

B. The Commission Should Permit Proxy Access Shareholder Proposals To Modify Any Proposed Election Contest Rules [A.10., I.6.]

If the Commission were to adopt the Proposed Election Contest Rules, we believe that shareholders should be permitted to propose amendments to a company's bylaws that would increase or decrease the requirements of the Proposed Election Contest Rules and/or provide for proxy reimbursement in lieu of a proxy access regime. Under the proposed amendment to Rule 14a-8(i)(8), shareholders would be permitted to propose amendments to a company's bylaws to provide an additional means for including shareholder director nominees in company proxy materials, but would not be permitted to propose amendments that would have the effect of preventing a shareholder that meets the requirements of the Proposed Election Contest Rules from including its director nominees in the company's proxy materials.[205] In other words, the Proposed Election Contest Rules would act as a "floor" where, under Rule 14a-8(i)(8), shareholders could only seek to impose lower but not more stringent access requirements on nominating shareholders, even if a majority of the shareholders believe that more restrictive access requirements are in a company's best interests.

We believe that there is no legitimate reason to allow shareholder proposals that would impose more lenient but not more restrictive access requirements on nominating shareholders. Rather, the Commission should let companies and their shareholders decide whether or not, and to what degree, they wish to permit shareholders to include their director nominees in

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203 However, we believe that modifications to the disclosure regime are needed, as discussed further in Sections II.D and III.G *infra*.

204 While we support the adoption of a modified version of the Commission's proposal to amend Rule 14a-8(i)(8), we believe the Commission needs to address the Commission staff's increasingly narrow application of the "substantially implemented" standard in Rule 14a-8(i)(10), as we believe the rigid application of this standard is inappropriate, particularly in the context of proxy access.

205 *See* 74 Fed. Reg. at 29,056 n.255.

company proxy materials. For example, if a company's shareholders wish to impose ownership thresholds higher than those in the Proposed Election Contest Rules for nominating shareholders, the Commission should not prevent them from doing so. Similarly, shareholders should be allowed to submit proposals that would have the effect of lowering the thresholds in the Proposed Election Contest Rules, or providing for a proxy reimbursement system in lieu of proxy access. This approach would allow flexibility for shareholders to tailor bylaws relating to nomination procedures to a company's specific characteristics at any given point in time.

Prescribing a default proxy access standard that companies and shareholders cannot change is inconsistent with the traditional enabling approach of state corporate law, which permits companies and their shareholders to tailor a company's internal organization to account for its individual characteristics. Allowing companies and their shareholders to develop their own approaches to dealing with shareholder nominations that are adapted to the unique qualities of the company is in keeping with this enabling philosophy. State law recognizes that there is significant value in allowing individual companies to design their own approaches to proxy access, as reflected in the recent Delaware law amendments, which do not mandate, or even prescribe default parameters for, proxy access or proxy reimbursement bylaws. Likewise, the amendment to Rule 14a-8(i)(8) should recognize that shareholders and companies may determine that a more restrictive proxy access system is appropriate for a given company, or that a proxy reimbursement system would provide a better alternative. For example, a proxy access system that is appropriate for a small primarily family-owned company may not be the right approach for a Fortune 100 company whose shares are held primarily by large institutional investors. These views were supported by several participants at the Commission's 2007 proxy process roundtables ("2007 Proxy Process Roundtables").[206] Consequently, we believe that

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[206] *See, e.g.*, Joseph A. Grundfest, Stanford Law School, May 7th Roundtable, at 226 ("If you really believe in corporate democracy, then doesn't it inevitably follow that we can look to the shareholders of the corporation and the corporation itself to set the rules by which it wants to govern access to the corporation's own proxy? And even if you have two corporations, both of which are chartered in Delaware, their individual circumstances can differ in very, very dramatic ways and it could well be the case that the optimal rules of proxy access for one corporation are very different than the optimal rules of proxy for another and clearly different than a national standard set by the [Commission] . . . ."); Stephen P. Lamb, Delaware Court of Chancery, May 7th Roundtable, at 83 ("[T]he Commission is thinking about adopting or had been thinking about adopting this very complex 'one size fits all' system. It just seemed in great tension with the normal state laboratory sense of allowing corporation law and state corporation law to work those problems out."); John C. Coffee, Columbia Law School, May 7th Roundtable, at 66 ("I do think, however, the shareholders have great power to adopt by-laws addressing the shareholder nomination process . . . and there could be any number of by-laws in that area . . . . I do think when we are dealing with the basic issue of the nomination process and the voting process, that shareholder power to establish the rules of the game is part of an

[Footnote continued on next page]

any final rule amending Rule 14a-8(i)(8) to allow shareholder proposals seeking to address a company's nomination procedures should permit shareholders to propose procedures that would modify the requirements of the Proposed Election Contest Rules, if the Commission proceeds with adopting the Proposed Election Contest Rules.

C. The Commission Should Adopt Enhanced Eligibility Thresholds For Proxy Access Shareholder Proposals [A.10., I.8., I.9.]

We believe that the Commission should revise its proposal to amend Rule 14a-8(i)(8) to increase the ownership threshold for shareholders submitting proxy access shareholder proposals.[207] As proposed, shareholders submitting proxy access shareholder proposals under Rule 14a-8(i)(8) would be subject to the same ownership thresholds as shareholders submitting any other type of shareholder proposal under Rule 14a-8. We believe that this system fails to take into account some important differences between proxy access shareholder proposals and other types of Rule 14a-8 shareholder proposals. If approved by the shareholders, proxy access shareholder proposals would result in amendments to a company's bylaws in an area of fundamental significance to the company—director elections. Moreover, a system of proxy access will create significant costs and burdens for companies and their shareholders, as well as the Commission and its staff, as discussed in further detail in Section III.H below. Thus, these

[Footnote continued from previous page]

enabling system of corporate law."); Leo E. Strine, Jr., Delaware Court of Chancery, May 7th Roundtable, at 79 ("If [a binding by-law shareholder proposal] relates to the actual system of elections, let the state courts determine that. That will allow stockholders to have innovation and actually elegantly gets [the Commission] out of the middle of this, which is you are facilitating change of the electoral process, responsiveness to stockholders, without a single solution to myriad circumstances.").

[207] Although our comments relate specifically to the proposed amendment to Rule 14a-8(i)(8) about which the Commission has solicited comment, we believe that the Commission should raise the ownership threshold for *all* Rule 14a-8 shareholder proposals. As we discussed in our comment letter relating to the Commission's 2007 Proposal, the Commission should consider increasing the ownership threshold for Rule 14a-8 shareholder proposals due to the significant time, effort and other resources spent by companies and their shareholders, and the Commission and its staff, on proposals that often are not of widespread interest to a company's shareholders. *See* Letter from Business Roundtable to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-16-07 and S7-17-07, at 13-14 (Oct. 1, 2007). For example, our July 2009 Survey revealed that companies spend an estimated 47 hours and incur associated costs of $47,784 in preparing and submitting a single no-action request to the Commission, and that they spend an estimated 20 hours and incur associated costs of $18,982 in printing and mailing one shareholder proposal in their proxy materials.

costs and burdens necessitate a substantial increase in the threshold for shareholder proposals regarding shareholder nomination procedures or disclosures.

Under current Commission rules, a shareholder is eligible to submit a Rule 14a-8 proposal if the shareholder has continuously held at least $2,000 in market value, or 1%, of the company's shares for at least one year. The Commission has not adjusted this threshold since 1998, when it raised the threshold from $1,000 to the current $2,000 eligibility threshold. Even at that time, many commentators expressed the view that this small increase would do little to reduce the significant time and resources expended by companies and the Commission in dealing with Rule 14a-8 shareholder proposals.[208] Over ten years later, this increase has been rendered relatively meaningless given increased investments by shareholders.[209]

As several participants in the 2007 Proxy Process Roundtables noted, this low eligibility threshold subjects companies to the "tyranny of the 100 share shareholder."[210] Essentially, a shareholder holding a *de minimis* investment has the ability to use the company's resources (and by extension, the resources of all the company's shareholders) to put forth his or her agenda. Every year, companies spend significant time and financial resources responding to shareholder proposals, negotiating with proponents, and deciding whether to adopt proposals, include them in their proxy materials or attempt to exclude them by submitting no-action requests to the Commission.[211] In turn, the Commission staff must respond in a short time frame to each no-action request that it receives from a company.[212] The time and expense associated with Rule 14a-8 proposals relating to shareholder nominations and disclosures is likely to consume additional company, shareholder and Commission resources since these issues are of such a high degree of importance and complexity. Consequently, the proposed

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208 *See, e.g.*, Letter from Burlington Northern Santa Fe Corporation to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-25-97 (Dec. 31, 1997); Letter from American Society of Corporate Secretaries to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-25-97 (Dec. 8, 1997).

209 For example, the median value of stock owned by U.S. families with stock holdings increased 10% between 1998 and 2007. *See* 2007 Survey of Consumer Finances, Board of Governors of the Federal Reserve System, at 27 tbl. 7 (Feb. 2009), *available at* http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf.

210 *See, e.g.*, John C. Coffee, Columbia Law School, May 7th Roundtable, at 44-45; William J. Mostyn III, Bank of America Corporation, May 25th Roundtable, at 32.

211 *See supra* note 207.

212 *See infra* Section III.H for a more detailed discussion of the Commission resources required to process no-action requests.

amendment to Rule 14a-8(i)(8) that would require companies to include such proposals in their proxy materials necessitates a significant increase from the current $2,000 eligibility threshold in order to justify the burden and cost on companies, shareholders and the Commission. Thus, we urge the Commission to increase the eligibility threshold to at least 1% of a company's outstanding shares for proxy access shareholder proposals.

D. The Commission Should Amend And Clarify Schedule 14N [A.10., I.11., I.12.]

We agree with the Commission's proposal to require nominating shareholders or groups to file a Schedule 14N, containing the information required by Rule 14a-19, to notify a company of their intent to submit a nominee for inclusion in the company's proxy materials pursuant to an applicable state law provision or the company's governing documents. Such a requirement will provide that shareholders receive full and accurate disclosure so they have an opportunity to make informed decisions in voting for directors. However, as discussed in more detail in Section III.G below, we believe that the disclosure could be improved by adding to Schedule 14N the requirement that the nominating shareholder or group include a description of any material transaction of the shareholder or group with the company or any of its affiliates that occurred during the 12 months prior to the formation of any plans or proposals, or during the pendency of any proposal or nomination. In addition, we believe that amendments to Schedule 14N are needed to clarify certain provisions relating to material changes to the information provided in a shareholder's originally-filed Schedule 14N, as discussed further in Section III.G below.

III. If The Commission Nevertheless Adopts The Proposed Election Contest Rules, Extensive Revisions Are Necessary [A.6.]

A. The Proposed Election Contest Rules Should Not Preempt State Law [A.2., B.1., B.2., B.7., B.10., B.12., I.6.]

We strongly oppose the Proposed Election Contest Rules because they would preempt state law, setting forth in a federal regulation the substance of a shareholder's right to access a company's proxy materials, despite decisions made by the company or its shareholders. Rather than facilitating rights that shareholders have under state corporate law, the Proposed Election Contest Rules would create a new, federal right, going against a 200-year history of state primacy in the regulation of substantive corporate law. To avoid this result and preserve shareholder choice, we believe that, if the Commission adopts the Proposed Election Contest Rules, they should not apply where a company's shareholders or board have adopted a proxy access bylaw or a proxy reimbursement bylaw, or where a company is incorporated in a state whose law includes a proxy access right or the right to reimbursement of expenses that shareholders incur in connection with proxy contests.

The Proposing Release states that "[i]n identifying the rights that the proxy process should protect, the Commission has sought to take as a touchstone the rights of shareholders under state corporate law."[213] However, the Proposed Election Contest Rules would preempt, rather than protect, state law rights. The Proposed Election Contest Rules would impose a proxy access regime on almost all public companies.[214] They would require these companies to include shareholder nominees for director in their proxy materials in circumstances where, among other things, a shareholder has met various specified substantive criteria. If the Commission adopts the Proposed Election Contest Rules as proposed, shareholders and boards could implement additional methods for shareholders to include nominees in company proxy materials, but they could not adopt thresholds or other requirements that would prevent a shareholder from nominating directors if the shareholder has otherwise satisfied the criteria in the Proposed Election Contest Rules.[215] In this respect, the Proposed Election Contest Rules plainly would preempt state law, a result that is inadvisable and inappropriate for the reasons discussed below.

Historically, state corporations statutes have been the primary source of corporate law, establishing and facilitating organizing principles in the area of corporate governance. As discussed in Section I.A.3 above, state corporate law is often described as "enabling" because it generally gives corporations flexibility to structure their operations in a manner appropriate to the conduct of their business. In fact, the Commission recognizes "the traditional role of the states in regulating corporate governance" in the Proposing Release.[216] The Proposed Election Contest Rules would subvert this role by creating a federal right in an area—director nominations and elections—that traditionally has been the province of state corporate law.[217] In proposing the Proposed Election Contest Rules, the Commission has made substantive determinations about the criteria that shareholders must satisfy in order to include a nominee for director in the company proxy materials. These criteria, as Commissioner Casey observed,

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213 74 Fed. Reg. at 29,025.

214 As noted in the Proposing Release, the Proposed Election Contest Rules would apply to all companies that are subject to the proxy rules under the Exchange Act, except companies subject to the rules solely because they have registered a class of debt securities under Section 12 of the Exchange Act. The Proposed Election Contest Rules would not apply to foreign private issuers, as they are exempt from the proxy rules. 74 Fed. Reg. at 29,032 n.104.

215 74 Fed. Reg. at 29,056 n.255.

216 *Id.* at 29,025.

217 *See, e.g.*, *CTS Corp.*, 481 U.S. at 89 ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.").

"strongly suggest[] that the rule is not merely 'procedural,' but rather goes to the heart of the policy considerations properly left to state legislatures or, where legislatures so provide, to the companies and their shareholders."[218]

In this respect, the Proposed Election Contest Rules embody an approach that is fundamentally inconsistent with a long tradition of addressing corporate governance matters at the state level through private ordering by shareholders, boards and companies acting within the framework established by state corporate law. By its very nature, state corporate law permits shareholders and companies to adopt individualized approaches to corporate governance, fostering innovation and minimizing regulatory burdens. State corporate law also offers the advantage of being able to respond in a timely manner as corporate governance practices evolve. This is reflected in the recent action of the Delaware legislature in amending the Delaware General Corporation Law to address proxy access and reimbursement bylaws (discussed above in Section I.A.2) as well as action at the state level to facilitate majority voting in director elections (discussed above in Section I.A.3). These are only a few of the reasons why state law has played a predominant, and highly successful, role in regulating corporate governance matters.

Moreover, the Proposed Election Contest Rules would contravene the policy of the Obama Administration on federal preemption of state law, as set forth in a May 2009 Presidential Memorandum articulating the Administration's position on this subject. This memorandum states that it is the "general policy of [the] Administration that preemption of State law by executive departments and agencies should be undertaken only with full consideration of the legitimate prerogatives of the States and with a sufficient legal basis for preemption."[219] That legal basis is utterly absent here, and the Proposed Election Contest Rules completely disregard the "legitimate prerogatives of the States" to address corporate governance matters through their corporations statutes, as they have done for several hundred years.

In addition, the Proposed Election Contest Rules would substitute the Commission's judgment about what constitutes the "right" approach to proxy access for that of shareholders, boards and state legislatures. The Commission indicates throughout the Proposing Release that it seeks to empower shareholders and facilitate their rights by removing impediments to their ability to nominate and elect directors.[220] In fact, the Proposed Election Contest Rules would have the opposite effect: disenfranchising shareholders by taking away rights that they have under state law. Specifically, the Proposed Election Contest Rules would eliminate the right to

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218 Commissioner Casey, Statement at Open Meeting (May 20, 2009), *supra* note 7.

219 President Barack Obama, Memorandum for the Heads of Executive Departments and Agencies, Preemption, 74 Fed. Reg. 24,693 (May 22, 2009).

220 *See, e.g.*, 74 Fed. Reg. at 29,025-26.

decide whether to adopt proxy access in the first instance and, if a company chooses to adopt it, the right to decide how to implement it. A company's shareholders or its board reasonably could conclude, based on the company's circumstances and a thoughtful weighing of the costs and benefits, that proxy access is not necessary or is not in the best interests of the company and its shareholders. For example, shareholders or the board might conclude that a better approach is to provide shareholders with the right to reimbursement of expenses incurred in connection with proxy contests, something that recent amendments to the Delaware General Corporation Law now explicitly permit through the adoption of reimbursement bylaws.[221] If shareholders or the board decide to provide for a proxy access right, they reasonably could make the judgment that it is appropriate to apply thresholds and other criteria different from those in the Proposed Election Contest Rules.[222] In fact, recent amendments to the Delaware General Corporation Law, discussed above in Section I.A.2, authorizing the adoption of proxy access bylaws contemplate that shareholders and boards will make choices about a number of the criteria addressed in the Proposed Election Contest Rules. As Commissioner Casey noted, the criteria in the Proposed Election Contest Rules are "the exact same matters included in a non-exclusive list, under the Delaware amendments, that may be addressed in a proxy access bylaw"[223] if a company's shareholders or its board choose to adopt one.

The Commission itself acknowledges the possibility that shareholders and boards could make different choices than those embodied in the Proposed Election Contest Rules, pointing out in the Proposing Release that "a company could choose to provide a right for shareholders to have their nominees disclosed in the company's proxy materials regardless of share ownership,"[224] and that proxy access provisions that a company includes in its bylaws:

> may not limit the number of board seats for which a shareholder or group could nominate candidates or include a requirement that the nominating shareholder

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[221] 8 DEL. CODE ANN. § 113 (2009).

[222] *See* Joseph A. Grundfest, *Internal Contradictions in the SEC's Proposed Proxy Access Rules* (Rock Ctr. for Corporate Governance at Stanford Univ. Working Paper No. 60, 2009), *available at* http://ssrn.com/abstract=1438308. Professor Grundfest notes that the Proposed Election Contest Rules contain an inherent contradiction: "A fundamental premise of every proxy access proposal is that the majority of shareholders are sufficiently intelligent and responsible that they can be relied upon to nominate and elect directors other than the nominees proposed by an incumbent board . . . . But the Proposed [Election Contest] Rules prohibit the identical shareholder majority from establishing a proxy access regime, or from amending the Proposed [Election Contest] Rules to establish more stringent access standards." *Id.* at 2.

[223] Commissioner Casey, Statement at Open Meeting (May 20, 2009), *supra* note 7.

[224] 74 Fed. Reg. at 29,031; *see also id*. at 29,056.

> or group lack intent to change the control of the issuer or to gain more than a limited number of seats on the board (as is the case under proposed Rule 14a-11).[225]

However, the Proposed Election Contest Rules would only permit shareholders and boards to make their own choices where these choices result in a proxy access right that is more expansive than what the Commission has proposed. In this respect, the Proposed Election Contest Rules establish a "floor" of minimum substantive requirements that will apply to shareholders and companies across the board even if they disagree with the requirements and would have adopted different proxy access criteria if given the choice.

Thus, the Proposed Election Contest Rules would impose a federal "one size fits all" mandate on almost every public company—whether it is a Fortune 50 company, a newly public company or a small company with a significant shareholder—requiring that all follow the same practices with respect to the Proposed Election Contest Rules. However, shareholders and boards need to be able to make choices about a range of issues in implementing proxy access, including such matters as:

- whether to require that shareholders nominating a director candidate own a minimum amount of the company's stock and, if so, what that amount should be;
- whether to address swaps and other forms of derivative positions for purposes of calculating shareholders' stock ownership, something that the Proposed Election Contest Rules do not address;
- whether to impose minimum requirements on the duration of a nominating shareholder's stock ownership and, if so, what those requirements should be—for example, a company could specify that a shareholder must hold its stock through the shareholders' meeting, for a specified period (such as a year) thereafter, or for the duration of the nominee's membership on the board;
- how to address other issues that can arise under a company's capital structure or governing documents, such as when companies have multiple classes of voting shares or classified boards;
- how to address shareholders seeking to pool their shareholdings in order to meet applicable ownership thresholds and jointly nominate a director, including such questions as whether to impose a limit on the number of shareholders that can act together for this purpose and whether the shareholders individually should also

225 *Id.* at 29,060.

have to satisfy any applicable requirements relating to minimum periods of continuous ownership;

- whether to limit the number of director candidates that shareholders can nominate under a company's proxy access bylaw and, if so, what the limit should be;

- how to determine which nominees to include in a company's proxy materials where the company receives multiple nominees;

- what, if any, future limits to place on the nomination rights of a shareholder whose nominee is not elected to the board or does not receive a minimum number of votes; and

- how to address the independence of shareholder-nominated directors, and whether to permit relationships between nominating shareholders and their nominees.

The Proposed Election Contest Rules would prohibit shareholders and boards from making choices about matters such as those listed above. This, in turn, would prevent them from establishing the optimum corporate governance structure for their companies and deprive them of flexibility in deciding on the practices that will enable them to govern their businesses most effectively. This is not in the best interests of shareholders, boards or companies. By contrast, as discussed above in Section II, revising Rule 14a-8 to permit the adoption, through the shareholder proposal process, of proxy access or proxy reimbursement bylaws, would enable shareholders to implement proxy access if they choose to do so, and give them flexibility to make choices about how to do it. It also would enable shareholders to provide for reimbursement of expenses incurred in proxy contests if they believe this is a better alternative to proxy access.[226] This approach is far superior to the Proposed Election Contest Rules from the standpoint of providing shareholder choice, and, unlike the Proposed Election Contest Rules, it does not disregard the long tradition of private ordering within the framework established by state corporate law.

As noted above in Section I.A.2, recent state corporate law developments—most notably the adoption of new Delaware General Corporation Law Sections 112 and 113—have directly addressed the issue of proxy access and proxy reimbursement.[227] Moreover,

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[226] *See, e.g.*, Charles M. Elson, *Shareholder Election Reform and Delaware Corporate Regulation*, 26 DELAWARE LAWYER 18, 18 (2008) (noting the cost of waging a proxy contest is problematic and arguing that "[t]he simplest solution . . . is to provide some sort of reimbursement of reasonable expenses to challengers in non-control directorial election challenges").

[227] *See also* N.D. CENT. CODE §§ 10-35-02(8) & 10-35-08 (2009) (allowing shareholders of companies subject to the North Dakota Publicly Traded Companies Act to nominate

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companies already have begun to take voluntary action to address proxy access-related issues. These actions reflect the wide range of choices available to shareholders and companies seeking to structure a proxy access right. As early as 2003, Apria Healthcare Group Inc. adopted a policy allowing shareholders that beneficially owned at least 5% of the company's common stock for two years or more to nominate up to two directors. Where the company received more than two nominations, the policy gave priority to those shareholders owning the greatest number of shares,[228] a sorting mechanism that differs from the "first-in" approach that the Proposed Election Contest Rules would mandate.

In 2007, Comverse Technology, Inc. became what is believed to be the first company to adopt a proxy access bylaw. The Comverse bylaw permits shareholders that have beneficially owned at least 5% of the company's common stock for at least two years to nominate one director. If a shareholder's nominee does not receive at least 25% of the votes cast with respect to the nominee's election at the company's annual meeting, the bylaw precludes the shareholder from submitting additional nominees for four years from the date of the annual meeting.[229] RiskMetrics has adopted a proxy access bylaw that permits shareholders that have beneficially owned at least 4% of the company's common stock for at least two years to nominate directors. Like the Comverse bylaw, RiskMetrics' proxy access bylaw precludes a shareholder from nominating directors for four years if the shareholder's nominee fails to receive at least 25% of the votes cast.[230] Neither Comverse nor RiskMetrics places a ceiling on the number of shareholder nominees who can appear in their proxy materials in connection with any given meeting, unlike the Proposed Election Contest Rules, which impose a limit of one nominee or a number representing 25% of the company's board, whichever is greater. In addition to voluntary action on the part of companies, and in anticipation of more companies taking action to address proxy access, the American Bar Association and other organizations

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directors for inclusion in company proxy materials if they have beneficially owned more than 5% of the company's shares for at least two years).

228 Apria Healthcare Group Inc., Policy Regarding Alternative Director Nominations by Stockholders, Exhibit A to Definitive Proxy Statement for 2003 Annual Meeting of Stockholders (Schedule 14A) (June 11, 2003). According to the disclosure in Apria's proxy statement, the policy was "intended to facilitate the ability of stockholders to choose freely among competing candidates who may be proposed by stockholders who have a significant, long-term, interest in Apria's success." *Id.* at 4.

229 Bylaws of Comverse Technology, Inc. Art. IV § 3(b) (Amended and Restated as of Apr. 20, 2007), *available at* http://www.cmvt.com/financial.htm.

230 RiskMetrics Group, Inc., Second Amended and Restated Bylaws of RiskMetrics Group, Inc. § 2.7, Exhibit 3.2 to Amendment No. 3 to Form S-1 (Form S-1/A) (Jan. 8, 2008).

have begun publishing model proxy access bylaws that provide sample language and outline alternatives for companies to consider in crafting an access bylaw.[231]

The historical predominance of state corporate law in regulating corporate governance, the importance of providing shareholder choice, and the need for flexibility, all make clear that proxy access is most appropriately addressed through private ordering by shareholders, boards and companies, rather than through a federal, "one size fits all" mandate. Accordingly, we strongly oppose the Proposed Election Contest Rules, and, as discussed in more detail above in Section II, we believe that amending Rule 14a-8 to facilitate the adoption of proxy access or reimbursement bylaws by shareholders that wish to implement them is a far better approach. However, if the Commission decides to move forward, the Proposed Election Contest Rules should not apply where a company has a proxy access or reimbursement bylaw.[232] Furthermore, the Proposed Election Contest Rules should be inapplicable regardless of whether the company's shareholders or its board approved the bylaw. The Commission should defer to the shareholders' choice, or the reasoned business judgment of the company's board, as the case may be. For this reason, where state law permits a company to adopt a proxy access or reimbursement bylaw and it has done so, the Proposed Election Contest Rules should not preempt state law and the Proposed Election Contest Rules should be inapplicable. For similar reasons, the Proposed Election Contest Rules should not apply to companies incorporated in a state whose legislature has made the judgment to include a mandatory proxy access right, or a mandatory proxy reimbursement right, in the state's corporations statute.[233]

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[231] *See, e.g.*, Task Force on Shareholder Proposals, Section of Business Law, Committee on the Federal Regulation of Securities, American Bar Association, Illustrative Access Bylaw with Commentary (Exposure Draft) (June 15, 2009), *available at* http://meetings.abanet.org/webupload/commupload/CL410000/sitesofinterest_files/illustrative_access_bylaw.pdf; Wachtell, Lipton, Rosen & Katz, Model Proxy Access Board Resolution and By-Law (May 7, 2009), *available at* http://blogs.law.harvard.edu/corpgov/files/2009/05/wlrk-model-proxy-access-board-resolution-and-bylaw-05-09.pdf.

[232] Further, as we explain in Section III.N *infra*, we believe at least a one-year transition period is necessary to provide companies with an opportunity to consider amendments to their bylaws in light of the amendments to the Delaware General Corporation Law concerning proxy access and proxy reimbursement.

[233] *See, e.g.*, N.D. CENT. CODE §§ 10-35-02(8) & 10-35-08 (2009).

B. The Proposed Election Contest Rules Should Apply Only Where There Is Objective Evidence Of A Need For Greater Director Accountability [A.8., B.13., B.14.]

Given the discussion above regarding the substantial costs and adverse consequences of the Proposed Election Contest Rules, we believe that any federal proxy access mandate imposed by the Commission should apply only where there is objective evidence of need for greater director accountability (a "triggering event"). Below we describe possible triggering events that demonstrate such a need—specifically when a director fails to receive a majority of votes cast and either does not resign or the board does not accept the director's offer to resign and where a shareholder proposal receives a majority of votes cast and the company fails to respond to the proposal. We do not believe that the triggering events listed in the Proposing Release or the triggering events in the 2003 Proposal are appropriate, as they do not necessarily evidence the need for greater director accountability. Finally, if the Commission adopts the Proposed Election Contest Rules and conditions their applicability on one or more triggering events, the Commission should clarify that the triggering events apply only at the next shareholders' meeting.

1. The Proposed Election Contest Rules Should Apply Only If Certain Triggering Events Occur [B.13.]

The Commission recognized the value of triggering events in the 2003 Proposal, where the Commission stated that triggering events create a "structure [that] addresses best the concerns of some commenters regarding the potential adverse impact of such a nomination procedure on public companies."[234] The Commission added that "the nomination procedure triggering events should be tied closely to evidence of ineffectiveness or security holder

[234] 68 Fed. Reg. at 60,790. For concerns, *see* Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* 15-16 (UCLA School of Law, Law & Econ. Research Paper No. 03-22, Nov. 14, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=470121 (discussing such adverse impacts); Commissioner Paredes, Remarks, *supra* note 9 (noting that the Proposed Election Contest Rules may erode investor confidence); Bill Mostyn, Deputy General Counsel and Corporate Secretary of Bank of America, May 25th Roundtable (describing how small shareholders may consume resources of the company for issues not of general interest); David Hirschmann, President of the U.S. Chamber of Commerce Center for Capital Markets Competitiveness, May 25th Roundtable (describing board decisions to incur significant costs to fight shareholder proposals); Letter from the U.S. Chamber of Commerce to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, SEC File Nos. S7-16-07 and S7-17-07 (Oct. 2, 2007) (detailing the cost and disruption to companies).

dissatisfaction with a company's proxy process."[235] However, the Commission now proposes rules that would impose proxy access on almost all public companies, regardless of the existing rights that shareholders have to promote director accountability. The Proposing Release indicates that the Commission's decision not to include triggering events "reflects [the Commission's] concern that the federal proxy rules may be impeding the exercise of shareholders' ability under state law to nominate directors at all companies, not just those with demonstrated governance issues."[236] Yet, the Commission has not given any consideration to the significant costs that a "one size fits all" rule will impose on those companies where the Proposed Election Contest Rules are not needed.

2. Events That Trigger The Proposed Election Contest Rules Should Be Limited To Those That Indicate A Need For Greater Director Accountability [B.13., B.14., B.15., B.17.]

We believe that the triggering events proposed below serve as the best indicators of situations in which there may be a need for greater director accountability.

a. A Director Nominee Does Not Receive A Majority Of Votes Cast And Continues To Serve On The Board

We recommend that the Proposed Election Contest Rules apply where a board-nominated director nominee does not receive support from a majority of votes cast in an uncontested election and that nominee continues to serve on the board. If a company has plurality voting, the director nominee would need to receive more votes "for" than "withhold" votes. If this did not occur, under state law the nominee would still be elected. However, we believe that the Proposed Election Contest Rules should then apply if the director continued to serve on the board (for example, unless the director either resigned or the board accepted the director's offer to resign). If a company has majority voting, the director nominee would need to receive more votes "for" than "against" votes. If this did not occur, under state law the nominee would not be elected. However, under most state laws, in this situation an incumbent director remains on the board as a "holdover" director until the director resigns or a successor is elected or appointed.[237] Thus, as with plurality voting, we believe that the Proposed Election Contest Rules should then apply if the director continued to serve on the board.

We recognize that there may be instances where a director's decision not to resign or a board's decision not to accept the director's offer to resign is in the best interests of the company. However, if the Commission proceeds with the Proposed Election Contest Rules, we

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235 68 Fed. Reg. at 60,790.

236 74 Fed. Reg. at 29,033.

237 *See, e.g.*, 8 DEL. CODE ANN. § 141(b) (2009).

note that a director's continued service on the board may indicate the need for greater shareholder involvement and thus the availability of the Proposed Election Contest Rules.[238]

b. A Shareholder Proposal Receives A Majority Vote And The Board Does Not Respond

We also suggest that the Proposed Election Contest Rules apply where a shareholder proposal submitted under Commission Rule 14a-8 is supported by a majority vote (as determined in a company's governing documents) and the board does not respond to the proposal within six months and publicly disclose its response. In considering the actions that would trigger the Proposed Election Contest Rules when a shareholder proposal receives a majority vote, the Commission should focus on those companies that fail to *respond* to a majority-approved shareholder proposal, rather than using the "substantially implemented" standard in Rule 14a-8, as interpreted by the Commission's staff.[239] The board must be given flexibility in implementation of the approved proposal since, for example, a board's fiduciary duties may require it to implement the proposal in a manner different from that presented by the proposal. Such a decision by the board in the exercise of its fiduciary duties should not subject the company to the Proposed Election Contest Rules.

3. Once Triggered, The Proposed Election Contest Rules Should Be In Effect For A Limited Time [B.16.]

If the Commission adopts the Proposed Election Contest Rules and limits their application following certain triggering events, as we recommend, the Commission should clarify that the Proposed Election Contest Rules will then apply only at the next shareholder meeting. This limitation balances the purported need for greater director accountability with the need of the board and company to concentrate on operating the business and maximizing shareholder returns without the distraction of constant election contests.

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[238] We note that in 2003, the Commission proposed triggering proxy access when a board-nominated director nominee receives "withhold" votes from more than 35% of the votes cast. *See* 68 Fed. Reg. at 60,789. We do not believe this triggering event should be considered because it incorrectly assumes that a 35% withhold vote for a director nominee necessarily indicates the need for greater director accountability when, in fact, the director may be strongly supported by the other 65% of shareholders. Moreover, the fact that a director receives a minority of "withhold" votes (or "against" votes, if the company has adopted majority voting) does not demonstrate that the directors are not accountable to shareholders. On the contrary, it is evidence that the company's proxy process is working: the majority of shares did vote for the director, and he or she was elected to the board.

[239] 17 C.F.R. § 240.14a-8(i)(10) (2009).

C. **The Commission Should Exempt Companies That Have Adopted Director Accountability Measures From The Proposed Election Contest Rules** [B.9, B.10.]

The Commission should exempt from any Proposed Election Contest Rules companies whose governing documents provide shareholders with alternative means to achieve greater director accountability. We believe that shareholders at those companies should not bear the costs of the Proposed Election Contest Rules when the proxy processes are sufficient. In addition to exempting companies with a proxy access or reimbursement bylaw (as discussed in Section III.A. above), we believe that such an exemption should apply to companies that have adopted majority voting in uncontested director elections.

As discussed in Section I.A.3. above, historically, companies generally have elected directors using a plurality voting standard. Under this standard, a candidate will be elected as long as the candidate receives one affirmative vote. Under a majority voting regime, a candidate must receive a majority of votes cast in order to be elected. In response to investor concerns about director accountability, many companies have adopted a majority vote standard in uncontested director elections. Majority voting increases shareholder influence and encourages greater board accountability and, as a result, we believe that the Proposed Election Contest Rules are unnecessary at companies with majority voting in uncontested director elections. Accordingly, companies with such a provision should be exempted from the Proposed Election Contest Rules.

D. **The Commission's Proposed Qualifications For Shareholders To Nominate Director Candidates Must Be Revised** [C.1.]

Under the Proposed Election Contest Rules, any shareholder or group of shareholders beneficially owning—individually or in the aggregate—the requisite number of the company's voting securities for at least one year would be permitted to nominate one or more director candidates in the company's proxy materials.[240] As proposed, such requisite number is equal to 1%, 3% or 5% of the company's voting securities, tiered according to the size of the company. As discussed below, we believe given the disruption, costs, and other serious consequences presented by individual shareholder nominees in company proxy materials,[241] the ownership thresholds should be raised to 5% for all companies and the holding period extended to two years in order to meet the Commission's objective of limiting the Proposed Election Contest Rules to "holders of a significant, long-term interest."[242] Moreover, a nominating shareholder's ability to nominate candidates in successive years should be linked to the success of the shareholder's candidate(s) in previous elections.

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240 *See* 74 Fed. Reg. at 29,035.

241 *See supra* Section I.B.

242 74 Fed. Reg. at 29,035.

1. **The Need For Meaningful Ownership Thresholds** [C.2., C.5., C.6., C.7., C.15., C.19., C.22., PRA 2]

In view of the substantial cost and disruption and other serious consequences that would result from the Proposed Election Contest Rules, 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 thresholds fail to ensure "that only holders of a significant, long-term interest in a company"[243] are able to rely on the Proposed Election Contest Rules and, thus, are far too low. We believe the threshold for individual shareholders should be raised to 5% for all companies. In addition, we believe that if the Commission is determined to allow shareholders to aggregate their shares, the Commission should impose a heightened ownership requirement of 10% on groups of shareholders. Further, we believe that a 13D "beneficial ownership" standard, which can be satisfied by merely being delegated or sharing voting or investment control over shares with no real economic interest in a company, is an insufficient standard and that the Commission should require nominating shareholders to have a net long economic and direct beneficial ownership position (in the form of being the "ultimate" beneficial owner with full voting and investment power) during the entire requisite holding period.

When a board nominates a slate of director candidates, the directors' fiduciary duties require that they act in the best interests of the company and all of its shareholders. Accordingly, a board that receives a shareholder nominee through the Proposed Election Contest Rules would be required to consider whether the board's own nominees would better oversee the business and affairs of the company and better satisfy applicable expertise standards (*e.g.*, the Commission's "audit committee financial expert" rules[244] and NYSE and NASDAQ financial literacy/expertise requirements[245]). If so, the board's fiduciary duties would require it to act to support its candidates and to counter the shareholder nominee.[246] As discussed in Section III.H below, this is likely to result in substantial costs, which will be borne by the company and *all* of its shareholders. The holders of just 1% or 3% of a company's voting

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243 *Id.*

244 *See* Regulation S-K, Item 407(d)(5).

245 *See* NYSE Listed Company Manual, Commentary to § 303A.07(a); NASDAQ Rule 5605(c)(2)(A).

246 *See* 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS 4-98 to -100 (3d ed. 2009).

shares lack a sufficient stake in the company to warrant imposing such costs on *all* shareholders.[247]

In an attempt to support its proposed ownership thresholds, the Commission relies heavily on the high percentage of companies that have at least one shareholder meeting the relevant threshold.[248] However, the Commission provides no basis for the proposition that every company should have at least one shareholder eligible in its own right to nominate a director under the Proposed Election Contest Rules. Further, we believe the Commission should focus on shareholders with a significant, long-term interest in a company, as it claims to be the objective, instead of trying to ensure that each company has a shareholder eligible to nominate a director. For these reasons, in the case of an *individual* shareholder, we believe the Proposed Election Contest Rules should only be available if the shareholder beneficially owns at least 5% of the company's shares.[249]

The ownership thresholds in the Proposing Release are even more troubling given the ease with which shareholders could band together to reach the respective thresholds, particularly with the availability of the Internet and social media as a way for shareholders to communicate. For example, in 2007, a shareholder of Yahoo! was able to leverage an Internet blog and a number of videos posted on YouTube into a coalition of 100 shareholders that gathered a 33% "against" vote for one of the company's directors.[250] Likewise, the proposed ownership thresholds could result in 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 one-quarter of 1% of a company's shares. In this regard, the Commission errs in relying on data concerning the number of shareholders that *individually* could satisfy the thresholds to conclude that the proposed thresholds are

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[247] This is confirmed by analogy to settings other than the federal securities laws. For example, the National Labor Relations Board will generally not even consider a labor organization's petition for recognition as a representative of a company's employees for collective bargaining unless at least 30% of the company's employees designate the organization for that purpose. *See* 29 C.F.R. § 101.18(a) (2009).

[248] *See* 74 Fed. Reg. at 29,036.

[249] In addition, a 5% ownership threshold is consistent with the 5% ownership threshold in the Commission's rules requiring a shareholder or group of shareholders to file a Schedule 13D.

[250] *See* Christine Dunn, *The Investor Activist Who Took Down Yahoo*, COMPLIANCE WEEK, July 17, 2007, *available at* https://www.complianceweek.com/article/3512/the-investor-activist-who-took-down-yahoo.

appropriate for shareholders *aggregating* their shares.[251] Further, the Commission's data ignores the concentration of ownership of the largest companies in the United States. For example, at the 50 largest companies, the top 10 shareholders hold, on average, 27% of the outstanding shares,[252] meaning that the Commission could raise its highest proposed threshold fivefold and shareholders would likely still have access to the proxy materials of the country's largest companies.[253]

As a result, we believe that if the Commission is determined to allow shareholders to aggregate their shares, the Commission should at least impose a heightened ownership requirement due to the increasing ease with which shareholders can unite. In such cases, we believe that it would be more appropriate to limit the Proposed Election Contest Rules to groups of shareholders that beneficially own at least 10% of a company's voting securities. This threshold would be more of an indication that a significant percentage of shareholders are willing to bear the costs of a contested election.

2. The Need For A Meaningful Holding Period [C.2., C.14., C.16., C.17.]

Given the Commission's expressed desire to limit the right to use the Proposed Election Contest Rules to "holders of a significant, long-term interest,"[254] a one-year holding period, as

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[251] *See* 74 Fed. Reg. at 29,035-36.

[252] *See* NERA Economic Consulting, Top 50 Companies by Market Capitalization: Percentage of Shares Outstanding Held by Top 5 and 10 Institutions (using data from FactSet Research Systems, Inc., Bloomberg, L.P. and SEC filings, as of March 31, 2009) (attached as an exhibit).

[253] In this regard, we disagree with certain comments of the Council of Institutional Investors ("CII") in its August 4, 2009 letter to the Commission. In answer to question C.1. of the Proposing Release, CII asserts that "the ten largest public pension funds in a sample of five accelerated filers and five non-accelerated filers indicates that if a group of the ten largest holders were to aggregate shares, they would not be able to meet a five percent threshold and would be unlikely to meet even a three percent threshold." Letter from CII to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-10-09, at 28 (Aug. 4, 2009). We note that it is inappropriate to consider the holdings of only a small sub-set of institutional investors—public pension funds—in analyzing the Commission's proposed ownership threshold, since according to CII, public and union pension funds hold less than 10% of U.S. securities, in contrast to the more than 60% held by all institutional owners. *Id.* at 27-28. We do not understand why the Commission should disregard the holdings of these other institutional investors in determining the proper ownership thresholds.

[254] *See* 74 Fed. Reg. at 29,035.

proposed, is far too short. We agree that shareholders should be required to demonstrate a commitment to a company and its business prior to being entitled to nominate director candidates for inclusion in the company's proxy materials. Thus, we believe that a minimum holding period of at least two years is appropriate, as was proposed in the 2003 Proposal.[255] Any shorter holding period would allow shareholders with a short-term focus to nominate directors who, if elected, would be responsible for dealing with a company's long-term issues.

In addition, we believe that a two-year holding period that continues through the date of the annual meeting is insufficient and consideration should be given to extending it through the service of any elected shareholder-nominated director. The Proposed Election Contest Rules would require that nominating shareholders intend to hold their securities through the date of the relevant annual or special meeting.[256] Although the Commission also proposes a disclosure requirement under which a nominating shareholder or group would state their intent with respect to continued ownership of their shares after the election, the Proposed Election Contest Rules are unclear as to what this would require.[257] The disclosure would likely consist of boilerplate language, and it would not prevent shareholders from selling their holdings in a company following an election. Moreover, permitting shareholders to liquidate their holdings in the company immediately upon election of a director candidate that they have nominated would impose no consequences on shareholders that nominate "special interest" directors. Thus, we believe that nominating shareholders, as part of their initial notice requirement, 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, or at least through the term for which they have nominated the director.

3. **Limit The Right To Nominate Candidates In Successive Years** [C.18., D.16.]

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. If a company's shareholders have determined that they do not support the shareholder's candidate, it would be inappropriate to require *all* of the company's shareholders to again bear the cost of either that shareholder submitting a nominee or that nominee seeking a seat on the board. A shareholder whose nominee fails to receive significant support (*e.g.*, at least 25% of the shares outstanding in an election in one year) should not be permitted to use the Proposed Election Contest Rules for the subsequent two years, as that shareholder has not demonstrated sufficient support to elect its candidates to the board. Likewise, in such instances where a shareholder nominee receives

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255 *See* 68 Fed. Reg. at 60,794.

256 *See* 74 Fed. Reg. at 29,037.

257 *See id.*

minimal support, that nominee should not be eligible to be nominated as a candidate for the company's board of directors for the following two years.

4. **Require Attendance At The Shareholders' Meeting** [C.4.]

We believe that the Proposed Election Contest Rules 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 director candidates in person. Given that the Commission has indicated that it is seeking to have the "the proxy rules . . . function[], as nearly as possible, as a replacement for an actual in-person meeting of shareholders,"[258] it seems appropriate that the nominating shareholder should be required to attend the meeting to make the nomination. In analogous circumstances, a shareholder, or a qualified shareholder representative, is required to attend the company's annual meeting; under Rule 14a-8(h), proponents of a shareholder proposal or their representatives must attend the annual meeting to present shareholder proposals. We do not understand why the Commission did not include a similar requirement in the Proposed Election Contest Rules. Similar to Rule 14a-8(h)(3), if the nominating shareholder or a qualified representative of that shareholder fails 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 nominees submitted by that shareholder or any shareholders included in a group of shareholders that fails to comply with this requirement.

E. **The Commission Should Adopt Other Meaningful Eligibility Requirements For Shareholder Nominees**

1. **Prohibit Relationships Between The Nominee, The Nominating Shareholder(s) And The Company** [D.3., D.13., D.14.]

The Proposed Election Contest Rules fail to address the concern that shareholders would nominate affiliated "special interest" or "single issue" directors who advance the relatively narrow agendas of the shareholders that nominated them. The Commission's 2003 Proposal, in recognition of this concern, included a limitation on relationships between a nominating shareholder or group of shareholders and their director nominee or nominees.[259] Specifically, the 2003 Proposal prohibited shareholders from nominating: (i) if the shareholder was a natural person, the shareholder or an immediate family member, (ii) if the shareholder was an entity, an employee during the then-current or immediately preceding calendar year, (iii) anyone accepting consulting, advisory, or other compensatory fees from the nominating shareholder, (iv) an officer or director (or a person fulfilling similar functions) of the nominating shareholder, and (v) a nominee who controls the nominating shareholder or is an interested

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[258] *See id.* at 29,025.

[259] *See* 68 Fed. Reg. at 60,796.

person (as defined in the Investment Company Act of 1940) of such shareholder. In the Proposing Release, the Commission asserts that "such limitations may not be appropriate or necessary" because, if elected, a director is subject to state law fiduciary duties owed to the company. However, we do not believe that state law fiduciary duties will adequately resolve the issue of "special interest" or "single issue" directors nor can there be any assurance that the shareholder-nominated director would act in accordance with his or her fiduciary duties. Therefore, we believe that the Commission should limit the relationships between a nominating shareholder or group and their director nominee or nominees by imposing the same restrictions as in the 2003 Proposal.

In addition, 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.[260] We also agree that, if the Commission adopts the Proposed Election Contest Rules, the Commission should expressly permit negotiations and other communications between the nominating shareholder and the company regarding shareholder nominees.[261] 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 a shareholder nominee in the company's proxy materials.

2. **Require Consistency With State Law, Federal Law, Exchange Rules And Governing Documents** [D.1., D.2.]

We agree that a company should not be required 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.[262] However, the Proposed Election Contest Rules should go further and permit a company to exclude a shareholder nominee if the nominee fails to meet the eligibility requirements set forth in the company's governing documents,[263] including its requirements with respect to director independence and qualifications.

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260 *See* 74 Fed. Reg. at 29,041.

261 *See id*.

262 *See id.* at 29,040.

263 The Proposed Election Contest Rules do not clarify what is meant by "governing documents." We use the term "governing documents" to refer to a company's certificate of incorporation, bylaws, corporate governance guidelines, and board committee charters.

Under the Proposed Election Contest Rules, a company is not permitted to exclude a shareholder nominee on the grounds that the nominee fails to meet the standards in the company's governing documents that are more restrictive or expansive than those proposed by the Commission (*i.e.*, the objective independence standards of the exchanges).[264] However, this approach is inconsistent with state law, which typically permits a company to establish qualification standards for its directors in its governing documents.[265] Likewise, the Proposed Election Contest Rules are inconsistent with the Commission's recently proposed proxy disclosure amendments, which require additional disclosure with respect to the particular experience, qualifications, attributes, and skills of each director and nominee. The focus of such proposed amendments is on the quality and experience of directors and nominees, "[r]egardless of who has nominated the director."[266] Finally, under Delaware law, the qualifications of *each* director are crucial, since in litigation the conduct of each director is examined individually, as opposed to scrutinizing the board of directors as a whole.[267]

Moreover, many companies have implemented eligibility and enhanced independence requirements for their board members to ensure that they maintain high-quality boards. For example, as discussed in Section I.B.2 above, some companies have adopted more rigorous independence standards for all their independent directors than imposed by exchange rules, such as applying the heightened standards for audit committee members to all independent directors, as well as mandatory retirement ages, and limitations on the number of other boards on which a director may serve. Likewise, some companies have established independence standards limiting a director's affiliation with nonprofit organizations receiving contributions from the company. Finally, certain industries, such as defense contracting and gaming, impose additional requirements on the directors of companies in those industries.[268] We strongly believe that all of a company's directors and director nominees, including shareholder nominees, should be subject to these eligibility requirements.

Finally, as mentioned above, we agree that a company should be able to exclude a 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. Absent such a requirement, a shareholder could nominate a director candidate who is

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264 *See* 74 Fed. Reg. at 29,040 n.152.

265 *See*, *e.g.*, 8 DEL. CODE ANN. § 141(b) ("The certificate of incorporation or bylaws may prescribe other qualifications for directors.").

266 *See* 74 Fed. Reg. at 35,083.

267 *See*, *e.g.*, *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005).

268 *See supra* Section I.B.2.

employed by the company's competitor, potentially causing the company to violate Section 8 of the Clayton Act of 1914.[269]

3. **Require Nominees To Satisfy Subjective Independence Standards** [D.4., D.5., D.6., D.8.]

Although we agree with the Commission's determination that shareholder nominees must meet the *objective* independence standards of a national securities exchange (*e.g.*, the NYSE or NASDAQ) or national securities association,[270] we believe strongly that nominees also should be required to meet the *subjective* independence standards of the NYSE[271] or NASDAQ[272] (requiring a board determination that the nominee has no material relationship that would impair independence). In this regard, we believe that a shareholder nominee should be required to complete the same questionnaires and provide the same information as a company's other directors so that the board can make a determination with respect to the eligibility and independence of the shareholder nominee.

As stated in the commentary to the NYSE independence requirements, "[i]t is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company."[273] Therefore, "it is best that boards making 'independence' determinations broadly consider all relevant facts and circumstances."[274]

In addition, the board's subjective independence determination provides material information to shareholders. Both the NYSE and NASDAQ require a majority of a company's board to be independent,[275] and Item 407 of Regulation S-K requires disclosure of relationships that the board considered in making independence determinations.[276] Moreover, both exchanges require all of a company's audit committee members (and compensation and

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269 *See* 15 U.S.C. § 19. Under Section 8, no person is permitted to serve simultaneously as a director of competing corporations such that the elimination of competition by agreement between the corporations would constitute a violation of the antitrust laws.

270 *See* 74 Fed. Reg. at 29,040.

271 *See* NYSE Listed Company Manual, § 303A.02(a).

272 *See* NASDAQ Rule 5605(a)(2).

273 *See* NYSE Listed Company Manual, Commentary to § 303A.02(a).

274 *Id.*

275 *See* NYSE Listed Company Manual, § 303A.01; NASDAQ Rule 5605(b)(1).

276 Regulation S-K, Item 407(a).

governance committee members, in the case of the NYSE) to meet the subjective independence requirements. Whether a shareholder's nominee will qualify as an independent director and be eligible to serve on these various committees is material information that a company's shareholders should have when voting for nominees for director.[277]

Until now, the Commission has long supported the requirement of a subjective board determination of independence. For example, the Commission previously stated "that requiring boards to make an affirmative determination of independence, and to disclose these determinations, will increase the accountability of boards to shareholders and give shareholders the ability to evaluate the quality of a board's independence and its independence determinations."[278] We believe that the Commission's rationale should apply equally to shareholder nominees under the Proposed Election Contest Rules.

F. The Commission Must Revise The Scope Of The Proposed Election Contest Rules

1. Further Limitation On The Number Of Shareholder Nominees [E.1., E.2., E.5., E.7., E.8.]

The Commission has proposed to require a company to include in its proxy materials one shareholder nominee or the number of nominees that represents 25% of the company's board of directors, whichever is greater.[279] We believe that 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 that is unable to function effectively. Permitting dissident shareholders to include *more* than one nominee in company proxy materials would only exacerbate these problems. The Commission itself concedes in the Proposing Release that changes in board membership have "the potential to be disruptive to the board."[280] The scope of the disruption is reflected in the results of our July 2009 Survey, in which companies responding had an average of 11.5 directors, meaning that many surveyed companies would be required to include multiple nominees in their proxy materials.

We agree with the proposal that an incumbent director who was elected as a shareholder nominee pursuant to the Proposed Election Contest Rules should count against the

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[277] *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

[278] Order Approving Proposed Rule Changes Related to Corporate Governance, SEC Release No. 34-48745, 68 Fed. Reg. 64,154, 64,176 (Nov. 4, 2003).

[279] *See* 74 Fed. Reg. at 29,043.

[280] *See id.*

maximum number of shareholder nominees discussed above. Any other approach would allow nominating shareholders to gain more than a limited number of seats on the board by repeatedly nominating additional candidates for director, thus adding to the problems caused by dissident directors and undermining the Commission's goal of preventing shareholders from using the Proposed Election Contest Rules "as a means to effect a change in control of a company."[281] For these same reasons, incumbent directors nominated by shareholders outside the Proposed Election Contest Rules also should be counted against the maximum number of shareholder nominees. For example, directors nominated by shareholders pursuant to applicable state law or a company's governing documents also should be deemed "shareholder nominees" for purposes of the Proposed Election Contest Rules.

In addition, we think the Commission should clarify whether an incumbent director loses his or her status as a "shareholder nominee" if the nominee subsequently is nominated by the company. Otherwise, there would be a strong incentive for companies not to nominate directors who were previously nominated by shareholders since they could otherwise end up with a board having a majority of members nominated by shareholders.

Likewise, the Commission needs to address the status of an individual that a company agrees to nominate as a board/company nominee, but only after a shareholder or group of shareholders provides notice to the company of their intent to nominate the individual. Specifically, the Commission should clarify that such a nomination does not constitute an agreement between the shareholder or the nominee and the company, and thus, the nominee would still be treated as a "shareholder nominee" for purposes of the Proposed Election Contest Rules.

2. Multiple Proxy Access Nominees [E.10., E.13.]

The Commission's proposal for addressing situations in which the number of nominees exceeds the number of permitted nominees also should be revised. The Proposed Election Contest Rules require companies to include in their proxy materials the nominee(s) of the first nominating shareholder or group from which it receives timely notice of intent to nominate a director.[282] However, this first-in-time approach is an arbitrary basis on which to select nominees. First, a first-in-time approach ignores the qualifications of the nominees and their ability to represent the concerns of the shareholders, seemingly undercutting the purpose of the Proposed Election Contest Rules. Second, because such an approach bears no relation to the length of time or amount of a shareholder's ownership of company securities, it ignores the Commission's stated purpose of providing proxy access only to those shareholders with a "significant, long-term interest." Finally, because the Proposed Election Contest Rules do not include an outside date for a shareholder to submit a nomination where the company's bylaws

281 *See id*.

282 *See id.* at 29,044.

do not specify a deadline, shareholders will be incentivized to rush their nominations. As a result, shareholder nominees may be determined a year or more in advance of the director elections for which they are nominated without regard to whether a particular candidate is best positioned to advance the purposes of the Proposed Election Contest Rules. We recommend instead that, in the event that more nominees are submitted than permitted, the shareholder holding the company's shares for the longest period of time be permitted to nominate a candidate. This approach is consistent with the Commission's stated goal of making the Proposed Election Contest Rules available to shareholders with a long-term interest.

3. **Exclusion Of Proxy Access Nominees During A Proxy Contest** [C.24., General 1]

Finally, we believe that the Proposed Election Contest Rules should not apply when shareholders are conducting a traditional proxy contest at a company. In this situation, the Proposed Election Contest Rules are simply not necessary, as the company's shareholders are already "effectively exercis[ing] their rights under state law to nominate and elect directors."[283] Further, the inclusion of shareholders in a company's proxy materials under the Proposed Election Contest Rules during an ongoing proxy contest is likely to result in shareholder confusion, as shareholder nominees would appear in both the company's proxy materials and the dissidents' proxy materials. Moreover, if exclusion were not permitted in these circumstances, shareholder nominees elected under the Proposed Election Contest Rules, in combination with those elected pursuant to the proxy contest, could result in a change in control. In this regard, the election of both directors nominated in a proxy contest and directors nominated pursuant to the Proposed Election Contest Rules could result in a board composed of a majority of shareholder-nominated directors. Such a result would be contrary to the stated purpose of the Proposed Election Contest Rules—to facilitate the inclusion of shareholder nominees on a company's proxy materials "so long as the shareholders are not seeking to change the control of the issuer or to gain more than a limited number of seats on the board."[284]

4. **Timeline Issues** [F.8., F.9., F.10., G.8.]

Under the Proposed Election Contest Rules, a shareholder intending to submit a nominee must provide notice to the company by the date specified by the company's advance notice bylaw provision, or where no such provision is in place, no later than 120 calendar days before the date that the company mailed its proxy materials for the prior year's annual meeting.[285] However, linking the deadline for shareholder notice to a company's advance

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[283] *Id.* at 29,026.

[284] *Id.* at 29,031.

[285] *See id.* at 29,045.

notice bylaw creates an unworkable timeline. This is because the typical deadline for providing notice under a company's advance notice bylaw is between 90 and 120 days prior to the company's annual meeting. At the same time, the Proposed Election Contest Rules require a company to provide any notice of its intent to exclude a nominee to the Commission at least 80 days before the company files its proxy statement, which typically is done 30 to 45 days prior to the meeting. Thus, under the Proposed Election Contest Rules, it is likely that the company will be required to challenge a shareholder nominee's inclusion in its proxy materials before it ever receives notice of such shareholder nomination.

Moreover, companies cannot resolve this problem by amending their advance notice bylaw deadlines to coincide with the date their proxy materials are first released. In this regard, a Delaware court has invalidated at least one company's advance notice bylaw containing a deadline that was tied to the filing of the company's proxy materials.[286] As a result, we suggest that the Commission not use the deadlines in a company's advanced notice bylaw to determine the deadline for shareholder notice under the Proposed Election Contest Rules. Instead, the Commission should create an independent deadline for the shareholder notice under the Proposed Election Contest Rules.

Even if the Commission divorces the shareholder notice deadline from the deadlines in a company's advance notice bylaw, the default deadline of 120 calendar days before a company mails its proxy materials is far too short. It fails to allow sufficient time for companies to resolve any eligibility issues presented by potential nominees, including resolution through the Commission staff no-action process, possible appeals to the Commission, and possible litigation. In light of these concerns, we recommend that, at a minimum, shareholders should be required to provide notice to a company of their intention to submit a nominee at least 150 days before the date that the company mailed its proxy materials for the prior year's annual meeting.

G. The Commission Should Improve Schedule 14N And Other Disclosure Requirements [F.1., F.14., F.19.]

We agree with the Commission's determination that nominating shareholders or groups of shareholders should be required to file Schedule 14N to notify a company of their intent to submit a nominee for inclusion in the company's proxy materials. One of our primary concerns with the Commission's 2007 Proposal, as noted above, was that it would have permitted shareholders to include their nominees in company proxy materials without the attendant disclosures mandated by the Commission's rules governing proxy contests. In contrast, the Proposed Election Contest Rules include disclosure requirements that will provide shareholders with important information about shareholder nominees that will assist them in making

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286 *See*, *e.g.*, *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 344 (Del. Ch. 2008).

informed voting decisions. However, we believe that minor revisions to the proposed requirements are appropriate.

1. **Additional Disclosure In Schedule 14N** [F.2., F.3., F.20.]

We believe that the disclosure could be improved by adding to Schedule 14N one of the disclosure requirements that was proposed in the 2007 Proposal that is not included in the Proposed Election Contest Rules: a description of any material transaction of the nominating shareholder with the company or any of its affiliates that occurred during the 12 months prior to the formation of any plans or proposals to nominate a candidate, or during the pendency of any proposal to nominate someone or any nomination.[287] Shareholders should be aware of any material business relationship or potential conflict of interest of the shareholder nominee arising from a transaction with the company in the previous 12 months in order to make an informed voting decision.

2. **Amendment Of Schedule 14N And Notice To Shareholders Of Material Changes** [C.17., F.16., F.17.]

We agree with the proposed requirement that Schedule 14N be amended promptly for any material change to the facts set forth in the originally filed Schedule 14N. However, the Commission should either expressly state that "promptly" means within two business days, or should clarify that the requirement should be interpreted in a similar manner to the "promptly" standard of Rule 13d-2(a),[288] which generally is thought to be within two business days.[289]

The Commission also should clarify what actions are required if the information provided by the nominating shareholder or group changes materially after the proxy statement is mailed to shareholders. An express provision should be included stating that a company is not required to amend its proxy statement and redistribute materials to shareholders if the information to be amended is solely that provided by the nominating shareholder or group. Rather, the nominating shareholder or group should be required to amend its Schedule 14N promptly and also notify shareholders, at its own expense, of the material change. For example, Item 7(a) of Schedule 14A requires the disclosure of material legal proceedings to which a director nominee is a party. If a shareholder nominee is convicted of securities fraud after the proxy statement has been mailed, the nominating shareholder or group should have the obligation to notify the shareholders of such a legal proceeding.

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287 *See* 74 Fed. Reg. at 29,047; Shareholder Proposals, SEC Release No. 34-56160, 72 Fed. Reg. 43,466, 43,472 (Aug. 3, 2007).

288 17 C.F.R. § 240.13d-2(a) (2009).

289 *See* ARNOLD S. JACOBS, THE WILLIAMS ACT—TENDER OFFERS AND STOCK ACCUMULATIONS 261 (West 2009).

As stated earlier in Section III.D.2, we believe that the nominating shareholder or group should be required to hold its shares for the term its nominees remain on the board. However, if the nominee is not elected to the board, we agree that the nominating shareholder or group should be required to file a final amendment to Schedule 14N within 10 days of the final results of an election disclosing the nominating shareholder's or group's intention with regard to continued ownership of their shares. We believe this will be important information to other shareholders as to whether the outcome of the election altered the intent of the shareholder and will assist other shareholders in evaluating whether the nominating shareholder or group acquired the shares solely for the purpose of nominating a director.

3. Distinguish A Company's Statements From Those Made By Nominating Shareholders [General 1]

Should the Commission adopt the Proposed Election Contest Rules, it is imperative that shareholders be able to easily distinguish between a company's statements and those made by nominating shareholders in the company's proxy statement. To that end, the Proposed Election Contest Rules should be clarified to provide that companies may indicate in their proxy materials that: (i) the relevant statements were provided by the nominating shareholder, not the company; (ii) the company has no responsibility or liability for the statements; and (iii) the nominating shareholder has sole responsibility and liability for the statements.[290] A number of comments on the 2003 Proposal suggested the inclusion of such a provision.[291] Companies also should be able to set the shareholder statements apart from their own materials by using different fonts, colors, graphics or other visual devices.[292] The use of such measures would make proxy statements containing shareholder nominees clearer and less confusing to shareholders.

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290 *See infra* Section III.I for further discussion of the liability issue.

291 *See* Letter from Jay D. Browning, Vice President, Secretary and Managing Attorney, Corporate Law, Valero Energy Corporation, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 18, 2003); Letter from Henry A. McKinnell, Chairman of the Board and CEO, Pfizer Inc., Chairman, Business Roundtable, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 22, 2003).

292 Currently, the Proposing Release states that "the company could identify any shareholder nominees as such and recommend how shareholders should vote for, against, or withhold votes on those nominees and management nominees on the form of proxy." 74 Fed. Reg. at 29,049. However, there is no language included in the proposed rule itself which would permit such a distinction.

H. The Proposed Company/Commission Staff Process Will Not Work And Will Require Inordinate Staff Resources [G.12., G.17., G.18., G.19., PRA 1]

In order to address issues related to whether a shareholder nominee must be included in a company's proxy materials, the Commission has proposed to create a procedure modeled on the procedure under Rule 14a-8 governing shareholder proposals. For the reasons set forth below, we believe that the proposed process will not work and will require inordinate staff resources.[293]

The Commission is proposing to create a procedure by which companies would notify the Commission when they intend not to include a shareholder nominee in their proxy materials.[294] Under this procedure, a company could seek no-action assurance from the staff with respect to its determination to exclude a shareholder nominee from its proxy materials. We believe that the Commission has underestimated significantly the cost to companies of challenging shareholder nominees under this proposed procedure. For purposes of calculating

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[293] The Commission and others have questioned the adequacy of the Commission's resources. For example, a report issued by the Commission's Office of Inspector General concluded that Commission delays in reviewing Bear Stearns' 2006 annual report on Form 10-K deprived investors of "material information [that would have helped investors] make well-informed investment decisions . . . [and] could have been potentially beneficial to dispel the rumors that led to Bear Stearns' collapse." U.S. Securities and Exchange Commission Office of Inspector General, *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program*, 44-46 (Sept. 25, 2008), *available at* http://www.sec-oig.gov/; Scott Cohn, *Audit Report Blasts SEC's Oversight of Bear Stearns*, CNBC (Sept. 26, 2008), *available at* http://www.cnbc.com/id/26905494. *See also* Wouter Klijn, *SEC Stripped of Staff Before Crisis: Regulator Still Under-Funded, Chairman Says*, InvestorDaily (July 16, 2009) (discussing Chairman Schapiro's remarks before the International Corporate Governance Network conference in which she stated that the Commission needs more staff members in order to properly fulfill its responsibilities); Senator Jack Reed, Remarks Before the Council of Institutional Investors, A Blueprint for Reforming our Regulatory Framework (Jan. 27, 2009) ("Because of limited resources, the SEC examines only about 10% of broker-dealers in a given year. This is hardly enough to keep bad actors in check and discover problems."). Moreover, the Commission recently endorsed the Obama Administration's financial regulatory reform proposals, which would give the Commission significant new responsibilities and further burden the Commission's already taxed resources. *See* SEC Commissioner Mary L. Schapiro, Testimony Before the United States House of Representatives Committee on Financial Services, Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals (July 22, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts072209mls.htm.

[294] *See* proposed Rule 14a-11(f)(7)-(14); 74 Fed. Reg. at 29,050.

Paper Reduction Act burden estimates, the Commission assumes that the cost to companies of submitting a no-action request seeking to exclude a shareholder nominee from a company's proxy materials is "comparable to preparing a no-action request to exclude a proposal under Rule 14a-8."[295] However, unlike many shareholder proposals submitted under Rule 14a-8, most of which are non-binding and many of which address issues tangential to the company's business, the composition of a company's board of directors and the election of the board's nominees are issues of fundamental importance to a company. As discussed elsewhere in this comment letter, once a board has determined to nominate a slate of directors that it believes is best suited to govern the company on behalf of its shareholders, the board will expend significant resources to scrutinize and challenge shareholder nominees and to elect its own nominees.[296] Thus, comparing the cost of challenging a Rule 14a-8 shareholder proposal with the cost of challenging a shareholder nominee fails to account for this difference. A more relevant analogy would be the costs companies expend in short-slate proxy contests, which far exceed the costs considered by the Commission relating to shareholder proposals.

Moreover, although the Proposing Release concedes that "companies may expend more resources on efforts to defeat the election of shareholder nominees," it erroneously contends that "boards generally would be cautious in expending resources to defeat shareholder nominees insofar as incumbent board members generally are interested in the outcome of elections and in the corporation's policy in connection with opposing shareholder nominees."[297] Contrary to this statement, pursuant to the board's fiduciary duty to act in the best interests of the company and all its shareholders, a board is likely to expend significant resources to defeat shareholder nominees whom the board believes are unqualified or less qualified to serve on the company's board than the board's nominees. Accordingly, the cost to companies of challenging shareholder nominations is likely to be significantly higher than the Commission estimates. Adding to these substantial costs is the likelihood that, in order to comply with the timelines imposed by the Proposed Election Contest Rules, companies may have to submit multiple no-action requests if they receive multiple shareholder nominations

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295 74 Fed. Reg. at 29,065 n.311.

296 Even if we were to assume that the cost of challenging a Rule 14a-8 shareholder proposal is comparable to the cost of challenging a Rule 14a-11 shareholder nomination, the figures cited in the Proposing Release are from 2003, and thus, are outdated. *See* 74 Fed. Reg. at 29,065 n.311. Consequently, the cost estimates the Commission relies on in the Proposing Release are unreliable. *See infra* Section IV.B; *see also supra* Section II.C (noting that our July 2009 Survey revealed that companies spend an estimated 47 hours and incur associated costs of $47,784 in preparing and submitting a single no-action request to the Commission, and that they spend an estimated 20 hours and incur associated costs of $18,982 in printing and mailing one shareholder proposal in their proxy materials).

297 74 Fed. Reg. at 29,075.

because companies will not be certain which nominee(s) they ultimately will be required to include in their proxy materials.

There also is likely to be substantial litigation relating to Commission or staff determinations under the new procedures given the significance of these determinations. This litigation is likely to be brought by both companies and nominating shareholders that have received unfavorable staff determinations with respect to shareholder nominations. Companies already have shown a willingness to file lawsuits seeking to exclude shareholder proposals to amend the company's bylaws to allow shareholders to nominate directors and have their nominees included on the company's ballot.[298] If shareholders are given the right to have their nominees included in the company's proxy materials, as they would be under the Proposed Election Contest Rules, companies will be even more inclined to sue to exclude such shareholder nominees from their proxy materials, and the resulting litigation is likely to consume considerable resources of the company and the nominating shareholder as well as the Commission itself, whose responses to no-action requests will be challenged.

Despite these expected Commission costs, the Proposing Release does not even discuss the impact the Proposed Election Contest Rules will have on the Commission itself. In the Proposing Release, the Commission estimates that 4,163 reporting companies (other than registered investment companies) are likely to have at least one shareholder that is eligible to submit a nominee for director, and that 208 (or 5%) of these companies will receive shareholder nominations.[299] The Commission further estimates, without any supporting evidence, that approximately 42 (or 20%) of reporting companies (other than registered investment companies) that receive a shareholder nomination would seek to exclude the nominee from their proxy materials via a no-action letter from the Commission staff.[300] As the Commission would have it, less than half of companies receiving a shareholder nomination would seek to challenge that nomination. We believe that the Commission has grossly underestimated the efforts companies will undertake to see that the director nominees selected by their boards, as opposed to shareholder nominees, are elected to the board. As such, we believe that the vast majority of companies receiving shareholder nominations will seek to exclude those shareholder nominees from their proxy materials pursuant to the Commission's no-action letter process. In this regard, while some of the grounds for seeking exclusion are objective (*i.e.*, shareholdings), others (*e.g.*, whether the representation in the nominating shareholder's notice to the company is false or misleading) are more subjective and will invite no-action requests.

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298 *See* Brenda Sapino Jeffreys, *Reliant Energy Fights Hedge Fund-Shareholder Over Bylaws Proposal*, Feb. 5, 2007, *available at* http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1170410592852.

299 *See* 74 Fed. Reg. at 29,063-64.

300 *See id.* at 29,065.

This, in turn, would consume a considerable amount of time and effort on the part of Commission staff in processing no-action requests—an area where the Commission already devotes an "inordinate amount of resources" in connection with shareholder proposals.[301] Each year, the Commission expends significant resources reviewing the hundreds of no-action requests it receives under Rule 14a-8.[302] We understand that for the 2009 proxy season, the Commission assigned a 22-member task force to review no-action requests submitted under Rule 14a-8.[303] In a speech before the American Bar Association in August 2008, then-Director of the Commission's Division of Corporation Finance (the "Division"), John W. White, outlined the Commission's process for reviewing and analyzing Rule 14a-8 no-action requests.[304] Mr. White explained that in addition to "analyz[ing] each of the bases for exclusion that a company asserts, as well as any arguments that the shareholder chooses to make in response," the Commission staff also "conducts independent research, including reviewing prior no-action letters and Commission releases."[305] Mr. White noted as well that "each no-action request is subject to multiple levels of review" and that "many no-action requests are reviewed by four attorneys."[306] Any reconsideration request is reviewed by a senior staff member of the

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301 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 proposal process." Commissioner Paul S. Atkins, Remarks Before the Council of Institutional Investors (Mar. 27, 2003).

302 A tally of the no-action letters publicly available on the Commission's website shows that in 2008, the Commission staff issued 404 no-action letters, and by July 16, 2009 had already issued 324 no-action letters for 2009, with another six no-action requests pending.

303 Ted Allen, *Investors Decry Proposal Omissions*, RiskMetrics Group Risk & Governance Blog (Dec. 22, 2008), *available at* http://blog.riskmetrics.com/2008/12/investors_decry_proposal_omiss.html.

304 John W. White, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, Remarks Before the American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities, Corporation Finance in 2008—A Year of Progress (Aug. 11, 2008), *available at* http://www.sec.gov/news/speech/2008/spch081108jww.htm.

305 *Id.*

306 *Id.*

Division.[307] Finally, if a shareholder or a company requests that the Division seek the Commission's views on a matter, the Division must consider the request and determine whether to recommend that the Commission consider the matter.[308] As Mr. White's remarks illustrate, the Commission's process for reviewing Rule 14a-8 no-action requests is extensive, time-consuming and labor-intensive. Consequently, before adopting any procedure that contemplates staff involvement in reviewing shareholder nominations under the Proposed Election Contest Rules, it is critical that the Commission evaluate the additional burden such review will place on its resources.

Even if the volume of no-action requests under the Proposed Election Contest Rules is lower than for Rule 14a-8 no-action requests, the issues presented by no-action requests under the Proposed Election Contest Rules are likely to be much more complex than those associated with Rule 14a-8, requiring subjective, nuanced determinations (for example, with respect to determining whether a nominee's candidacy would violate state law),[309] which will inevitably be more time-consuming for the staff. Moreover, due to the importance of director elections, both companies and nominating shareholders are likely to submit requests for reconsideration by the staff and requests for review by the Commission when they receive an unfavorable no-action letter, which will further increase the burden on the Commission and staff. As a result, given the proposed timing requirements of the Proposed Election Contest Rules, the staff may be left with insufficient time to adequately review no-action requests under the Proposed Election Contest Rules, as discussed in more detail elsewhere in this comment letter.[310]

Finally, in setting up the proposed process, the Commission is placing itself in a position of having to be the arbiter of state law issues. For example, companies would not be required to include shareholder nominees whose candidacy or board membership would violate state law or the company's governing documents.[311] Accordingly, the Commission staff often would be called upon to determine whether a nominee is qualified to serve on a company's board under the company's charter or bylaws, which may involve complex state law judgments. As noted by several participants in the Commission's 2007 Proxy Process Roundtables, it is not appropriate for the Commission to resolve issues of state law; rather, such issues should be considered by the state courts.[312] For example, Professor Joseph Grundfest of Stanford Law

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307 *Id.*

308 *Id.*

309 *See* proposed Rule 14a-11(a)(2).

310 *See supra* Section III.F.4.

311 *See* proposed Rule 14a-11(a)(2).

312 We recognize that the Commission is permitted to certify issues of state law to the Delaware Supreme Court under a procedure available under the Delaware Constitution.

[Footnote continued on next page]

School stated: "[T]o the extent that there are questions of state law rights of access . . . aren't the state courts the appropriate venue for the resolution of those issues? I don't know that I want people in the Division of Corporation Finance wearing Justice Strine's robes and opining on matters of Delaware law."[313]

I. The Commission Must Revise The Proposed Liability Standards [L.1.]

In the Proposing Release, the Commission proposes several rules related to liability for statements made by a nominating shareholder or nominating shareholder group. We agree with the Commission's proposed amendments to Rule 14a-9 to make nominating shareholders liable for any materially false or misleading statements provided to the company and then included in the company's proxy materials, whether made pursuant to Rule 14a-11, an applicable state law provision, or a company's governing documents.[314] However, because companies are acting as a mere conduit for the shareholders' materials, we disagree with the liability standard proposed in Rule 14a-11(e) and in the note to Rule 14a-19, which would make a company liable for including such statements in its proxy materials if the company "knows or has reason to know that the information is false or misleading."[315] Companies will have no involvement in the preparation of the information submitted by shareholders and, with respect to proposed Rule 14a-11, can only exclude such information from their proxy materials if the Commission staff concurs that a nominating shareholder did not satisfy the eligibility or procedural requirements of Rule 14a-11.[316] Accordingly, we believe that the Commission

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See Del. Const. art. IV, § 11(8). However, this procedure is available "only where there exist important and urgent reasons for an immediate determination by [the Delaware Supreme] Court of the questions certified." *See* Del. Sup. Ct. R. 41(b). Moreover, it is not practical for the Commission to use this procedure to address the myriad of state law issues likely to arise under the Proposed Election Contest Rules on a regular basis.

313 Joseph A. Grundfest, Stanford Law School, May 25th Roundtable, at 101. Professor Grundfest's comment echoed the sentiments of other participants in the 2007 Proxy Process Roundtables. *See, e.g.*, Jill E. Fisch, Fordham University School of Law, May 7th Roundtable, at 92-93 ("We talk about the fact that we don't want shareholders to micro-manage the company. I think we also don't want the Commission to try to micro-manage the voting process. Why don't we want that? Because it is a delicate balance between how much power shareholders should have vis-à-vis directors and management . . . . The courts and the state legislatures are really in an ideal position to weigh that balance. The Delaware Courts have traditionally done this in a very incremental way.").

314 *See* 74 Fed. Reg. at 29,082.

315 *See id.* at 29,084 (Rule 14a-18) and 29,087 (Rule 14a-19).

316 *See id.* at 29,084.

should provide that a company is not responsible for the statements submitted by shareholders, similar to the standard in Rule 14a-8(l).

We believe that it is inappropriate to hold a company to the "knows or has reason to know" standard when it is acting as a mere conduit in including a nominating shareholder's information in its proxy materials. Moreover, such a liability standard is inconsistent with the standards imposed by the Commission in analogous situations.[317] For example, Exchange Act Rule 14a-8 provides that companies must include shareholder proposals in their proxy materials in certain circumstances.[318] However, Exchange Act Rule 14a-8(l)(2) explicitly states: "the company is not responsible for the contents of [the shareholder proponent's] proposal or supporting statement."[319] Rule 14a-7 also permits a shareholder to request that the company send copies of its own proxy materials to shareholders in certain situations where a company intends to solicit proxies from shareholders.[320] However, Rule 14a-7(a)(2)(i) provides that the company "shall not be responsible for the content of the material" it sends on behalf of the shareholder.[321] In this regard, we note that the Commission's 2003 Proposal proposed the

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317 In similar circumstances courts recognize that companies should not be held liable for third party statements absent significant involvement in preparing such statements. For example, courts generally do not hold companies liable for misstatements made by stock analysts absent a company's substantial involvement in the preparation of the analysts' reports or explicit endorsement of those reports. *See, e.g.*, *Raab v. Gen. Physics Corp.*, 4 F.3d 286, 288-89 (4th Cir. 1993); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980).

318 17 C.F.R. § 240.14a-8 (2009).

319 17 C.F.R. § 240.14a-8(l)(2) (2009). The liability standard in the 2003 Proposal was "modeled on Exchange Act Rule 14a-8(l)(2)." *See* 68 Fed. Reg. at 60,802.

320 17 C.F.R. § 240.14a-7(a)(2)(i) (2009).

321 *Id.* In other areas of the federal securities laws where the Commission has imposed a "reason to know" standard, the circumstances are distinguishable from the Proposed Election Contest Rules. For example, Item 403 of Regulation S-K permits a company to rely on beneficial ownership information set forth in Schedules 13D/G when including the information in the company's proxy materials "unless the registrant knows or has reason to believe that such information is not complete or accurate or that a statement or amendment should have been filed and was not." 17 C.F.R. § 229.403 (2009). That situation is not analogous to shareholder nominees included in company proxy materials because Item 403 is limited to beneficial ownership of the company's shares, which the company has some knowledge of, while the disclosures required under proposed Rule 14a-18 and proposed Rule 14a-19 are more expansive. In other instances, the company is the actor, unlike in the Proposed Election Contest Rules. Exchange Act Rule 10, for

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following standard: "The registrant is not responsible for any information in the notice from the nominating security holder or nominating security holder group pursuant to paragraph (c) of this section or otherwise provided by the nominating security holder or nominating security holder group."[322] Commentators on the 2003 Proposal supported this standard.[323] The Commission now has proposed to deviate from this standard without explaining the reasons for doing so.

The established liability standard for third party statements included in company proxy materials also is appropriate from a policy perspective. Increased liability would place a significant burden on companies to investigate each and every shareholder statement and to determine what various individuals in the company "know" about the various statements made by a nominating shareholder or nominating shareholder group or could be read to require a search of public records. Furthermore, potential directors faced with such liability may be reluctant to serve on public company boards. For these reasons, courts have long recognized that it makes little sense to hold directors accountable for information that is outside the realm

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example, provides that management's responsibility to promptly disclose material facts regarding the company's financial condition "may extend to situations where management knows or has reason to know that its previously disclosed projections no longer have a reasonable basis." 17 C.F.R. § 229.10(b)(3)(iii) (2009). Exchange Act Rule 10b-18 provides an issuer with a safe harbor from anti-manipulation provisions for certain repurchases of blocks of stock unless the company knows or has reason to know the block was accumulated for the purpose of resale to the company or knows or has reason to know that it was sold short to the company. 17 C.F.R. § 240.10b-18(a)(5) (2009). Both rules apply where the company is the actor—be it with respect to the company's financial condition or when repurchasing its own shares—and not merely as a conduit for a third party.

322 *See* 68 Fed. Reg. at 60,822.

323 *See* Letter from the Committee on Federal Regulation of Securities, Section of Business Law, American Bar Association, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Jan. 7, 2004); Letter from Mark C. Smith, Chair, Task Force on Security Holder Director Nominations, The Association of the Bar of the City of New York, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 22, 2003); Letter from Henry A. McKinnell, Chairman of the Board and CEO, Pfizer, Inc., Chairman, Business Roundtable, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 22, 2003); Letter from Jay D. Browning, Vice President, Secretary and Managing Attorney, Corporate Law, Valero Energy Corporation, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 18, 2003); Letter from William J. Casazza, Vice President, Deputy General Counsel and Corporate Secretary, Aetna, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 10, 2003).

of their duties.[324] But without further guidance from the Commission as to the diligence necessary with regard to shareholder statements, companies would face significant uncertainty in implementing any new rules. Such uncertainty breeds inefficiency and would encourage frivolous litigation.[325]

For these reasons, we urge that the Commission amend the Proposed Election Contest Rules to state that a company is not responsible for the statements submitted by a nominating shareholder or nominating shareholder group and included in a company's proxy statement.

J. The Proposed Schedule 13D Exemption Is Inappropriate, And The Commission's Criteria Governing Schedule 13G Eligibility Should Remain Intact [C.24., J.1., J.2.]

We oppose the proposed amendments to Rule 13d-1 that would allow a nominating shareholder or group relying on the Proposed Election Contest Rules to remain eligible to report their beneficial ownership on Schedule 13G, rather than Schedule 13D.[326] Shareholders or groups of shareholders seeking to nominate up to 25% of a company's directors are by definition *not* passive investors and should be required to report their holdings, plans, proposals, intentions and other interests on Schedule 13D. Moreover, the proposal to classify

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[324] For example, "[k]nowledge or recklessness is required for a finding of scienter under § 10(b)" of the Exchange Act, 15 U.S.C. § 78j(b), in order to hold a director liable for making material misrepresentations to the public. *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1063 (9th Cir. 2000). Moreover, outside directors with little knowledge of a company's inner workings are generally held to a lower standard of accountability for statements made in corporate disclosures than directors who participate in day-to-day corporate activities. *See, e.g.*, *In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935, 949 (E.D. Pa. 1999); *Barnes v. Andrews*, 298 F. 614, 620 (S.D.N.Y. 1924) (Hand, J.) (noting that to require an outside director to independently verify all statements in a company circular not known to him would be to charge him "with detailed supervision of the business, which, consistently carried out, would have taken most of his time. If a director must go so far as that, there will be no directors.").

[325] *See* D. Joseph Meister, Note, *Securities Issuer Liability for Third Party Misstatements: Refining the Entanglement Standard*, 53 VAND. L. REV. 947, 980 (2000).

[326] The Commission states in the Proposing Release that "[c]entral to Schedule 13G eligibility is that the shareholder be a passive investor that has acquired the securities without the purpose, or the effect, of changing or influencing control of the company." 74 Fed. Reg. at 29,059.

such shareholders or groups as passive investors is inconsistent with the Commission's long-standing position on the subject.[327]

Eligibility for passive investors to report on Schedule 13G was premised on investors not seeking to influence a company's board of directors or management. Therefore, the proposed amendments allowing shareholders or groups to nominate up to 25% of a company's board while remaining on Schedule 13G contradicts the original purpose and rationale for the extension of Schedule 13G eligibility to passive investors. Even the Commission acknowledges in the Proposing Release that shareholder nominations under the Proposed Election Contest Rules are potentially contrary to passive investor status. Specifically, in footnote 281, the Commission notes that "if a nominating shareholder is the nominee, and is successful in being elected to the board of a company, the shareholder would most likely be ineligible to continue filing on Schedule 13G because of its ability as a director to directly or indirectly influence the management and policies of the company."[328] In addition, the certification that the Commission has proposed requiring nominating shareholders to provide under Schedule 14N differs from the standards required for shareholders to qualify as passive investors who are eligible to file on Schedule 13G because nominating shareholders would not be required to certify on Schedule 14N that shares were not acquired for the purpose of influencing the control of the issuer, which seems to reflect the Commission's tacit recognition that nominating shareholders may be seeking to influence control over companies.

We believe the Schedule 13D disclosure requirements provide much needed information to investors and the company regarding any plans, arrangements or understandings that may exist between group members and present a much better picture of the persons making such nominations, including their aggregate beneficial ownership, their plans for their securities holdings and other activities they intend to undertake when seeking to change up to one quarter of the board. Schedule 13D requires disclosure of derivatives and similar instruments and contracts relating to the subject securities. This information is critical to a complete understanding of a shareholder's or group's economic interest in and motivations with respect to the company. Schedule 14N and the related proposed rules (*e.g.*, Rules 14a-18 and 14a-19) do not adequately cover important disclosure items set forth in

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[327] In the 1989 release that first proposed Schedule 13G eligibility for passive investors, the Commission observed that the "beneficial ownership reporting scheme is intended to inform the marketplace of acquisitions of a company's securities that could affect control. . . . The reduced number of Schedule 13D filings [resulting from the introduction of the passive investor category for 13G eligibility] would allow the marketplace, as well as the staff of the Commission, to focus more quickly on acquisitions involving a potential change in control." Reporting of Beneficial Ownership in Publicly-Held Companies, SEC Release No. 34-26598, 54 Fed. Reg. 10,552, 10,555 (Mar. 6, 1989).

[328] 74 Fed. Reg. at 29,060.

Schedule 13D. For example, disclosure of the source and amount of funds (Item 3 of Schedule 13D) and disclosure of the purpose of the transaction (Item 4 of Schedule 13D) are not addressed at all by Schedule 14N while disclosure of a shareholder's contracts, arrangements, understandings or relationships with respect to the securities of the company (Item 6 of Schedule 13D) is inadequately addressed.[329] Absent full 13D-level disclosure, nominating shareholders or groups could potentially obtain significant representation on a company's board without providing the advance notice and other disclosure that Schedule 13D was intended by Congress to provide both to the company and its shareholders.

The Schedule 13D disclosure requirements are not overly burdensome, are well understood by all participants in the financial markets, fulfill a legitimate purpose and have served the investing public well for nearly 40 years. In addition, the prompt amendment requirements applicable to 13D reporting persons provide a critical safeguard.[330] In contrast, under current rules, certain qualified institutional investors and passive investors are subjected to a lower standard, only having to amend their Schedule 13Gs within 45 days after the end of each calendar year to report any changes.[331]

We also note that there is a distinct possibility that a nominating shareholder or group may initially take the position (and certify) that its nominations are not being made for the purpose or with the effect of changing control of a company, but it may later turn out, or at least appear, that such nomination was done for exactly that purpose. Once elected, directors nominated by a shareholder or group could very well engage in any number of activities that are designed to change or influence control of the company (*e.g.*, lobby other board members to sell the company to a competitor or seek to remove other company-nominated directors in the hopes of carrying out a pre-planned strategy). We believe that such activities would in most cases lead to expensive and time-consuming litigation between the company, the nominating shareholder or group and the directors on the specific issue of exactly whether, where and how those initiatives or plans were first formed. If it were later discovered during the course of litigation that the nominating shareholder or group had such plans from the

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329 Schedule 14N incorporates Item 5(b)(1)(viii) of Schedule 14A by reference, which appears to be narrower than Item 6 of Schedule 13D.

330 Rule 13d-2 requires that "If any material change occurs in the facts set forth in the Schedule 13D required by [Rule 13d-1(a)], including, but not limited to, any material increase or decrease in the percentage of the class beneficially owned, the person or persons who were required to file the statement shall promptly file or cause to be filed with the Commission an amendment disclosing that change." 17 C.F.R. § 240.13d-2 (2009).

331 *Id*. In certain circumstances, they need to report during the year if and when they cross 10% or if they increase or decrease their beneficial ownership by more than 5%.

outset, then the validity of the election of the shareholder's or group's nominees would be called into question.

Likewise, a nominating shareholder or group could later change its intent and become a control-oriented rather than passive shareholder following the election of its director nominees. In that situation, it is unclear how such a change in intent might impact the validity of their election. At that point it would be too late to require the heightened disclosure on Schedule 13D (as opposed to Schedule 13G) or proposed Schedule 14N. For example, Perry Corporation recently ran afoul of the Section 13(d) reporting requirements when it tried to influence the outcome of a merger vote by acquiring a large block of Mylan, Inc. stock but failed to report the acquisition within ten days on Schedule 13D.[332]

The academic community also has noted that shareholders that seek to control or influence a company's management often have interests that diverge from the interests of passive shareholders. In a 2005 paper, Professor Stephen Bainbridge noted that "private benefits" can disproportionately flow to activist shareholders.[333] Professor Bainbridge cites the example of union pension funds using "shareholder proposals to obtain employee benefits they couldn't get through bargaining."[334] Professor Roberta Romano also identifies the same problem, writing that:

> It is quite probable that private benefits accrue to some investors from sponsoring at least some shareholder proposals. . . . Examples of potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment.[335]

Given the risks of divergent interests held by activist shareholders and those investors that are truly passive, it is vitally important that the Schedule 13D disclosure regime be retained intact and applied to shareholders or groups formed to nominate directors under the Proposed Election Contest Rules.

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332 SEC Admin. Proc. Release No. 34-60351 (July 21, 2009).

333 Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* 15 (UCLA School of Law, Law and Economics Research Paper No. 05-20, 2005), *available at* http://ssrn.com/abstract=796227.

334 *Id.* at 16.

335 Roberta Romano, *Less Is More: Making Institutional Investor Activism A Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 231-32 (2001).

K. **Proposed Rule 14a-2(b)(7) Does Not Provide A Level Playing Field** [H.1., H.2.]

If adopted, the Proposed Election Contest Rules would add a new exemption to the proxy solicitation rules "for communications made in connection with . . . [the Proposed Election Contest Rules] that are limited in content and filed with the Commission" on the date of first use.[336] This rule would supplement existing Rule 14a-2(b)(2), which provides an exemption for solicitations "other than on behalf of the registrant" of up to ten shareholders. We believe that it is inappropriate to provide shareholders with a greater ability to communicate with fellow shareholders than is otherwise available to companies, particularly in an election contest where both the company's and the shareholder's nominees are included in the same proxy materials.

In *J.I. Case Co. v. Borak*, the Supreme Court stated that "[t]he purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."[337] Section 14(a) was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders."[338] Accordingly, if the exception in Rule 14a-2(b)(2) allowing shareholders to communicate and solicit proxies from up to ten other shareholders does not interfere with the "free exercise of the voting rights of stockholders," then a similar right should be made available to companies.

L. **The Shareholder Communications System Must Be Improved Before The Commission Adopts The Proposed Election Contest Rules** [General 1]

The Proposed Election Contest Rules would revise the proxy rules in a manner that implicates the entire proxy voting system. The current shareholder communications system is complex and integrated, involving companies, directors, shareholders, proxy solicitors, proxy voting services and others. We are concerned that the Commission has not considered adequately the impact the Proposed Election Contest Rules would have on the proxy process as a whole. As such, the Commission should not adopt these rules without contemporaneously improving the mechanics for communicating with 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 itself has acknowledged the need to review the shareholder communications system. For example, on July 1, 2009, Chairman Mary Schapiro stated at an open meeting that "there are . . . areas of shareholder communication

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336 74 Fed. Reg. at 29,054.

337 377 U.S. 426, 431 (1964).

338 *Id.* (*quoting* S. Rep. No. 792, 73d Cong., 2d Sess., 12).

and voting that the Commission will be studying carefully this year."[339] At the same meeting, Commissioner Elisse Walter noted that the Commission needed to take a "more in depth look into . . . 'proxy plumbing' issues like shareholder communications (or, the 'NOBO/OBO' distinction) as well as over and empty voting."[340] We applaud the Commission for its recognition that the shareholder communications system needs improvement, but we urge the Commission to complete its review and implement improvements before adopting the Proposed Election Contest Rules, which will increase the frequency of proxy contests and the resultant need for communications with shareholders.[341]

1. Deficiencies In The Current Shareholder Communications System [General 1]

The Commission's existing shareholder communications rules (set forth in Exchange Act Rules 14b-1,[342] 14b-2[343] and 14a-13[344]) 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% of all outstanding public company shares were held in street name.[345] 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 nominees contract with agents,

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339 Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Statement at SEC Open Meeting (July 1, 2009), *available at* http://www.sec.gov/news/speech/2009/spch070109mls.htm.

340 Commissioner Elisse B. Walter, U.S. Securities and Exchange Commission, Statement at SEC Open Meeting (July 1, 2009), *available at* http://www.sec.gov/news/speech/2009/spch070109ebw.htm.

341 As discussed in Section I.B.5 *supra*, there are a number of deficiencies in the proxy voting system itself which present voting integrity issues. These problems would also be exacerbated by the increase in proxy contests that would result under the Proposed Election Contest Rules.

342 17 C.F.R. § 240.14b-1 (2009).

343 17 C.F.R. § 240.14b-2 (2009).

344 17 C.F.R. § 240.14a-13 (2009).

345 *See* Order Granting Approval to Proposed Rule Change Relating to a One-Year Pilot Program for Transmission of Proxy and Other Shareholder Communication, SEC Release No. 34-38406, 62 Fed. Reg. 13,922, 13,922 n.5 (Mar. 24, 1997). *See also infra* at note 360.

primarily Broadridge Financial Services, Inc. ("Broadridge")[346] to perform shareholder communications and proxy services.[347]

Historically, only nominees or their agents were able to contact directly the beneficial owners of securities held in street name.[348] 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") that did not object to having their names and addresses supplied to companies.[349] Objecting beneficial owners (or "OBOs") still may be contacted directly only by nominees or their agents. It is estimated that OBOs represent approximately 75% of shares held in street name.[350]

Even companies' ability to communicate with NOBOs (those that 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.[351] 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.[352] (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

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346 Broadridge was formerly known as ADP Brokerage Services Group ("ADP"), before it was spun-off by Automatic Data Processing, Inc. in 2007.

347 *See supra* note 345.

348 *See* Facilitating Shareholder Communications, SEC Release No. 34-19291, 47 Fed. Reg. 55,491 (Dec. 10, 1982).

349 *See* Facilitating Shareholder Communications Provisions, SEC Release No. 34-20021, 48 Fed. Reg. 35,082 (Aug. 3, 1983).

350 Based on information provided by ADP representatives at meetings of the Proxy Voting Review Committee held on August 29, 2001 and October 17, 2001. *See also* Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, at 11 (June 5, 2006) ("Proxy Working Group Report").

351 *See* Shareholder Communications Facilitation, SEC Release No. 34-23847, 51 Fed. Reg. 44,267, 44,268 (Dec. 9, 1986) (stating that "[s]tate law generally recognizes exercise of voting authority by record owners only").

352 *See* Facilitating Shareholder Communications, SEC Release No. 34-22533, 50 Fed. Reg. 42,672 (Oct. 22, 1985).

and agents to disseminate its proxy materials, but 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 Broadridge).[353] Broadridge's fee is based on a sliding scale, wherein the per-NOBO fee depends on the size of the NOBO list (the per-NOBO fees are: $0.165 for 1,000 to 10,000 NOBOs; $0.115 for 10,001 to 100,000 NOBOs; or $0.105 for 100,001 or more NOBOs).[354]

The shareholder communications process described above is cumbersome, circuitous and often prohibitively expensive. As noted above, 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 quarter-century, street-name holdings have become increasingly prevalent,[355] further restricting companies' ability to communicate with the owners of these shares. Furthermore, the current system does not take full advantage of the tremendous technological advances that have been made since the 1980s.

2. Shareholder Communications Should Be Improved Now [B.8., General 1]

As discussed in Section III.H above, a board's fiduciary duties to the company and its shareholders likely will require that the board seek to defeat shareholder nominees whom it believes are unqualified or less qualified to serve on the company's board than the board's nominees. As in a traditional or short-slate proxy contest, this would result in additional communications between the company and its shareholders in order to solicit support for board-nominated candidates. As such, the Proposed Election Contest Rules would add to the already-increased need for companies to communicate with all of their shareholders, which has resulted from increasing activism by institutional shareholders, the prevalence of majority voting and recent amendments to NYSE Rule 452 eliminating the ability of brokers to vote uninstructed shares held in street name under the "10-day rule" in uncontested director elections.

In this regard, we note that the Proposed Election Contest Rules represent one of several rulemakings by the Commission and the NYSE since 2003 dealing with individual elements of the proxy process in a piecemeal fashion, including the 2003 and 2007 Proposals,

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353 *See* NYSE Rule 451, Supplementary Material .92.

354 *See* Broadridge Fee Schedule (2008). We note that these fees have increased substantially from $0.10, $0.05 and $0.04 at the time of our comment letter on the Commission's 2003 Proposal. *See* ADP Fee Schedule (Mar. 2003).

355 *See* SEC Release No. 34-38406, 62 Fed. Reg. at 13,923 (noting that "stockholdings continue to migrate from registered to street or nominee ownership").

the "notice and access" rules and the amendments to NYSE Rule 452.[356] At each step along the way, Business Roundtable and other commentators have urged the Commission to revisit its rules relating to the shareholder communications system and cautioned against the perils of dealing with selected components of the proxy process without considering collateral impacts on other elements of the proxy system, including shareholder communications. In April 2004, Business Roundtable filed a Petition for Rulemaking urging the Commission to revise its rules to improve the shareholder communications system.[357] Business Roundtable's efforts have been widely supported, including by companies, trade associations and securities industry participants. Supporters have included the Shareholder Communications Coalition,[358] which has repeatedly urged the Commission to address the deficiencies in the current communications system.[359] Indeed, the need to address the shareholder communications system has been recognized by the Commission on a number of occasions,[360] and was highlighted by the NYSE Proxy Working Group in its recommendations regarding Rule 452.[361]

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356 *See* Notice of Filing of Proposed Rule Change, SEC Release No. 34-59464, 74 Fed. Reg. 9864 (Mar. 6, 2009) (proposing amendments to NYSE Rule 452); Shareholder Proposals, SEC Release No. 34-56160, 72 Fed. Reg. 43,466, 43,472 (Aug. 3, 2007) (proposing rules regarding proxy access shareholder proposals); Internet Availability of Proxy Materials, SEC Release No. 34-52926, 70 Fed. Reg. 74,598 (Dec. 15, 2005) (proposing rules relating to Internet availability of proxy materials); Security Holder Director Nominations, SEC Release No. 34-48626, 68 Fed. Reg. 60,784 (Oct. 23, 2003) (proposing proxy access rules).

357 *See* Request for Rulemaking Concerning Shareholder Communications, SEC File No. 4-493, submitted by Steve Odland, Chairman-Corporate Governance Task Force, Business Roundtable (Apr. 12, 2004).

358 We note that the Shareholder Communications Coalition consists of Business Roundtable, the National Association of Corporate Directors, the National Investor Relations Institute, the Securities Transfer Association and the Society of Corporate Secretaries & Governance Professionals.

359 *See, e.g.*, Letter from John J. Castellani, President, Business Roundtable, Louis M. Thompson, Jr., President & CEO, National Investor Relations Institute, Charles V. Rossi, President, Securities Transfer Association and David W. Smith, President, Society of Corporate Secretaries & Governance Professionals, to Alan L. Beller, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, SEC File No. 4-493 (Jul. 29, 2005).

360 Chairman Cox remarked in 2007 as follows: "Between 70 and 80 percent of all public company shares are now held in street name. As a result, companies don't know a significant percentage of their shareholder base. They have difficulty in identifying their beneficial owners, and they have to rely on a complex web of intermediaries to communicate with these beneficial owners and conduct proxy solicitations." Transcript of

[Footnote continued on next page]

The Commission has already begun work to reexamine the proxy system as a whole, including issuing the 2003 Staff Report and holding several roundtables in 2004 and 2007. As recently as July 14, 2009, Chairman Schapiro noted that "later this year, we will undertake a comprehensive review of other potential improvements to the proxy voting system."[362] In addition, the Proxy Working Group formed by the NYSE engaged in an extensive study of the shareholder communications system and recommended that the system be improved in light of the increasing importance of shareholder communications. In its 2006 report to the NYSE, the Proxy Working Group made the following recommendation:

> Given the potential impact that eliminating broker voting of uninstructed shares in director elections would have on issuers, particularly as a result of the trend towards "majority voting" for directors, the Working Group believes that there is a significant need for more effective communications between issuers and shareholders. The Working Group recognizes that various groups have urged the SEC to review its existing shareholder communication rules to make it easier for issuers to communicate with beneficial owners, and believes that the NYSE should support a review by the SEC of these rules.[363]

[Footnote continued from previous page]

the Roundtable Discussion on Proxy Voting Mechanics, U.S. Securities and Exchange Commission (May 24, 2007). John W. White, then the Director of the Commission's Division of Corporation Finance, remarked that a number of issues have been "swept up in the policy debate" regarding proxy access and need to be addressed soon, including the NOBO/OBO rules and "company communications with shareholders." *See* John W. White, Don't Throw Out the Baby with the Bathwater, Keynote Address at the ABA Section of Business Law Fall Meeting (Nov. 21, 2008), *available at* http://www.sec.gov/news/speech/2008/spch112108jww.htm.

361 *See, e.g.*, Proxy Working Group Report, at 4-5 (recommending that the NYSE support efforts to improve the ability of issuers to communicate with beneficial owners); Letter from Larry W. Sonsini, Chairman, Proxy Working Group, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, SEC File No. SR-NYSE-2006-92, at 3 (Mar. 25, 2009) (reiterating the recommendation of the Proxy Working Group and its sub-committee focused on shareholder communications that the Commission "review its existing shareholder communications rules to make it easier for issuers to communicate with beneficial owners").

362 Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission, Testimony Concerning SEC Oversight: Current State and Agenda (July 14, 2009).

363 Proxy Working Group Report, at 4-5.

The Proxy Working Group's concerns were echoed at the Commission's July 1, 2009 open meeting approving amendments to NYSE Rule 452. In opposing these amendments, Commissioner Casey noted,

> I believe that we are doing investors a tremendous disservice by approving this amendment without closely analyzing the effects this action is likely to have and determining what other changes to the proxy voting process should be adopted concurrently with this rule change. . . . I am disappointed that we were not able to take a more holistic approach before moving forward with approving the amendments to Rule 452 today. Therefore, I am unable to support it.[364]

Commissioner Paredes also opposed the amendments and included the following in his remarks:

> The Commission should evaluate the elimination of the broker vote as part of a broader reconsideration of the proxy process. Broker discretionary voting in director elections is just one piece of a proxy system made up of numerous interconnected parts that must work together. Changing one component but not others may have unintended and counterproductive consequences.[365]

While Chairman Schapiro and Commissioner Walter voted in favor of the NYSE Rule 452 amendments, they nonetheless noted the need to review the proxy system as a whole.[366]

We support the efforts by the Commission and the NYSE to evaluate the current communications system. We also appreciate that the need to address the problems identified in our 2004 rulemaking petition finally has been recognized by the Commission. Nonetheless, we are concerned that the Commission has again proposed significant changes to an individual, critical element of the proxy process without addressing the shareholder communications system. As a result, we reiterate our position that it is incumbent upon the Commission to address the deficiencies in its rules relating to shareholder communications prior to, or concurrently with, any adoption of the Proposed Election Contest Rules or similar rules.

M. The Commission Should Revise The Proposed Amendments To Rule 14a-4 [G.4.]

We strongly oppose the Commission's proposed amendments to Rule 14a-4, which would require that when one or more shareholder nominees are included in a company's proxy materials, the company's proxy card may not include a mechanism for shareholders to vote "for

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364 Commissioner Casey, Statement at Open Meeting (July 1, 2009), *supra* note 82.

365 Commissioner Paredes, Statement at Open Meeting (July 1, 2009), *supra* note 88.

366 *See* Chairman Schapiro, Statement at Open Meeting (July 1, 2009), *supra* note 339; Commissioner Walter, Statement at Open Meeting (July 1, 2009), *supra* note 340.

the company nominees as a group, but would instead require that each nominee be voted on separately."[367] The proposed amendments are contrary to current rules, which provide that a proxy card may contain a box for shareholders to check in order to vote for or withhold voting authority from the company's director nominees as a group, and likely will lead to investor confusion.[368] In this regard, the proposed amendments are inconsistent with investor expectations and voting protocols that have been in place since the Commission amended Rule 14a-4(b)(2) to allow voting for a company's director nominees as a group almost 30 years ago.[369] In addition, because the new form of proxy card will list more director nominees than open board seats, it may result in over-voting, under-voting and other voting errors.

By making shareholder voting more burdensome on shareholders, the proposed amendments may actually have the unintended effect of discouraging shareholder participation in director elections. As we have witnessed already with respect to the Commission's "notice and access" rules, changes in proxy voting procedures can negatively impact the participation of retail investors in the electoral process. The proposed amendments to Rule 14a-4 will only exacerbate the difficulties for retail investors.

At a minimum, if the proposed amendments to Rule 14a-4 are adopted, the Commission should explicitly provide for a mechanism in the rule that would allow companies to clearly differentiate between the company's nominees and shareholder nominees.[370] Companies should be permitted to separately list groups of directors in a distinctive order and include additional clarifying or explanatory text on their proxy cards, rather than be required to intermix the names of company and shareholder nominees (for example, through an alphabetical listing of director nominees). This concept should be included in any final rule that is adopted.

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[367] 74 Fed. Reg. at 29,049.

[368] *See* 17 C.F.R. § 240.14a-4(b)(2) (2009).

[369] *See* Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, SEC Release No. 34-16356, 44 Fed. Reg. 68,764 (Nov. 29, 1979).

[370] Currently, the Proposing Release states that "the company could identify any shareholder nominees as such and recommend how shareholders should vote for, against, or withhold votes on those nominees and management nominees on the form of proxy." 74 Fed. Reg. at 29,049. However, there is no language included in the proposed rule itself that would permit such a distinction.

N. A Sufficient Transition Period Is Required [B.22.]

Although the Proposing Release does not discuss an anticipated effective date for any proxy access rules that the Commission determines to adopt, certain Commissioners have suggested that final proxy access rules should be in place in time for the 2010 proxy season. For the reasons discussed below, we strongly believe that at least a one-year transition period is necessary before the effective date of any rules creating a federal proxy access mandate.

The Proposed Election Contest Rules will bring about a sea change in the director election process, creating the potential for far more election contests. The Proposed Election Contest Rules set up an elaborate process for shareholders and companies, and indeed the Commission and its staff. We do not believe that any of the affected parties would have sufficient time to be ready for the new regime by the 2010 proxy season even if final rules were adopted this fall. Moreover, as we have noted elsewhere in this letter, we believe that extensive changes in the Proposed Election Contest Rules are necessary, and we anticipate that other commenters will have similar views. Thus, it could be much later this fall before the Commission is able to take action on the Proposed Election Contest Rules. Since the Commission has been studying the issue of proxy access for more than 70 years, we do not believe that it must act precipitously in order to have rules in place for the 2010 proxy season.

Companies will need substantial time to consider whether amendments to their governing documents will be necessary following any adoption of the Proposed Election Contest Rules. Moreover, some companies are in the early stages of considering whether to amend their governing documents in light of the amendments to the Delaware General Corporation Law concerning proxy access and proxy reimbursement that became effective on August 1, 2009.[371] Companies will need to determine how the Commission's new rules interact with their existing governing documents and the new legislation, make recommendations to the board and have the board consider any revisions.

Moreover, as discussed above in Section III.H, the Proposed Election Contest Rules would place significant additional responsibilities on the Commission's staff at a time when the Commission's resources are being taxed. Devoting the necessary resources to administer the anticipated dispute resolution process will likely divert the Commission's staff from other important projects. In addition, as the Commission is well aware, disputes relating to proxy materials are particularly time-sensitive as they relate to companies' annual meetings that are scheduled months in advance. The staff does an admirable job in meeting company deadlines with respect to Rule 14a-8 shareholder proposals, but, as discussed earlier, disputes relating to shareholder nominations in company proxy materials are likely to be far more contentious and time-consuming.

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371 *See supra* Sections I.A.2 and III.A.

A one-year transition period also is appropriate if the Commission concurs with our view that the Proposed Election Contest Rules should apply only following one or more triggering events.[372] Any potential triggering events may relate to matters voted on at a company's last shareholders' meeting, and we believe that there should be at least one shareholders' meeting after adoption but before implementation of any federal proxy access mandate.

IV. The Proposed Election Contest Rules Are Flawed In Other Significant Respects

A. The Proposed Election Contest Rules Will Reduce Efficiency, Stifle Competition And Deter Capital Formation [ECCF 1]

Section 3(f) of the Exchange Act requires the Commission to determine whether a rulemaking will promote efficiency, competition, and capital formation ("ECCF"). Section 23(a)(2) of the Exchange Act also prohibits any rulemaking that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

To fulfill those responsibilities, the Commission must produce a *reasoned* evaluation of costs and ramifications of new regulation: "[A]n estimate" of costs, the District of Columbia Circuit has explained:

> would be pertinent to [the Commission's] assessment of the effect the condition would have upon efficiency and competition, if not upon capital formation . . . . [U]ncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and Congress—of the economic consequences of a proposed regulation before it decides whether to adopt the measure.[373]

The superficial discussion of ECCF in the Proposing Release[374] indicates that the Commission is dramatically underestimating the harmful "economic consequences" of the Proposed Election Contest Rules. As we explain below—and as we will describe in addressing cost-benefit analysis in Section IV.B below—the Proposed Election Contest Rules will sharply increase the number of proxy contests for director elections each year, raising costs along several dimensions and thereby deterring companies from tapping the public markets. The result will be the imposition of an undue burden on capital formation, one that will provide few significant offsetting benefits to the vast majority of investors.

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[372] *See supra* Section III.B.

[373] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) ("*Chamber of Commerce I*").

[374] 74 Fed. Reg. at 29,077-78.

In particular, the Proposed Election Contest Rules will (i) disrupt board decision making, (ii) empower certain institutional shareholders with interests different from those of the shareholders at large to interfere with the company's corporate governance, (iii) drive companies to avoid public offerings, (iv) impede companies seeking to recruit and retain qualified directors, and (v) increase litigation costs for companies and directors both in federal and state courts.

It bears emphasis that the Commission's failure to address those aspects of ECCF in the Proposing Release meaningfully constrains the Commission's manner of addressing them later in this rulemaking. Under the notice-and-comment requirements of the Administrative Procedure Act ("APA"), an agency cannot develop a rule using secret data, which means that "the most critical factual material that is used to support the agency's position" must be "made public in the proceeding and exposed to refutation."[375] The "information that must be revealed for public evaluation" includes "the technical studies and data upon which the agency relies."[376] Consequently, the Commission is foreclosed from "extensive reliance upon extra-record materials in arriving at its cost estimates" concerning the Proposed Election Contest Rules, unless it provides "further opportunity for comment" on those materials and the Commission's analysis of them.[377] If, in other words, the Commission decides to adopt the Proposed Election Contest Rules, and it relies on new data to support its ECCF analysis, then the Commission should re-open the comment period so as to avoid possible violation of the requirements of 5 U.S.C. § 553(c).

1. Interference With Efficient And Informed Board Decision Making

The Proposed Election Contest Rules will predictably increase the number of contested director elections and thereby interfere with the board's ability to oversee the company's business operations effectively. In theory shareholders would only nominate and elect *qualified* directors (which shareholders may do under applicable state law, but then they must prepare and distribute their *own proxy* materials). But in practice there is a significant probability that many shareholder nominees will not be qualified. By shifting the cost of proxy material printing and distribution from nominators onto companies (and, thus, the

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[375] *Chamber of Commerce v. SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006) (internal quotation marks omitted) ("*Chamber of Commerce II*").

[376] *Id.* at 899 (internal quotation marks omitted).

[377] *Id.* at 901. In *Chamber of Commerce II*, the D.C. Circuit went on to hold that 5 U.S.C. § 553(c) required the Commission to "reopen the record" for public comment where the Commission supported cost estimates with "an extra-record summary of extra-record survey data that, although characterized as 'a widely used survey,' was not the sort, apparently, relied upon by the Commission during the normal course of its official business." *Id.* at 904-05, 909.

shareholders at large), the Proposed Election Contest Rules would reduce the incentives for nominators to put forward properly-vetted and fully-qualified candidates for director.

Because the presence of unqualified directors would reduce the effectiveness of board deliberations, directors and management will be required to invest substantial energy—that is, valuable time and money—to prevent the election of such unqualified directors. Consequently, such proxy contest elections would consume director resources, reducing the resources available to oversee corporate operations and carry out other legal obligations (including, of course, important fiduciary duties under state law and significant obligations under federal laws such as the Sarbanes-Oxley Act). It is not merely that "boards *may* devote less time to fulfilling their other responsibilities as a result" of more frequent proxy contests, as the Commission asserts;[378] rather, such a result is a virtual *certainty*. As one company has previously explained to the Commission: "Election contests are not only expensive and time consuming but they are also extremely disruptive and divert the attention and energy of a company's board and management away from the governance and management of the corporation."[379]

To be sure, the cost-benefit analysis contained in the Proposing Release acknowledges, in one paragraph, the existence of a related cost—the "disruptions or polarization in boardroom dynamics" that would occur upon election of an insurgent nominee, and that this "may delay or impair the board's decision-making process."[380] The Commission is correct that such "impairment in the decision-making process could constitute an indirect economic cost to shareholder value."[381] But that is only one aspect of the harm the Proposed Election Contest Rules would cause to board decision making, and if the Commission does not broaden its view to more fully appreciate the significant additional energy boards will have to invest in fending off unqualified nominees, the Commission will not adequately understand the "economic consequences of [the] proposed regulation."[382]

The Commission appears already to have concluded that concerns about unqualified nominees are not warranted "*to the extent that* shareholders understand that experience and competence are important director qualifications."[383] The Commission has not pointed to

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378 74 Fed. Reg. at 29,078 (emphasis added).

379 Letter from Daniel R. DiMicco, Nucor Corporation, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, SEC File Nos. S7-16-07 and S7-17-07, at 2 (Oct. 1, 2007).

380 74 Fed. Reg. at 29,075.

381 *Id*.

382 *Chamber of Commerce I*, 412 F.3d at 144.

383 74 Fed. Reg. at 29,075 (emphasis added).

empirical or anecdotal evidence that shareholders tend to nominate qualified candidates. Nor is there evidence to support the Commission's apparent belief that qualified candidates would find election contests attractive.[384] Indeed, the more complex and technologically driven the nature of a company's business operations, the more crucial it is for directors to have the specialized knowledge necessary to oversee those operations effectively, and the more likely it is that a shareholder—inherently less familiar than is the board with the nuances of the company's business—will nominate a less qualified candidate than the board itself will select.[385] Given the undeniable importance of high-technology firms to the national economy, the Commission must take *particular* care not to adopt proxy rules that would disproportionately disrupt corporate governance at such human-capital-intensive firms. The Proposed Election Contest Rules appear to be exactly such undesirable rules.

A distracted board cannot efficiently and effectively fulfill its function. Public companies with distracted boards would be at a disadvantage to private companies, thereby reducing public companies' competitiveness. Companies choosing between capital structures would seek to minimize those disruptions by avoiding public markets—thereby dampening capital formation.

2. Exploitation Of Director Nominations By Self-Interested Shareholders

Because of the disruptive effects just described, a shareholder's threat to the company to commence a contested election under the Proposed Election Contest Rules would become a powerful weapon to be deployed against the board. The rule therefore would strengthen the position of shareholders with parochial interests while weakening the position of the board—whose members, unlike those shareholders, are under a fiduciary obligation to act in the best interests of the company and all shareholders. The Proposing Release underestimates the economic consequences of such insurgents' exploitation of the Proposed Election Contest Rules.

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384 *See id.* at 29,078 (speculating that increased number of election contests would have equivocal effect in that it "might *encourage or discourage* qualified candidates from running") (emphasis added).

385 Recent empirical research confirms that when outside directors, who almost by definition lack pre-existing familiarity with company operations, are added to their boards, companies whose operations are more difficult to master (that is, whose information costs are high) benefit less than do companies whose operations are easier to master (those whose information costs are low). *See* Ran Duchin et al., *When Are Outside Directors Effective?* 32 (USC Marshall School of Business Research Paper No. MKT 02.09, 2009) (finding evidence for the proposition that "outsiders are less effective when it is difficult for them to understand the firm's business"), *available at* http://ssrn.com/abstract=1026488.

To be sure, the Commission has noted the risk that "the nomination procedure" can be "used by shareholders to promote an agenda that conflicts with other shareholders' interests."[386] But the risk runs deeper than the Proposing Release appears to recognize.

The Proposing Release appears to misunderstand the effects of strengthening shareholder voting rights today, when "shareholder democracy or primacy has often come to be little more than code for what amounts to a *subsidy* for public pension and union funds and for other 'normal' institutional investors unwilling or unable to pay their own way with director election campaigns of their own."[387] The Proposed Election Contest Rules will help institutional investors, not the individual shareholders Congress intended the Commission to protect.

The institutional shareholders of special concern fall into two general categories: (i) union-affiliated and other large pension funds; and (ii) hedge funds. The risk that such institutional shareholders will exploit the nomination mechanism in the Proposed Election Contest Rules to achieve ends not in the interests of shareholders at large is significant. That risk could drive firms away from the public markets, raising serious ECCF concerns.

Union-Affiliated Pension Funds. As Vice Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery has noted, among institutional investors, "[t]hose . . . most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest."[388]

In particular, empirical research confirms that union-affiliated funds are the most aggressive users of the Commission's existing mechanisms for requiring companies to circulate shareholder proposals under Rule 14a-8. For example, union pension funds submitted 295 out of 699 shareholder proposals received by U.S. public companies in 2006, more than any other investor group.[389] Such union pension funds frequently vote in director elections to achieve labor relations objectives rather than to maximize shareholder value.[390]

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386 74 Fed. Reg. at 29,075.

387 Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 IOWA J. CORP. L. 681, 713 (2007) (emphasis added).

388 Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006).

389 Ashwini K. Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting* 9 (NYU Working Paper No. FIN-08-006, 2009), *available at* http://ssrn.com/abstract=1354494; *see also* Claudia H. Allen, *Study of Majority Voting in Director Elections* iv (Nov. 12, 2007) (finding that union pension funds have been more

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Given that history, we believe that union-affiliated funds will use the Proposed Election Contest Rules as a bargaining chip, whether in collective bargaining negotiations or in other labor-relations contexts, rather than as a proper means of exercising shareholder "voting rights arising under state law."[391] As proposed, Rule 14a-11 would not merely strengthen the "tyranny of the 100 share shareholder with a deep ideological commitment to a particular issue,"[392] but also expand the tools unions can use against companies that raise capital in the public markets.

Whether labor unions actually will succeed in raising wages or lowering the workload of their members by using the Proposed Election Contest Rules as leverage against company boards is, of course, irrelevant. Instead, to cause firms to steer clear of the public markets, all that is necessary is for boards to conclude, as they might reasonably do, that the rule would create the potential for labor unions to achieve such gains. Such public market avoidance would reduce rather than increase efficiency and capital formation. Yet the Proposing Release gives no indication that the Commission has included an assessment of the effects that the Proposed Election Contest Rules would have on the balance of power between companies and union-affiliated funds. The Commission must take this important aspect of the problem into account if it is to satisfy the statutory mandate of assessing the ECCF criteria.

Hedge Funds. The Proposed Election Contest Rules also stand to become a strategic tool for hedge funds to seek to pressure a company's board to engage in certain transactions.

Hedge funds pose a particular problem because, as is now well known, in addition to holding voting common stock that would entitle them to use the subsidized nomination procedure in the Proposed Election Contest Rules, they also may hold other securities that in effect allow them to profit if the company fails instead of succeeds. Votes and economic interests today are frequently disconnected because of "modern financial innovation"[393]: "The emergence of equity swaps and other over-the-counter (OTC) equity derivatives, the growth of lightly regulated hedge funds, related growth in the share lending market, and other factors now permit decoupling of voting rights from economic interest to occur quickly, at low cost, on

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active than other investor groups in advocating board adoption of a majority vote standard), *available at* http://www.ngelaw.com/files/upload/majoritystudy111207.pdf.

390 *See* Agrawal, *supra* note 389, at 2-6.

391 74 Fed. Reg. at 29,027.

392 John C. Coffee, Professor, Columbia Law School, May 7th Roundtable, at 44.

393 Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1076 (2007).

a large scale, and often hidden from view."[394] Because of that decoupling, a hedge fund may seek to exercise its voting power in a manner unmoored from—and possibly adverse to—the economic interests of other shareholders. Such "voteholders with a negative economic interest" render obsolete the "usual assumption that shareholders have a common interest in increasing firm value."[395]

A recent case, *CSX Corporation v. The Children's Investment Fund Management (UK) LLP,* illustrates that allegations have arisen concerning manipulation of derivatives by insurgent hedge funds to influence corporate transactions while circumventing reporting requirements of the federal securities laws.[396] The Commission is already familiar with that case, having participated as an amicus. In *CSX*, the District Court for the Southern District of New York determined that two hedge funds used so-called "total return" equity swaps to increase their economic interests in a company whose board they had targeted in a proxy contest, but failed to meet the disclosure requirements of Section 13(d) of the Exchange Act, as implemented in Rule 13d-3(a), which requires shareholders that beneficially own more than five percent of a company's shares to disclose such holding.[397] Among other things, the court found that one of the hedge funds "exerted pressure" on the target company, "a pressure that was enhanced by the lack of complete information" about the hedge fund's swap position.[398]

As the *CSX* case teaches, hedge funds that hold various novel financial instruments have incentives to behave strategically in proxy contests in a manner that may put them at odds with other shareholders. In addition, hedge funds such as those at issue in *CSX* often coordinate their efforts against boards of directors, thereby increasing their influence out of proportion to their share ownership. The availability of the Proposed Election Contest Rules raises the prospect that such a "wolf pack" will use the nomination mechanism (whether in one year or over a period of time to gradually transfer control) to further strategic ends—all at the expense of the shareholders at large.[399]

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394 Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 629 (2008).

395 Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 363 (2007).

396 562 F. Supp. 2d 511, 549-51 (S.D.N.Y. 2008) (discussing amicus letter from SEC's Division of Corporation Finance), *aff'd*, 292 Fed. Appx. 133 (2d Cir. 2008).

397 562 F. Supp. 2d at 516, 518.

398 *Id.* at 549.

399 The "wolf pack" problem is not solved by the existence of disclosure requirements for shareholder "groups" because courts have in some cases construed those requirements in

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The Commission must not only take that possibility of abuse into account where, as here, it proposes to amend the proxy rules, but it also must recognize the impact that the risk of such abuse would have on ECCF.

3. Discouragement Of Public Offerings

By increasing the costs of obtaining capital, the Proposed Election Contest Rules would establish yet another barrier between entrepreneurs and the public markets. The easier it is for dissident shareholders to commence bitter proxy contests for board seats, the more concerned entrepreneurs will be about distracted boards and aggressive institutional shareholders, which would discourage entrepreneurs from seeking financing in the public markets. Instead of going public, entrepreneurs would tend to favor private and offshore markets as sources of capital.

But those alternatives have well-known disadvantages, and shunting businesses towards them will tend to increase inefficiency and dampen capital formation. Turning to offshore markets has obvious logistical burdens, not the least of which is the need to learn and comply with applicable foreign law. Even within U.S. borders, private placements under the Commission's Rule 144A have distinct disadvantages compared to public financing. For example, it has long been understood that companies conducting a private placement bear the burden of an "illiquidity discount, which generally . . . attaches to restricted (unregistered) securities."[400] That is, because restricted securities must be held for a specified period of time (six months under Rule 144 as currently in force) before they can be resold, companies issuing such securities must pay investors a premium to compensate for the lack of liquidity when compared to publicly traded (registered) securities.[401] Moreover, securities may be sold in Rule 144A private placements only to a narrow subset of investors.[402]

Furthermore, it would make no sense to consider in isolation the effects of the Proposed Election Contest Rules on company choice between private and public financing.

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favor of hedge funds. *See, e.g.*, *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613, 616-18 (2d Cir. 2002) (shareholders were not an undisclosed group even though all three discussed actions concerning their investments, two purchased stock during same period, and one had prior history of acting as a raider).

400 U.S. Securities and Exchange Commission, Report of the Advisory Committee on the Capital Formation and Regulatory Process, at 18 (1996).

401 *See id.*; *see generally* 17 C.F.R. § 230.144 (2009).

402 *See, e.g.*, Report of the Advisory Committee on the Capital Formation and Regulatory Process, *supra* note 400, at 18 (noting that public offering is more advantageous than Rule 144A offering because latter is limited to a "prescribed class of qualified institutional buyers").

Instead, the Commission must recognize that any such effects would compound the effects of pre-existing regulatory burdens that make public markets less desirable. Indeed, there *already* is empirical evidence that the burdens imposed by the Sarbanes-Oxley Act are causing U.S. firms to avoid going public, particularly innovative ones in high-technology fields that need to take risks.[403] The additional regulatory costs created by the Proposed Election Contest Rules would only make matters worse, boding ill for capital formation—all in the midst of an ongoing economic crisis whose effects continue to linger.

The Commission's obligation to consider economic consequences also calls for inquiry into whether adoption of the Proposed Election Contest Rules would tend to deter foreign firms from entering the U.S. public markets. The nonpartisan Committee on Capital Markets Regulation already has documented a sharp preference by foreign companies for Rule 144A private placements over public offerings in the U.S.[404] A large fraction of the foreign companies that completed Rule 144A offerings in 2007 identified Sarbanes-Oxley Act burdens, the cost of compliance with U.S. Generally Accepted Accounting Principles, and the risk of securities fraud class actions as among the principal reasons for avoiding U.S. public equity markets.[405] The Proposed Election Contest Rules would add yet another reason to that list, because expensive and potentially embittering or divisive proxy contests could well come to be seen as a major disadvantage of tapping U.S. public markets.[406]

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403 *See* Leonce Bargeron et al., *Sarbanes-Oxley and Corporate Risk-Taking* 25 (Working Paper 2008) (finding empirical evidence that U.S. initial public offerings have declined compared to those in the United Kingdom after SOX became law, particularly among firms in industries with high levels of research-and-development investment), *available at* http://ssrn.com/abstract=1104063.

404 *See* Committee on Capital Markets Regulation Completes Survey Regarding the Use by Foreign Issuers of the Private Rule 144A Equity Market (Feb. 13, 2009) ("Increased use by foreign issuers of the private Rule 144A equity market is evident in both the initial IPO decision and the overall amount of equity raised by foreign issuers in the Rule 144A market relative to U.S. public markets."), *available at* http://www.capmktsreg.org/pdfs/09-Feb-13_Summary_of_Rule_144A_survey.pdf.

405 *Id*.

406 Firms from Continental Europe, for example, may find the Proposed Election Contest Rules particularly extravagant and burdensome, because in some countries in Continental Europe, unlike under the Proposed Election Contest Rules (and, indeed, Rule 14a-8 as currently structured with respect to shareholder proposals), "the solicitation of proxies at the firm's expense is prohibited, so the production and distribution costs of the solicitation request are borne by the activist." Peter Cziraki et al., *Shareholder Activism Through Proxy Proposals: The European Perspective* 13 (TILEC Discussion Paper

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By making private and offshore markets more attractive than U.S. public markets, the Proposed Election Contest Rules will hinder rather than promote capital formation. Against that reality, the Proposing Release offers only the unsubstantiated assertion that the proposals may benefit capital formation because they "may help to increase investor confidence during this time of uncertainty in our markets."[407] But this abstract investor-confidence rationale cannot conceivably outweigh the concrete harms we have described here.

4. Hampering Of Director Recruitment And Retention

As explained, the Proposed Election Contest Rules would deter qualified individuals from serving as directors by increasing the frequency of contested elections and raising the risk that directors will suffer damage to their reputation in the course of such contests.[408] That would lower the quality of directors overall, thereby reducing the efficiency of board oversight of corporate operations. It also would reduce the competitiveness of public companies when compared to private firms. Given a choice, talented director candidates will tend to prefer seats on the boards of private firms over public ones so as to avoid the potential bitterness of contested elections. Thus, the Commission's superficial remark in its cost-benefit analysis that contested elections "could discourage qualified board members from running"[409] apparently fails to grasp the consequences for ECCF of such interference with director recruiting and retention.

5. Increased Litigation Costs

The Proposing Release attempts to address the problem of litigation that could result from shareholder use of the nominating mechanism in the Proposed Election Contest Rules, but much more must be done to "make clear the company's responsibilities when it includes [nominating information provided by a shareholder under the Proposed Election Contest Rules] in its proxy materials."[410] Unclear liability rules unquestionably harm ECCF, especially given the

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No. 2009-019; ECGI - Finance Working Paper No. 252/2009, 2009), *available at* http://ssrn.com/abstract=1413125.

407 74 Fed. Reg. at 29,078.

408 *See supra* Section I.B.3.

409 74 Fed. Reg. at 29,075.

410 *Id.* at 29,062, Question L.3.

long history in the United States of aggressive and abusive filings of class action suits against companies, alleging violations of the federal securities laws.[411]

The Proposing Release notes that under proposed Rule 14a-11(e), a company would not be liable for misrepresentations or omissions in the nominating shareholder's information that is "then repeated by the company in its proxy statement, except where the company knows or has reason to know that the information is false or misleading."[412] The Proposing Release provides no guidance to companies that would enable them to determine whether their procedures for reviewing and verifying information contained in nominating statements would meet this requirement. Where, as here, the Commission creates a new liability rule, the Commission bears a special responsibility to spell out what regulated entities must do to avoid violating that rule. The vague and amorphous "knew or should have known" phrase is not enough to give the necessary guidance. As explained above in Section III.I, we recommend that the Commission amend the liability standard in the Proposed Election Contest Rules.

Moreover, even a company that takes a "gold plated" approach to vetting nominating shareholder statements would face a risk of significant legal costs in the event that other shareholders find a misstatement or omission in the nominating material and seek to hold the company liable for that misstatement. The point is not that such legal claims would ultimately be successful, but rather that the mere fact of being sued and possibly subject to costly discovery will deter companies from seeking out the public markets so as to avoid being subject to the Proposed Election Contest Rules, thus harming efficiency and capital formation.

Indeed, given that the courts have inferred a private right of action under Rule 14a-9 for material misstatements and omissions from proxy materials,[413] the Commission's creation of new rules for proxy solicitation such as the Proposed Election Contest Rules will foreseeably lead to claims by private plaintiffs that companies are liable to them for violations of the new rules. Although we believe such claims would be entirely invalid given the absence of any indication in the text of the Exchange Act that Congress conferred a right of action for violations of rules such as Rule 14a-8 or the Proposed Election Contest Rules, the uncertainty on that point could require years of costly litigation to resolve.

The many uncertainties in the liability scheme under federal law will thus add to the pre-existing fear of securities fraud class actions that keeps many companies from entering the

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411 *See, e.g.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (describing abuses of securities fraud suits that led to enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737).

412 74 Fed. Reg. at 29,061.

413 *See, e.g.*, *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1089-90 (1991).

public markets. The Proposed Election Contest Rules would thus tend to make the public markets less popular, and thereby inhibit capital formation.

B. The Commission Has Underestimated The Costs And Burdens Of The Proposed Election Contest Rules, Which Do Not Outweigh Any Purported Benefits [PRA 1, CBA 1, CBA 3, CBA 6]

In addition to the requirements of Section 3(f) of the Exchange Act, described above in Section IV.A, the Paperwork Reduction Act and Regulatory Flexibility Act require that the Commission undertake a thorough and accurate analysis of the costs that 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 that the Commission draws from the economic analysis have a reasoned, rational basis in the data the Commission gathers. Guidelines issued by the Commission 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 information, according to commonly accepted scientific, financial or statistical standards, by qualified third parties."[414] Here, however, the Commission's estimates of the Proposed Election Contest Rules' costs and burdens are inadequate and far too low. Moreover, the costs that will be imposed by the Proposed Election Contest Rules far outweigh any purported benefits espoused by the Commission.

First, we note that the Commission has underestimated the hours and cost burden valuations in its Paperwork Reduction Act analysis. In particular, we note the Commission has estimated that, if a company determines that it will include a shareholder nominee, a company would be subject to the following time burdens: (i) five hours per notice for the company's preparation of a written notice to the nominating shareholder or group; (ii) five hours per nominee for the company's inclusion in its proxy materials of the name of, and other disclosures concerning, a person or persons nominated by a shareholder or shareholder group; and (iii) 20 hours per nominee for the company's own statement regarding the shareholder nominee or nominees.[415] However, in our July 2009 Survey, our member companies reported that for each shareholder nominee the above-listed preparations would require a total of an average of 99 hours of company personnel and director time—a far greater time burden than the 30-hour estimate provided by the Commission. Further, the Commission, using an estimate

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[414] Securities and Exchange Commission Final Data Quality Assurance Guidelines (modified June 10, 2005), *available at* http://www.sec.gov/about/dataqualityguide.htm.

[415] 74 Fed. Reg. at 29,064.

of $400 per hour of services for outside professionals,[416] maintains that the total cost for outside professional services in connection with the above-listed preparations would be $12,000. In contrast, our July 2009 Survey reported that the average total cost for such outside services for the above-listed items would be $1,159,073 per company for each shareholder nominee. We note, moreover, that the Commission's use of a $400 per hour estimate for professional services is wholly inadequate. Additionally, according to our July 2009 Survey, if a company opposes a proxy access nominee, it will incur an average of 302 hours of company personnel and director time.

In addition, the Commission's cost-benefit analysis discussion is inadequate. The Commission anticipates that the Proposed Election Contest Rules will result in three costs: (i) potential adverse effects on company and board performance; (ii) potential complexity of the proxy process; and (iii) preparing the required disclosures, printing and mailing, and the costs of additional solicitations.[417] However, as our extensive comments above indicate, the Proposed Election Contest Rules will impose numerous other costs. First, we note that the Commission has completely failed to consider that the Proposed Election Contest Rules will promote short-termism at the expense of long-term value creation.[418] In addition, the Commission has not addressed the many voting integrity issues that plague the current proxy voting system, which the Proposed Election Contest Rules will only exacerbate.[419] Finally, as Section IV.A above explains, the Proposed Election Contest Rules will reduce efficiency, stifle competition and deter capital formation in a number of ways. Given the Commission's failure to consider these additional costs, the Commission's rulemaking is severely flawed.[420]

We further believe that any ostensible "benefits" do not outweigh the myriad costs associated with the Proposed Election Contest Rules. First, the Commission asserts that the Proposed Election Contest Rules will result in a reduction in costs related to shareholder nominations, when compared to the cost of a traditional proxy contest.[421] However, as we note above in Section I.A.4, and as the Commission itself acknowledges, the Proposed Election Contest Rules would not alleviate a majority of the costs associated with a proxy contest. The Proposed Election Contest Rules will not reduce the costs of legal counsel, proxy solicitors,

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416 *Id.* at 29,062 n.299.

417 *Id.* at 29,074.

418 *See supra* Section I.B.1.

419 *See supra* Sections I.B.5 and III.L.

420 *See, e.g.*, *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (stating that an agency rule is arbitrary and capricious where an agency has "entirely failed to consider an important aspect of the problem").

421 74 Fed. Reg. at 29,073.

public relations advisors and advertising. According to the Commission's own statistics, the average cost of a proxy contest to a soliciting shareholder is $368,000, and the Proposed Election Contest Rules would result in a mere $18,000 in estimated savings—less than 5% of the total cost of a traditional proxy contest. Further, the Commission maintains that the Proposed Election Contest Rules will result in improved board and company performance.[422] As we have argued above, however, the Proposed Election Contest Rules will likely have the opposite effect, as they will: (i) promote short-termism at the expense of long-term value creation; (ii) encourage the election of "special interest" directors; (iii) increase the influence of proxy advisory firms; and (iv) deter qualified directors from serving on corporate boards.[423] Finally, the Commission contends that the proposed Rule 14a-8(i)(8) amendments "may facilitate shareholders and companies working together to tailor companies' governing documents to suit the specific interests of the company and its shareholders."[424] We strongly disagree. The proposed Rule 14a-8(i)(8) amendments would permit shareholders only to impose more lenient but not more restrictive proxy access requirements on nominating shareholders, even if a majority of a company's shareholders desired more restrictive access requirements.[425] As such, the Commission's assertion that the proposed Rule 14a-8(i)(8) amendments will allow a company and its shareholders to "tailor" a company's governing documents is disingenuous.

C. The Commission Has Given The Public Insufficient Time To Comment On The Proposed Election Contest Rules, With The Consequence That The Commission Has Insufficient Information To Engage In Informed Rulemaking [General 1]

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 Proposed Election Contest 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. Business Roundtable and several other groups expressed these concerns to the Commission in a letter dated June 30, 2009, which requested that the comment period be extended by at least 30 days.[426] That request was denied.

The short 60-day comment period was inadequate for interested parties to comprehensively review, comment on, and provide all information requested in, the Proposing Release. As Commissioner Walter noted, the Proposing Release contains a "myriad of

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422 *Id.*

423 *See supra* Sections I.B.1, 3-4.

424 74 Fed. Reg. at 29,074.

425 *See supra* Section II.B.

426 The points made in the June 30, 2009 letter are incorporated herein by reference.

questions" for commenters to consider.[427] Chairman Shapiro "urge[d] all commenters to respond to the questions thoroughly" and noted the Commission would take all comments very seriously.[428] Yet, the abbreviated 60-day period did not provide sufficient opportunity for the many companies, organizations and other stakeholders that would be impacted by the Proposed Election Contest Rules to adequately assess and provide thoughtful commentary on the many significant, complex issues raised in the Proposing Release, including the more than 500 questions and requests for data and information.

As the Proposing Release indicates, the Commission previously has considered amendments to the proxy rules and regulations addressing proxy access in 1942, 1977, 1980, 1992, 2003 and 2007. Each of these considerations, including the Proposed Election Contest Rules, have raised questions regarding the Commission's authority, the relative roles of the states and federal government in establishing shareholder rights and delineating the responsibilities of shareholders and boards of directors, and the impact of the proposals on corporate governance. This illustrates not only the significance of the issues raised by the Proposed Election Contest Rules, but also the substantial record the public had to review and consider before submitting comments on the Proposed Election Contest Rules. In fact, the Proposing Release extensively cites the 2003 rulemaking record.

Consideration of issues raised by the Proposed Election Contest Rules, as well as their mechanics, is difficult. The complexity of the Proposed Election Contest Rules and requests for comment are demonstrated by the fact that the Commission approved the Proposed Election Contest Rules at an open meeting on May 20, 2009, but the Proposed Election Contest Rules were not issued and then published in the Federal Register until June 18, 2009—almost one month after the Commission's open meeting.

The 60-day comment period also was insufficient given that the Commission's requests for comments, data and information in the Proposing Release necessitated considerable effort by commenters. For example, the Commission requested comments on proposed eligibility thresholds and possible triggering events, the mechanics of proposed Rule 14a-11 and how often shareholders satisfying the Rule 14a-11 thresholds would invoke the rule, as well as quantitative data on the benefits and costs of enhanced shareholder access to company proxy materials and the costs to companies if Rule 14a-8(i)(8) were amended as proposed.

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427 SEC Commissioner Elisse B. Walter, Statement at Open Meeting on Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov./news/speech/2009/spch052009ebw.htm.

428 SEC Chairman Mary L. Schapiro, Statement at Open Meeting on Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov./news/speech/2009/spch052009mls.htm.

Further, the Proposing Release does not include important data or provide a detailed analysis of many issues implicated by the Proposed Election Contest Rules. Instead, the Commission has shifted the burden of data collection and analysis to the public in many respects. For example, in order to determine some of the costs of adopting the Proposed Election Contest Rules, the Commission explicitly relied on survey data collected by the American Society of Corporate Secretaries and submitted in a comment letter on the Commission's 2003 Proposal.[429] In order to update this data, commenters needed to once again engage in detailed survey research. Similarly, the Proposing Release contains extensive references to the analysis and commentary submitted in response to the 2003 Proposal but does not address how this analysis and commentary has been affected by the sea change in corporate governance that has occurred in the last six years.

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 is inadequate under the APA[430] and does not provide an opportunity for thorough, well-informed rulemaking in this important area. The 60-day comment period has not afforded interested parties enough time to consider and respond meaningfully to all of the questions posed by the Commission.[431]

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.'"[432] The notice of a proposed rulemaking is not sufficient where it does not "afford[] interested parties a reasonable opportunity to participate in the rulemaking process."[433] Moreover, the length of a comment period must enable "interested parties to comment meaningfully."[434] This requirement is designed "both (1) 'to reintroduce public participation and fairness to affected parties after governmental authority has been delegated

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[429] *See* 74 Fed. Reg. at 29,065 n.311.

[430] *See* 5 U.S.C. § 553(c) (2009).

[431] *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).

[432] *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)).

[433] *Am. Radio Relay League, Inc. v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008) (internal quotation marks and citations omitted).

[434] *Florida Power*, 846 F.2d at 771; *see also* Exec. Order No. 12,866 § 6(1), 58 Fed. Reg. 51735, 51740 (Oct. 4, 1993) (requiring agencies to "afford the public a meaningful opportunity to comment on any proposed regulation").

to unrepresentative agencies'; and (2) to assure that the 'agency will have before it the facts and information relevant to a particular administrative problem.'"[435] 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. 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,[436] and principles of sound public administration.

V. Conclusion

Adoption of the Proposed Election Contest Rules is unnecessary, would have serious adverse consequences, and is beyond the Commission's authority. The Proposed Election Contest Rules also have the potential to exacerbate one of the causes of the very economic crisis that the Commission says it seeks to address in the Proposed Election Contest Rules: the emphasis on short-term gains at the expense of long-term, sustainable growth. Moreover, the Proposed Election Contest Rules do not achieve the Commission's stated objective of removing impediments to shareholders exercising their state law rights, as the proposed "one size fits all" federal proxy access mandate would deprive shareholders and boards of directors of the choices that state law provides. Thus, 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 adopting the Proposed Election Contest Rules. We believe that a far better alternative would be for the Commission to defer any action on the Proposed Election Contest Rules and instead adopt a revised amendment to Rule 14a-8(i)(8) to permit shareholders to include proxy access shareholder proposals in company proxy statements. In addition, the Commission should adopt proposed Rule 14a-19 to provide shareholders with essential disclosures if a shareholder nomination is included in a company's proxy materials pursuant to state law or the company's governing documents.

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[435] *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)).

[436] *See* Exec. Order No. 12,866, *supra* note 434.

August 17, 2009

Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation

In Support of Comments by
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I. Introduction

In this Report, we address the substantial costs in terms of efficiency, competitiveness and capital formation that would result if the SEC's Proposed Election Contest Rules ("Proposal") were adopted. The SEC's Proposal would, at best, amount to modest savings for shareholders at a handful of companies, while imposing substantial costs on all public companies. If implemented, the Proposal would impose substantial efficiency costs on public companies, impair their competitiveness, and further undermine the attractiveness of U.S. equity markets.

Although Section 3(f) of the Securities Exchange Act of 1934 requires that the SEC consider the effect of certain proposed rules on efficiency, competition and capital formation and Section 23(a) of the statute prohibits any rulemaking that would unnecessarily or inappropriately burden competition, we find that the SEC has not considered or adequately recognized a number of costs associated with its proposal.[1] Key risks of the Proposal include the following:

- Ensuing shareholder nominations will lead to less qualified boards of directors that do not achieve the experience and skill mix required to meet the challenges facing companies today.

- Board members will be selected whose interests diverge from the goal of maximization of shareholder value.

- The Proposal would impose an additional disincentive for U.S. companies to go public, further undermining the competitiveness of U.S. capital markets.

- Deterring companies from public listing in the U.S. also increases the cost of capital for U.S. companies, thereby impeding capital formation and undermining those companies' competitiveness.

The Proposed Election Contest Rules would not only fail to achieve the predicted benefits, but would also impose a costly solution where there is little, if any, extant problem, at the risk of undermining shareholder wealth maximization. This report will discuss the available empirical and social science evidence on this topic. Our analysis of this evidence leads us to conclude that the proposed rules risk undermining, rather than improving, board quality and composition and are likely to undermine the ability of boards of directors to serve the interests of shareholders. Available measures and easily attainable alternatives effectively and affordably address the goal of disciplining weak management and revitalizing ineffective boards of directors. In sum, the Proposed Election Contest Rules fail to meet the standard that a new regulation should be introduced only if its benefits exceed its costs, and at minimum cost.[2]

[1] 15 U.S.C. Section 78c(f); 15 U.S.C. Section 78w(a)(2).

[2] This standard has been advocated in the recent reports of the Committee on Capital Markets, "The Global Financial Crisis: A Plan for Regulatory Reform" (p. ES-4) and Congressional Oversight Panel, "Special Report on Regulatory Reform," January 2009 (p. 3).

II. Available measures effectively and affordably discipline weak management and boards

Shareholders already possess means to address problems with management and boards of directors. In its obligation to determine whether the Proposal would unnecessarily burden competition, the Commission must make a convincing case that these measures are not adequate. In fact, however, shareholders' tools for addressing dissatisfaction with management and boards have proved powerful, and empirical evidence demonstrates that they are effective in disciplining managers.

A. The market provides multiple means of management discipline

There is a broad consensus that a robust market is the most effective mechanism for monitoring and disciplining corporate management and for providing incentives to officers and directors of public companies to maximize firm value.[3] Market participants reward or censure management by buying or selling shares, thereby increasing or reducing the share price and value of a company.

Investors can and do express dissatisfaction with boards by selling shares or taking short positions. The inherent nature of hedge funds is to take strategic positions. Other institutional investors keep, overall, the majority of their funds in actively managed strategies.[4] Such investors are likely to reduce their holdings in poorly performing companies through the actively managed portfolios that comprise the lion's share of stock holdings. Such decisions will be made for them by their active asset managers, who are generally evaluated on performance.

Empirical research bears out the theoretical insight that managers are replaced when a company's stock performance is poor. Numerous finance studies find that CEOs and other top managers of companies whose stock performance is weak measured relative to market returns are far more likely to be replaced than managers of companies with solid share performance.[5] Warner *et al.* (1988) find 50% higher turnover of top managers in the lowest decile of firms (ranked by stock returns), versus 8.6% in the highest decile of firms based on a random sample

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[3] Frank Easterbrook, "The Race for the Bottom in Corporate Governance" 95 *Virginia Law Review* 686 (2009); Jonathan Macey, *Corporate Governance, Promises Kept, Promises Broken*" (2008, Princeton University Press).

[4] In 2006, defined benefit, defined contribution and non-profits invested approximately two-thirds of their assets in actively-managed strategies (68.8, 64.3 and 71.3%, respectively), while public pension plans kept 47.3% in actively managed strategies. Kenneth R. French, "Presidential Address: The Cost of Active Investing," *Journal of Finance* (2008), vol. LXIII, no. 4, pp. 1537-1573.

[5] See, for example, Eugene P.H. Furtado and Vijay Karan, "Causes, Consequences, and Shareholder Wealth Effects of Management Turnover: A Review of the Empirical Evidence," *Financial Management*, Vol. 19, No. 2 (1990), pp. 60-75; Willard McIntosh, Ronald C. Rogers, C.F. Sirmans and Youguo Liang, "Stock Price and Management Changes: The Case of REITs," *Journal of American Real Estate and Urban Economics Association*, Vol. 22 (1994), pp. 515-526; Jerold B. Warner, Ross L. Watts and Karen H. Wruck, "Stock Prices and Top Management Changes," *Journal of Financial Economics* 20 (1988), pp. 461-492; George J. Benston, "The Self-Serving Management Hypothesis: Some Evidence," *Journal of Accounting and Economics* 7 (April 1985), pp. 67-84; Anne T. Coughlan and Ronald M. Schmidt, "Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation," *Journal of Accounting and Economics* 7 (April 1985), pp. 43-66.

of 269 firms listed on New York and American Stock Exchange from 1963 through 1978.[6] Similarly, Coughlan and Schmidt (1985) find top managers are 2.5 times more likely to turn over at firms in the lowest decile (ranked by stock returns) than in the highest decline, using a sample of 249 firms from 1978 through 1980.[7]

Takeovers also serve to change management.[8] Research by Davis and Stout (1992) finds that the probability that underperforming managers will be replaced is very high:

> Between 1980 and 1990, 144 members of the 1980 Fortune 500 (29 percent) were subject to at least one takeover or buyout attempt. While most of these attempts (77) were hostile—publicly resisted by management—the vast majority ultimately led to a change in control, including 59 of the hostile bids and 125 bids overall.[9]

In 10 years, mergers and takeovers resulted in management turnovers in roughly one-third of the largest industrial corporations in the U.S.[10]

B. Managers associated with wrongdoing are ousted

Advocates of more contested elections seem to overlook that the market is already disciplining managers. For example, Bebchuk (2007) has suggested that more contested elections would be desirable to rid companies of managers that have made accounting mistakes.[11] In fact, however, Karpoff, Lee and Martin (2008) find that 93% of all individuals associated with SEC and

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[6] Jerold B. Warner, Ross L. Watts and Karen H. Wruck, "Stock Prices and Top Management Changes," *Journal of Financial Economics* 20 (1988), pp. 461-492. Table 7.

[7] Anne T. Coughlan and Ronald M. Schmidt, "Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation," *Journal of Accounting and Economics* 7 (April 1985), pp. 43-66, Table 7.

[8] See, for example, Michael Jensen and Richard Ruback. "The Market for Corporate Control: The Scientific Evidence." *Journal of Financial Economics,* Vol. 1 pp. 5–50; Gregg A. Jarrell, James Brickley, and Jeffry Netter. "The Market for Corporate Control: The Empirical Evidence Since 1980." *Journal of Economic Perspectives* 2, no. 1 (Winter 1988): pp. 49–68; Roberta A. Romano, "Guide to Takeovers: Theory, Evidence, and Regulation." *Yale Journal on Regulation* 9 (1992): p. 119. ("the empirical evidence is most consistent with value-maximizing, efficiency-based explanations of takeovers"); Jonathan R. Macey. "Market for Corporate Control." *The Concise Encyclopedia of Economics*; David R. Henderson, ed. Liberty Fund, Inc. 2008. Library of Economics and Liberty [Online] available from http://www.econlib.org/library/Enc/MarketforCorporateControl.html; accessed 12 August 2009; Internet.

[9] Gerald F. Davis and Suzanne K. Stout, "Organization theory and the market for corporate control: a dynamic analysis of the characteristics of large takeover targets, 1980-1990," *Administrative Science Quarterly*, Vol. 37, 1992.

[10] *Id*.

[11] Lucian A. Bebchuk, "The Myth of the Shareholder Franchise," *Virginia Law Review* vol. 93, pp. 675 et seq. (2007).

Department of Justice enforcement actions relating to financial misrepresentation from 1978-2006 lost their jobs by the end of the enforcement period; 62% were fired.[12]

Boards also have the ability to discipline management, and board independence has steadily increased in recent years. Among companies in the S&P 1500, the overall proportion of independent directors increased from 69% in 2003 to 78% in 2008. In 2008, 85% of S&P 1500 companies had boards that were at least two thirds independent.[13] Section I.A.3. of Business Roundtable's Comment details numerous other improvements in corporate governance in recent years.

C. Contested director elections are often effective, but their low frequency suggests that they are rarely needed

The low frequency of proxy contests and activist campaigns, along with the frequent success of company/board slates against dissidents, suggest that shareholder dissatisfaction with outside directors is rare and that finding superior substitutes for incumbents is more difficult than generally is assumed. In 2008, there were a record 50 contested elections of outside directors.[14] However, this constitutes only 0.88% of all U.S. public companies.[15] Moreover, company/board director candidates won in 49.6% of contested elections during 2003-08, indicating that shareholders' actual dissatisfaction with management candidates—and preference for the available alternatives—is appreciably lower than the rate of proxy contests.[16]

Nonetheless, contesting director elections has proved to be an actively used and viable approach for shareholders to gain representation. Shareholders have contested an increasing number of director elections and gained either seats or concessions in an increasing percentage of those elections. As shown in Figure 1, the number of proxy contests over director seats has risen dramatically since 2005. Over 2003-08, of contests carried to completion or settlement, shareholders have won seats in 29.0% of contests and obtained settlements, presumably with concessions, in an additional 21.4% of contests.[17] In addition, many proxy contests—and many potential contests—are resolved without a vote through negotiations between dissatisfied shareholders and incumbent management.

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[12] Jonathan M. Karpoff, Scott D. Lee, and Gerard Martin, "The consequences to managers for financial misrepresentation," *Journal of Financial Economics*, vol. 88 (2008), pp, 193-215.

[13] RiskMetrics Group, "Board Practices: Trends in Board Structure at S&P 1,500 Companies," December 17, 2008, p. 2.

[14] Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46.

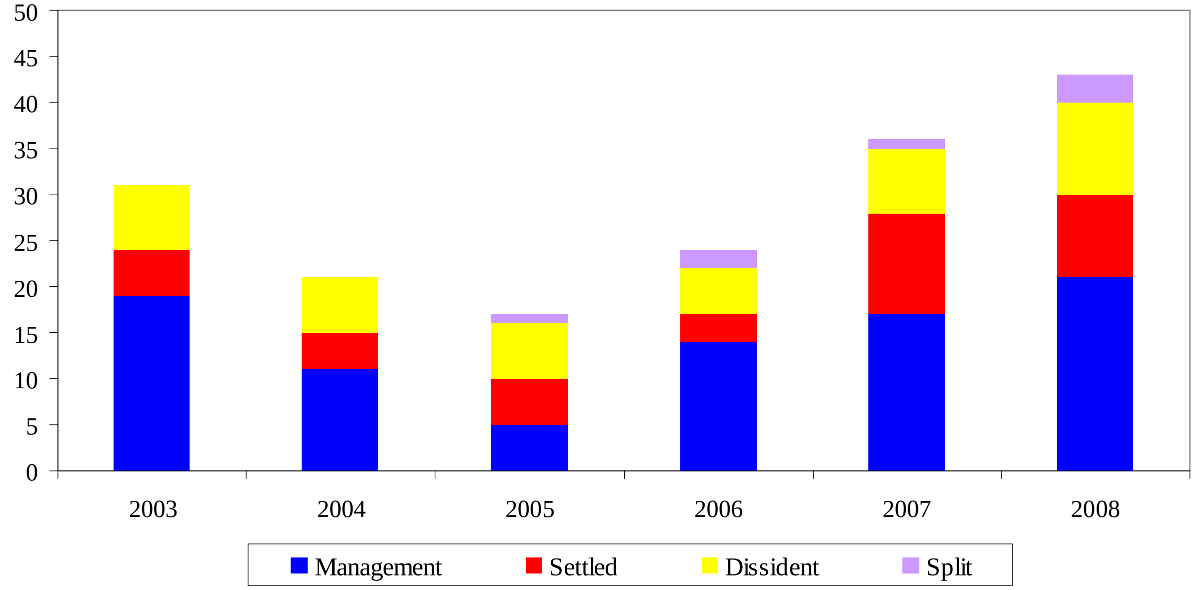
[15] FactSet Research Systems, Inc. reports a total of 5,707 U.S. companies traded on major U.S. exchanges in March 2009.

[16] Calculation using data from Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46. Includes only contests that carried to election or settlement; excludes contests categorized as Pending, None, Withdraw, No Result or Postponed.

[17] Calculation using data from Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46. Includes only contests that carried to election or settlement; excludes contests categorized as Pending, None, Withdraw, No Result or Postponed.

Figure 1

Outcome of Contested Proxy Solicitations
2003 - 2008



Source:
Georgeson Shareholder

D. Contesting elections is not expensive and dissidents' costs can be mitigated without changing the election rules

Although the primary goal of the Proposed Election Contest Rules seems to be to reduce the shareholder cost of putting forth outside director candidates, currently, proxy contests are relatively inexpensive to shareholders. Automatic Data Processing reported that, based on proxy statements filed by outsiders engaged in proxy solicitations during 2003–2005, the average cost of a contest was $368,000; based on their data, the median cost was $150,000 and 25% of contests cost $70,000 or less.[18]

1. The SEC proposal would reduce the cost of contesting elections by only 5%

Furthermore, the Commission itself estimates that savings due to being able to put a nominee on the company's ballot would only be the average $18,000 cost due to printing and postage, or 5% of the average cost. [19] This amount is truly trivial in relation to the value of the minimum stakes required to nominate a director candidate. On average, among firms with market capitalization

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[18] See Letter from Richard Daly, Co-President, Brokerage Servs. Group, Automatic Data Processing, to Nancy M. Morris, Secretary, SEC (Apr. 20, 2006), available at http://www.sec.gov/rules/proposed/s71005/ccallan1565.pdf. The cost of proxy contests in ADP's sample ranges from $950 to $5,900,000. The lowest-cost contest appears to be a significant outlier, as the next most inexpensive contest is reported to cost $10,000.

[19] SEC Release No. 33-9046, pp. 183-184.

greater than $700 million, it is equivalent to 0.13% of the value of a 1% holding. Put another way, the holder of a 1% stake in this category of firms, on average, gains or loses $18,000 as a result of a $0.02 change in the stock's price; it gains or loses $368,000 as a result of a $0.41 change in share price.[20]

Although the SEC states that nominating shareholders may achieve additional savings by spending less, or nothing at all, on public relations, advertising or proxy solicitors, current rules do not force shareholders to incur these expenditures. The low cost of many contests indicates that many activist shareholders already expend little beyond printing and postage costs.[21]

2. Investors can further mitigate costs of proxy contests by collaborating

Proxy contest costs can be mitigated if shared by multiple institutional investors who jointly back the proxy contest, as has occurred in a number of past instances. According to the IRCC Institute, between 2005 and 2008, there were 23 proxy contests that resulted in hybrid boards in which multiple hedge funds were identified as dissidents in SEC filings.[22] This represents 17% of the 133 proxy contests in the same period.[23] Prominent examples of collaboration include the following:

A. A group including Carl Icahn and JANA Partners LLC threatened to launch a proxy fight to name directors to the board of Kerr-McGee Corp. The contest never took place, and the dissident group agreed to cease proxy solicitation activities after Kerr-McGee initiated a $4 billion stock buyback.[24]

B. Hedge funds the Children's Investment Fund (TCI) and 3G Capital Partners engaged CSX Corporation in a proxy contest in 2008, and successfully elected four dissident directors to the board, including Christopher Hohn, the managing partner of TCI.[25]

C. Three hedge funds and a mutual fund, organized by ZelnickMedia Corporation, effected a change in control of the board of directors of Take Two Interactive Software, Inc. at an annual meeting.[26]

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[20] Based on an analysis of all U.S. domiciled companies with market capitalization greater than $700 million traded publicly on major U.S. exchanges. Data are from FactSet Research Systems, Inc.

[21] SEC Release No. 33-9046, p. 185.

[22] IRRC Institute, "Effectiveness of Hybrid Boards," May 2009, p. 17, available at www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf.

[23] Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46. The 133 proxy contests reported between 2005 and 2008 do not include contests that were not directly related to the election of directors.

[24] Stephen Taub, "Big Buyback Ends Kerr-McGee Proxy Fight," *CFO*, April 15, 2005.

[25] Chad Bray, "CSX to seat fund board members," *The Wall Street Journal*, September 17, 2008.

[26] Adam J. Kansler and Leila Zahedani, "Winning Without a Fight: Steps for Activist Shareholders to Change Management," *The Metropolitan Corporate Counsel*, June 2007, available at http://www.metrocorpcounsel.com/current.php?artType=view&artMonth=July&artYear=2009&EntryNo=6781.

3. Costs could also be reduced by increased reliance on electronic distribution of proxy materials

An alternative to the current proposal would be to reduce further the printing and postage costs of proxy contests through increased reliance on the Internet to distribute proxy materials. Under an SEC Rule effective January 1, 2008, issuers—as well as shareholders seeking to solicit proxies from other shareholders—may select the so-called "notice only" option for the delivery of proxy materials, in which proxy materials are posted on the internet, accompanied by a notice of the posting mailed to shareholders. Issuers must respond to shareholders' requests for paper copies of all materials, including permanent requests.

The Internet has already been used extensively and successfully by issuers as a complement to mail notices and vote solicitations: proxy materials that may be posted online include notices of shareholder meetings, proxy statements, consent solicitations, proxy cards, information statements, annual reports to security holders, additional soliciting materials and amendments to any of the foregoing. If any proxy materials are to be furnished online, then all soliciting materials must be furnished on the same website no later than the day such materials are first sent to shareholders or made available to the public. [27] The SEC estimated that issuers and others spent $962.4 million in printing and mailing fees to distribute proxy materials during the 2006 proxy season.[28] The SEC's Notice and Access model has been used in 1,965 distributions between July 2007 and May 2009 resulting in estimated savings of $377 million on printing and postage. Savings in the eleven month period from July 1, 2008 to May 31, 2009 alone were $234 million, equivalent to annual savings of $255 million.[29]

As to access, Internet penetration rates are currently high. As of April 2009, the Pew Internet and American Life Project reported that 79% of American adults use the internet and at least 94% of adults with household income greater than $50,000 use the Internet.[30] In addition, 63% of American adults have broadband access at home, and at least 80% of adults with household income greater than $50,000 have broadband access at home.[31]

III. Efficiency Costs

A. The Proposal would inefficiently allocate benefits and costs of proxy contests

The Proposal assumes that Rule 14a-11 will significantly reduce the costs of election contests, and that this will benefit shareholders. Both premises are mistaken. To be sure, the Proposal will facilitate a certain type of contest in which activist shareholders place nominees on the

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[27] SEC Release No. 34-56135, p. 11

[28] *Id.*, p. 38.

[29] Broadbridge, "Notice and Access: Statistical Overview of Use with Beneficial Shareholders as of May 31, 2009," http://www.broadridge.com/notice-and-access/, p. 11.

[30] Pew Internet & American Life Project, "Demographics of Internet Users," http://www.pewinternet.org/Static-Pages/Trend-Data/Whos-Online.aspx.

[31] Pew Internet & American Life Project, "Home Broadband Adoption 2009," June 2009, p. 14.

company proxy with no serious intent of campaigning for their election, but nonetheless impose significant costs on fellow shareholders. However, institutional investors that do have a serious intent to propose and elect alternate candidates will not realize significant cost savings from the Proposal. The Proposal will therefore impose unnecessary costs on fellow shareholders and will be less efficient than available alternatives.

1. Reducing costs to minimal levels will lead to excessive nominations

Under the Proposal, companies would be required to incur the cost of placing shareholder nominees in proxy materials. The proposed rule offers a benefit to the particular subgroup of shareholders who succeed in placing their chosen candidate on a company's board —a closely aligned board member and (presumably) improved information access—yet they will bear only a fraction of the costs. Effectively, companies will subsidize shareholders' costs of nominating directors. It is a well-known result in economic theory that when the marginal social cost of an activity exceeds its marginal private cost, as is the case with any subsidy, more of that activity will take place.[32] In the case of the proposed SEC rule, the marginal social cost of a shareholder nominating a director is higher than the marginal private cost because the costs of the contested election are borne in part by the issuer, rather than the nominating shareholder. This subsidy will inevitably increase the number of director nominations by shareholders.

As explained below, even if the company bears the costs of printing and postage under the Proposal, a pragmatic shareholder determined to get its candidate elected is likely to expend resources to improve its candidate's odds of being elected. (Those resources are far from prohibitive.) However, under the SEC's proposal, eligible shareholders would be able to nominate a candidate for a corporate board without campaigning for his election. The only cost would be that of identifying a candidate, and if the candidate is affiliated with the nominating shareholder, such as a partner of a hedge fund, these costs would be truly trivial. Any additional expenditures on advertising, public relations, legal fees or proxy solicitations would be optional. Although the likelihood of successful election will not be high in the absence of a concerted campaign, management and the incumbent board cannot assume the success of their chosen candidate and therefore will be compelled by their fiduciary responsibilities to expend great resources ensuring the candidate's defeat. (Ironically, precisely because such board candidates may be of the lowest quality, due to the proponent's low search efforts to identify a nominee, management and the incumbent board may feel compelled to devote extra efforts to assure the candidate's defeat.) Such low-cost candidacies—which involve low costs for the proponent but high costs for fellow shareholders—are particularly likely to be used by shareholders who wish to use the costs and risks to the company as leverage to obtain concessions on unrelated matters.

2. Requiring negotiation first is another superior alternative

The Proposed Election Contest Rules implicitly assume that a company and the shareholders seeking to nominate a director cannot reach a negotiated settlement. This is false: 76% of 2005

[32] See, for example: Hal R. Varian, ***Intermediate Microeconomics: A Modern Approach*** (New York: W.W. Norton & Company, 1996), pp. 565-6; Edgar K. Browning and Jacquelene M. Browning, ***Public Finance and the Price System*** (Englewood Cliffs: Prentice Hall, 1994), pp. 40-41.

- 2008 proxy contests that produced hybrid boards did so through engagement.[33] Another less costly alternative would be to require activist investors who want to place people on corporate boards to recommend candidates to the company's nominating committee. Many companies already have a process in place for shareholders to do this. This would mean that only if a candidate is rejected inappropriately would there be the necessity and expense of having an election.

B. Shareholder nominees will impair quality of boards

The Commission's Proposal rests on the premise that facilitating the election of dissident directors is largely an unadulterated good. For multiple reasons, that premise is mistaken.

1. Companies with dissident board members substantially underperform compared to their peers.

Several empirical studies establish that when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest. These findings are highly relevant to any cost-benefit analysis of the SEC Proposal because this data strongly suggests that directors who win seats pursuant to the new rule will in fact weaken, rather than strengthen, share prices in U.S. public companies. Thus, implementation of the rule likely will hurt U.S. shareholders and undermine the ability of U.S. companies to raise capital. Ikenberry and Lakonishok (1993) find a negative and statistically significant cumulative abnormal return (CAR) of -18.3%, relative to all companies of similar size trading on the NYSE and AMEX, in the 24 months following proxy contests at 97 firms from 1968 to 1987. This negative return, relative to a company's peers, is driven by cases where dissidents gain control of board seats: when dissidents gain at least one board seat, the 24-month CAR is -32.6%, and when dissidents gain the majority of a board's seats, this figure is -40.8%. Negative and statistically significant CARs are also found for 12- and 36-month periods for companies when at least one dissident joins the board.[34] In cases where dissidents do not gain any board seats, the CAR is small (-1.7%) and statistically insignificant.[35] Borstadt and Zwirlein (1992) study proxy contests from July 1962 to January 1978; when dissidents win, they find a negative and statistically significant CAR of -22.8% for the 24 months following the resolution of the contest.[36] Looking at 185 threatened proxy contests at NYSE- and AMEX-listed firms between 1977 and 1988, Fleming (1995) similarly finds negative and statistically significant returns of -19.4% in the 24 months

[33] IRRC Institute, "Effectiveness of Hybrid Boards," May 2009, p. 13.

[34] Where dissidents gain one or more board seat, the returns are -17.2% in the 12 months post-announcement and -36.2% for the 36 months post-announcement, both statistically significant at the 5% level. Where dissidents gain control, the 12 and 36 month returns are -22.0% and -40.9%, respectively.

[35] David Ikenberry and Josef Lakonishok, "Corporate Governance through the Proxy Contest. Evidence and Implications," *Journal of Business*, Vol. 66, No. 3, 1993, p. 420. See p. 410 for details on the methodology used to calculate CAR.

[36] CARs for proxy contests when dissidents win and there is no subsequent takeover. Returns are also negative over 12 and 36 month periods, but are statistically insignificant. Lisa Borstadt and Thomas Zwirlein, "The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance," *Financial Management*, Autumn 1992, p. 28.

following the announcement of a contested election for the 27 firms where dissidents win board seats.[37,38]

The Commission will have to come to terms with this substantial literature when determining the Proposal's effects on efficiency, competition and capital formation.

2. Board skill composition will be adversely affected

One of the most significant risks presented by the Proposal is that shareholder nominees will impede companies from achieving the skill and experience balances they need for their boards to function effectively. Unlike activist shareholders, whose interest is gaining board seats for like-minded people, in this age of specialization, boards of directors are required to determine the unique attributes and strengths of a company's existing management team and incumbent board members. Boards take these characteristics into consideration when nominating board candidates in order to insure a balanced and effective board that can respond to all of the challenges that the company might face after the election. Examples of critical expertise needs would be the minimum three independent board members with financial literacy required to staff the audit committees of NYSE-listed companies,[39] risk management expertise to serve on the risk management committee of a financial firm, marketing expertise, experience in international trade, or mergers and acquisitions or technology to serve on the boards of technology and non-technology companies. Whereas companies consider the entire board composition in selecting board nominees, shareholders often will lack the knowledge or the capacity to do this. Moreover, unlike boards of directors, activist shareholders, who owe no duties to anybody but themselves, may select nominees with vastly different objectives and agendas than other shareholders. In particular, activists will recruit nominees likely to support the nominating activist shareholder's particular, issue-specific agenda. This is likely to lead to numerous acute problems as a practical matter. For example, if a company's financially-literate nominee lost to a shareholder nominee, the company might be unable to staff its audit committee. If a nominee with a particular skill set were replaced by an activist's nominee, the company might not be as successful in achieving its objectives as it might otherwise have been.

Ultimately it will fall to voting shareholders to select the candidates with the experience needed to fill out the board. Yet, academic studies have recognized that shareholders have little incentive to carefully weigh their proxy contest choices and, as a result, inferior candidates may win. Shareholders who only own a small stake in the company will experience little wealth effect

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[37] Michael Fleming, "New Evidence on the Effectiveness of the Proxy Mechanism," Federal Reserve Bank of New York Research Paper No. 9503, March 1995, p. 17 and Table 1.

[38] Although other studies have found positive relative returns in companies with hybrid boards, those findings have not been statistically significant. See J. Harold Mulherin and Annette B. Poulsen, "Proxy contests and corporate change: implications for shareholder wealth," *Journal of Financial Economics* 47 (1998), pp. 279-313; IRRC Institute, "Effectiveness of Hybrid Boards," May 2009.

[39] NYSE Listed Company Manual, Section 303A.07.

even if the outcome of the contest affects shareholder value and will consider it unlikely that their few votes will affect the outcome of the contest.[40]

For these reasons, it is unrealistic to expect that voting shareholders will effectively assesses and weigh the skill and experience mix of the current board and the skills of proposed board candidates, the skills needed on the board (including technical requirements such as audit committee membership, technology or industry expertise), and incorporate that understanding into their voting.

3. Shareholders will nominate candidates to advance agendas at odds with shareholder value

An underlying, and unrealistic, assumption of the SEC's proposal is that shareholders will nominate qualified board candidates who will work collegially (or at least effectively) and contribute positively to management and shareholder value. In fact, institutional shareholders' incentives to put forth their own director candidate are not necessarily aligned with improving corporate governance, management or shareholder value. As such, they may not be aligned with the incentives of individual shareholders, nor with other types of institutional shareholders. The shareholders most likely to nominate director candidates are those who are most commonly activist: hedge funds, union benefit plans and public pension plans, all of which have a history of using proxy fights to pursue agendas other than shareholder value. If nominating a candidate has minimal cost, it is likely that they will put forth candidates at every election.[41]

Most companies with market capitalization of $75 million or more have multiple union and hedge fund shareholders. Approximately 36% of companies with market capitalization of $700 million or more have at least one hedge fund shareholder with a qualifying stake. Approximately 8% of such companies have at least one qualifying union-related or public pension fund shareholder, although this is likely an understatement as union holdings may be filed under their hired asset managers and may hold the same stock through multiple managers.[42]

Whatever the defects of the current system, current boards of directors are obligated to nominate directors who they believe will act in the best interests of the company and its shareholders to maximize long-term value creation. Investors, however, will not be obligated to do so—and may have incentives to do otherwise based on their particular agenda.

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[40] Lucien Arye Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests," *California Law Review* (1990), Vol. 78, p. 1080.

[41] Mutual fund and other asset managers frequently follow proxy advisory services, such as the RiskMetrics Group and Glass Lewis & Co., to satisfy their legal obligation to vote on behalf of their investors in an informed manner. Leo E. Strine, Jr., "Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America," 119 Harvard Law Review (2006), p. 1765. If the Proposed Election Contest Rules are put in place, such proxy advisory services will have enhanced power. It is at least possible that they would expand their services to recommending director candidates for qualifying shareholders to nominate, either individually or jointly.

[42] For companies with market capitalization of at least $700 million, a shareholder with a qualifying stake must have held at least a 1% stake at every quarter-end over the year from March 31, 2008 to March 31, 2009.

a. Hedge Funds

Hedge funds have possible perverse incentives as they may have a qualifying stake in the company yet have other positions, including derivative positions, which could cause them to profit if the company stock falls in value. In the case of *CSX Corporation v. Children's Investment Fund Management (UK) LLP*, the Children's Investment Fund was long up to 8.8% of CSX stock via total return swaps.[43] However, a hedge fund could equally well establish a qualifying long position in common stock, yet be net short the company via a larger position in total return swaps. For example, a hedge fund could have a qualifying 1% stake in a company with market capitalization of $700 million or more yet a short position equivalent to 2% via total return swaps for a net short exposure of 1% of market capitalization. Such a fund would have an incentive to put forth director candidates who would disrupt the board and pressure the company to take measures that would undermine shareholder value. The Commission's proposal includes no incentives or enforcement mechanism to prevent hedge funds from nominating directors intended to undermine share value such that they may profit via net short positions, nor even any means to determine the total position of shareholders with qualifying common equity stakes.

b. Union and public employee benefit plans

Union benefit plans have used elections to advance labor agendas, sponsoring, for example, withhold votes for board chairs to punish them for not granting concessions in ongoing collective bargaining. Agrawal (2008) finds that "AFL-CIO affiliated shareholders vote against directors partly to support union worker interests rather than increase shareholder value alone."[44] Examining the split of the AFL-CIO in 2005, Agrawal found that AFL-CIO funds were statistically significantly more likely to support director nominees at a corporation after the AFL-CIO ceased to represent that company's workers. Furthermore, AFL-CIO funds are statistically more significantly likely to vote against directors at firms with greater frequencies of conflict between labor and management.[45]

Public employee benefit plans have exhibited similar activism, sometimes joining forces, as in the 2004 challenge to Safeway management. In March 2004, five California public employee pension funds collaborated to launch a "vote no" campaign against three Safeway directors including Chairman/CEO Stephen Burd. The effort was concurrent with a major strike by Safeway employees in Southern California. In May, prior to board elections taking place, Safeway agreed to replace three directors, but retained Mr. Burd.[46]

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[43] *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, 562 F.Supp.2d 511, p. 15.

[44] Ashwini Agrawal, "Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting," Working Paper, September 2008, p. 1.

[45] *Id.*

[46] Joan Lublin and Janet Adamy, "Safeway CEO is Challenged by Dissident Holders," *The Wall Street Journal*, March 25, 2005; Janet Adamy, "Safeway to Replace Three Directors --- Pension Funds' Criticism is Driving Force for Move; Lead Director to be Named," *The Wall Street Journal*, May 3, 2004.

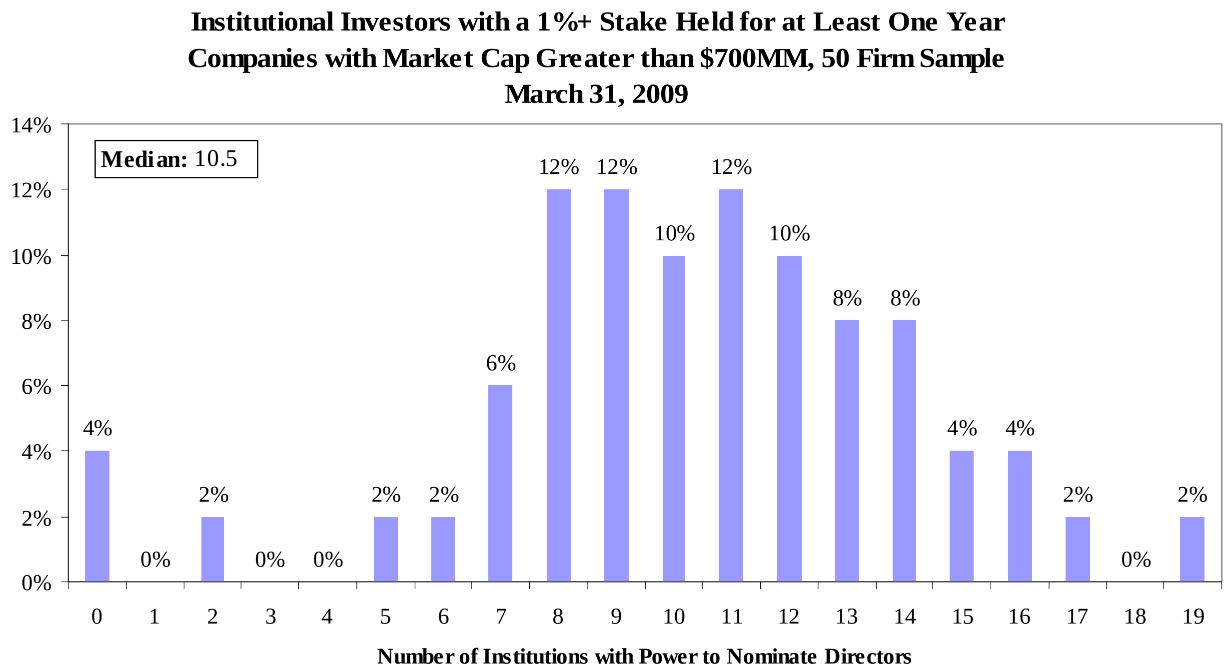
4. The Proposal's first-come, first-served rule will fail to select the best-qualified shareholder nominee

The SEC's proposed requirement that companies use a first-come, first-served process to place director candidates on the ballot, if multiple eligible shareholders submit director nominees, could place the least qualified of numerous shareholder nominees on the ballot and, ultimately, on the board. Whereas the SEC has focused on the percentage of companies with at least one eligible shareholder, or with a pair of shareholders who would be jointly eligible, it is important to recognize that many companies have five, ten or more eligible shareholders. This sets up a potential competition (or race) among shareholders to name their own nominee. If there is little cost to naming one's own candidate, it will be rational for eligible shareholders to nominate a candidate or candidates who are best aligned with their own, possibly narrow interests.

There is every reason to expect a race for eligible shareholders to get their nominees in, especially for larger companies. As of March 31, 2009, we find that companies with market capitalization of $700 million or more have a median of 10.5 shareholders eligible to nominate directors, based on a 50 company sample using the dual criteria of a 1% minimum stake held for at least one year.[47] Figure 2 shows the distribution of the number of eligible shareholders based on a 50-firm sample. Considering the possibility of smaller shareholders cooperating to put forth nominations based on their aggregate holdings, the number of potential nominations rises even higher. Companies with market capitalization of $700 million or more have a median of seven shareholders with stakes of at least 0.5% but less than 1%, based on the same 50 firm sample.

[47] 50 firms were randomly sampled from the set of all U.S. domiciled companies with market capitalization greater than $700 million traded publicly on major U.S. exchanges, obtained from FactSet Research Systems, Inc.

Figure 2



Notes and Sources

Institutional holdings from Factset Research Systems Inc. and SEC filings where unavailable.

Shares Outstanding data are from Bloomberg, LP.

If the first-come, first-served rule takes the form of a company opening nominations at a fixed time, it will be little different than attempting to be the first caller to a radio station to win a prize. Effectively, it would be random or at least not substantive: the first email to arrive at 9 a.m. on a particular date or the first of messengers sent to queue at company offices in the wee hours of the date in question.

The number of shareholder nominees would be limited to no more than one or the number that represents 25% of the company's board of directors, whichever is greater.[48] Allowing the first-in shareholder to nominate up to the maximum nominees, where that exceeds one, would only exacerbate the problem.

While eligible shareholders could in principle resolve the race to nominate by coordinating to select a single candidate, it is not apparent that different types of institutional shareholders with different objectives would be able to agree on a candidate. As noted, institutional shareholders fall into diverse categories including hedge funds and union and public pension funds. Past examples of cooperation have generally involved similar shareholders, although there have been

[48] It is not clear how the SEC would propose to resolve a situation where 25% of the board exceeds the number of independent directors up for election. Consider, for example, a 20 person board with 40% independent directors (8) and half of those elected each year (4 directors) or 20%.

instances of collaboration by different types of shareholders such as the case of Take-Two Interactive Software, Inc., in which a mutual fund collaborated with three hedge funds.[49]

5. Higher share ownership thresholds for nomination would mitigate incentive problems and negative effects on board quality

The SEC could better align the incentives of qualifying shareholders with other shareholders by setting higher ownership thresholds. By allowing nominations only by larger stakeholders, it would reduce the odds that shareholders would make nominations to advance agendas contrary to shareholder wealth maximization, as any negative impact on share price would be more costly to the nominating shareholder. This would be effective with shareholders with long positions, including union benefit and public pension plans. It would also make it more costly for any hedge fund to establish a qualifying stake and a net short position, then use the qualifying stake to try to bring about a fall in the company's stock price.

Large companies have a number of shareholders that can meet higher thresholds. Of the top 50 companies by market capitalization, on average, the top five shareholders jointly have an 18.4% stake (average of 3.68% each) and the top 10 jointly a 26.7% stake (average of 2.67% each). (See Appendix Exhibit 1.)

C. The Proposal does not distinguish between the issues associated with expressing disapproval of an incumbent director and the issues associated with identifying, nominating, legitimating, and electing an outside insurgent director

It is important to recognize the vast difference between the relatively straightforward issues involved when shareholders simply express their disapproval of existing directors and the vastly more complex issues involved in identifying, recruiting, nominating, legitimating, and electing a new director or slate of directors. Voting against or withholding votes from, or otherwise expressing disapproval of, an incumbent director presents few analytical problems.[50] Replacing directors involves the extremely challenging problem of identifying and recruiting replacement directors whom the majority of shareholders will be familiar with, much less trust. It may be the case that commentators such as Bebchuk are correct when they assert that directors should be voted out of office more often than they are. A default rule requiring some form of majority voting, would accomplish this result.

But the SEC's proposal goes well beyond simply enhancing the ability of shareholders to express their dissatisfaction with one or more incumbent directors. The SEC's proposal envisions contested elections, which will require not merely the expression of dissatisfaction with an incumbent, but the identification, recruitment, legitimization, nomination and election of entirely

[49] Adam J. Kansler and Leila Zahedani, "Winning Without a Fight: Steps for Activist Shareholders to Change Management," *The Metropolitan Corporate Counsel*, June 2007.

[50] For example, in March 2004, Michael Eisner was stripped of his post as chairman of Disney Corporation when forty-three percent of Disney shareholders withheld their votes from the embattled Disney chair, resulting in a decision by the Disney board to split the posts of board chair and CEO. See Michael McCarthy, Disney Strips Chairmanship from Eisner, USA Today, Mar. 4, 2004, at B1.

new candidate-directors. The SEC ignores two problems with the process of nominating and electing new directors, rather than merely expressing dissatisfaction with incumbent board members. First, the SEC provides no explanation for how outside challengers to incumbent boards are to be identified and recruited. Second, even if such directors can be identified and recruited, the SEC provides no guidance on the crucial question of how outside challengers for board positions will be able to send a credible signal to shareholders and other corporate constituencies that they will be faithful corporate stewards, much less that they will be able to outperform a company's incumbent directors.

As for the recruitment problem, it is not easy to find able, experienced, and competent people who are eager to become directors of public companies. In the political context, democracies have a highly developed system in which two or more political parties recruit, screen, and legitimize potential nominees for political office. There is no analogous process for corporate elections, and it is not obvious how one could be created. Rival board candidates compete along vectors such as competence, experience, and integrity, as well as along vectors such as ideology, interest-group identification, and loyalty. As such, it is far from clear what, if any, signaling function might be played by rival parties who nominate candidates in corporate elections.

The role of corporate director is both more time consuming and more risky than ever before. Presumably adoption of the SEC's proposal would not change this trend. We further presume that the SEC would not wish for directors to be less accountable, either to regulators and shareholders, than they currently are. Even at present, a significant number, perhaps as many as half of all prospects, decline offers to serve on boards, even when such offers are made by the companies, not by insurgents.[51] The SEC's proposal appears to assume away the acute problems of identifying, recruiting, and performing due diligence for potential challengers to incumbent directors.

Moreover, even to the extent that outside shareholder activists are able to locate challengers for board incumbents, it is far from clear how to make such challengers credible candidates for office. Corporate elections are plagued by a variety of collective action and signaling problems. Challengers in proxy contests have a difficult time signaling credibly to shareholders that they are seeking to displace the incumbent directors because they are better managers, rather than for more nefarious reasons.

Bebchuk (2007) generally recognizes the existence of these sorts of problems when he writes that:

> [S]hareholders cannot infer from a rival team's mounting a challenge that the rival directors would perform better. To begin with, even a rival team that believes it will perform better may be acting out of hubris. Furthermore, and very important, a rival's decision to mount a challenge does not even imply that the rival itself

[51] See Key Considerations for Serving on a Board of Directors, 2 Advantage (RSM McGladrey, Minneapolis, Minn.), Jan. 2006, http://advantage.hanleywood.com/default.aspx?page=article236.

> believes it will perform better. After all, a challenge could be motivated instead by a desire to obtain the private benefits associated with control.[52]

The SEC's Proposal will exacerbate, not mitigate, the credibility problems facing challengers. Rational shareholders will understand that if the SEC's reimbursement proposal is implemented, challengers will internalize an even smaller share of the costs of mounting a proxy contest for control, but will internalize the same benefits. This, in turn, will provide less-qualified, lower-probability candidates with greater incentives to run, particularly since those candidates with the lowest opportunity costs to their time and effort will benefit most by the prospect of having the company bear part of their election expenses.

D. Companies will incur additional efficiency costs to evaluate shareholder-nominated candidates

If shareholder nominees are included on the ballot in many elections, which we believe to be a likely outcome, companies will incur the costs now associated with a proxy contest far more frequently than they do now, when less than 1% of elections involve proxy battles.[53] The Commission's assertion that companies will be able to vet outside candidates in only 20 hours is unrealistic.[54] A survey of Business Roundtable companies estimates that the inclusion of a shareholder nominee will cost a company approximately $1,160,000 for the services of outside professionals, as well as approximately 300 hours of company personnel and director time.[55]

As mentioned above, shareholders will not have the same obligation as current directors to nominate directors who will maximize shareholder value, and may have incentives to nominate directors who will pursue agendas contrary to shareholder value. This risk imposes an obligation on companies to do thorough due diligence on shareholder nominees and, in the exercise of their fiduciary responsibilities, to vigorously oppose candidates whom they consider less qualified than the board nominee. The SEC's proposal not only fails to adequately account for the cost resulting from vetting and opposing candidates, but it also fails to account for the costs associated with litigation against new directors for acting in ways contrary to the company's interests.

In addition to the disruption to management and boards of contested elections and the associated costs to the company, additional disruptions may come from qualifying shareholders' ability to use the threat of nomination to extract concessions or private benefits from management. Indeed, this likely will be among the most frequent uses of the power: A meeting with management or board representatives in which the institutional investor communicates that if certain things are not done (e.g., a labor dispute resolved, or a contract with a union company

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[52] Lucian A. Bebchuk, "The Myth of the Shareholder Franchise," 93 Va. L. Rev. 675, 106 (2007).

[53] See III.B.4 for calculation of less than 1%.

[54] SEC Release No. 33-9046, p. 97.

[55] Business Roundtable, "Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rules of the U.S. Securities and Exchange Commission," August 17, 2009, p. 110.

signed), then they will run an alternative candidate (at shareholder expense). Management will have to consider the relative cost of fulfilling the shareholder demand versus the costs of opposing the alternative candidate. Because qualifying shareholders can nominate board candidates at very little cost, any qualifying shareholder will be able to make a credible threat of nominating.

IV. The Proposal will render U.S. equity markets less competitive with foreign markets

Although the SEC states that the Proposed Election Contest Rules will improve the competitiveness of U.S. companies by improving corporate governance practices relative to other leading markets, it ignores detrimental effects on the competitiveness of U.S. capital markets. As has been widely discussed since the passage of the Sarbanes-Oxley Act in 2002, the market share and competitiveness of U.S. capital markets have deteriorated markedly since the 1980s.

Holding constant the current merits of listing in the U.S. and overseas, the Proposed Election Contest Rules would be an added negative for U.S. markets. Even if other countries currently have similar rules for director nominations, this is an incremental cost to listing in the U.S. To the extent that it slows growth of U.S. equity markets relative to foreign markets, it will reduce the relative liquidity of U.S. markets, making them yet less competitive. Ironically, because the Proposal would apply only to companies subject to the proxy rules, it would be a greater deterrent to listing in the U.S. for American companies than for foreign companies.

A. U.S. equity market competitiveness has already been impaired by high regulatory costs.

By any measure, the U.S. share of equity listings has declined substantially in recent years. The 2006 report of the Interim Committee on Capital Markets stated, "[T]he United States is losing its leading competitive position compared to stock markets and financial markets abroad. … [C]ertainly one important factor contributing to this trend is the growth of U.S. regulatory compliance costs and liability risks compared to other developed and respected market centers."[56] U.S. share of IPOs done outside a firm's home country (measured by value of IPOs) decreased from 50% in 2000 to 5% in 2005; measured by number of IPOs, the U.S. share fell from 37% in 2000 to 10% in 2005.[57] In a 2009 update, Committee Chairman Hal S. Scott stated,

> While the latest results must be cautiously interpreted in light of the global recession, the competitiveness of U.S. public equity markets appears to continue to decline. [58]

[56] "Interim Report of the Committee on Capital Markets Regulation," November 30, 2006, Introduction p. ix.

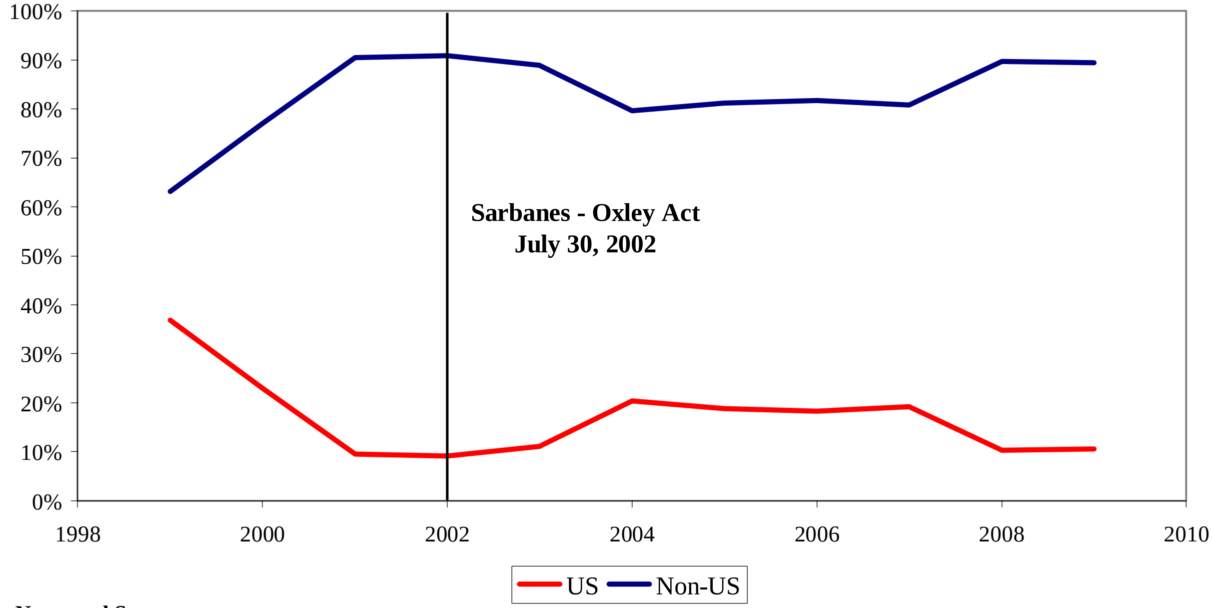
[57] "Interim Report of the Committee on Capital Markets Regulation," November 30, 2006, p. 2.

[58] Committee on Capital Markets Regulation, "First Quarter Measures Reveal Continued Decline in Competitiveness of U.S. Public Equity Markets," July 22, 2009, p. 1.

In dollar terms, the U.S. share of global IPOs fell from a 1996-2006 average of 28.7% to 6.9% in 2007 and 1.9% in 2008.[59] As shown in Figure 4 below, the U.S. share of IPOs (in number) declined from 36.9% in 1999 to 10.7% in 2008.

Figure 3

U.S. and International IPOs
1999 through 2009



Notes and Sources:
Data obtained from Bloomberg, L.P.

Other measures point to a similar, if not more severe, loss of market share:

- In 2006, nine of the 10 largest IPOs were done outside the U.S.; in 2005, the proportion is a more striking 24 of the top 25.[60] In both 2007 and 2008, none of the top 20 IPOs worldwide were done in the U.S.[61]

- A recent study of companies cross-listed in the U.S. and their home market found that the proportion of volume has reversed; whereas in the 1980s the majority of volume was traded in the U.S., by the 1990s, the preponderance of the volume had shifted to the home markets as the liquidity advantage of U.S. markets declined.[62]

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[59] *Id.*

[60] *Id.*

[61] Committee on Capital Markets Regulation, "First Quarter Measures Reveal Continued Decline in Competitiveness of U.S. Public Equity Markets," July 22, 2009, p. 2.

[62] "Interim Report of the Committee on Capital Markets Regulation," November 30, 2006, p. 3.

B. Private placement and private equity financing have grown at the expense of the public equity market

U.S. and foreign firms are increasingly relying on alternative markets to raise capital in the U.S., another sign that the balance between the public equity market and its alternatives is shifting in favor of the latter. One factor may be that companies find the increased regulatory burden of public ownership in the U.S. already outweighs any financing cost or liquidity advantage of public listing. The Proposal will add yet another cost to this equation. On balance, a shift from public to private equity markets deprives individual investors of the opportunity to invest.

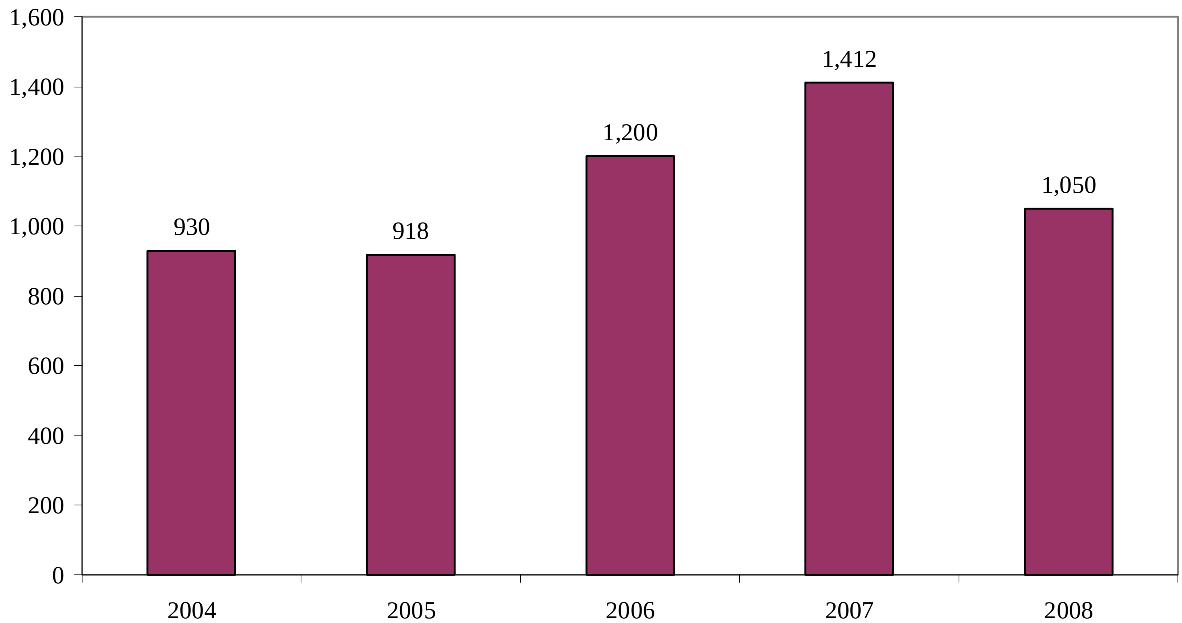
Private placements have grown to account for approximately 90% of the volume of capital raised in the U.S. by foreign companies in 2005, versus 50% in 1995. This signals foreign companies' preference to avoid the regulatory requirements associated with public listing. Rule 144A private placements allow foreign companies to raise funds from large institutional investors without subjecting themselves to most aspects of U.S. securities regulation, including avoiding all disclosure requirements, Sarbanes-Oxley Act Section 404 requirements, and liability provisions of the Securities Act of 1933.[63]

An increasing number of publicly-traded U.S. firms have opted to leave the equity markets and revert to private ownership, as shown in Figure 5. Despite the decline in 2008 associated with the credit crisis, the 2008 level remains higher than the number in 2004 or 2005.

[63] *Id.*, p.5

Figure 4

Leveraged Buyouts of North American Target Companies 2004 through 2008



Notes and Sources

Data are from Capital IQ's Monthly Market Observations, January 2009, p. 47. Figure is based on transaction announce dates and includes both closed and pending transactions as well as those without transaction values.

V. The Proposal will undermine competitiveness and capital formation at the company level

The Proposed Election Contest Rules will undermine the competitiveness of U.S. companies by burdening publicly-traded companies with the efficiency costs discussed above and, in doing so, effectively raise the cost of capital for U.S. companies. First and foremost, as discussed above, companies with dissident directors underperform their peers by 19 to 40% in the two years after the contested election. By facilitating contested elections, the Proposal is bound to result in more dissidents winning board seats.

Moreover, because the Proposal would make it more expensive to operate as a public company, public equity issuance would become relatively less attractive as a form of financing. To the extent that yet-unlisted companies choose to instead raise capital via debt or private placements, this may raise their cost of capital and impair their competitiveness. By the same token, the Proposal would make it more attractive, at the margin, to take public companies private.

In addition to the added costs of going public, the Proposal will introduce non-financial deterrents to going public that may cause company founders to prefer to keep their companies privately held. Company founders who wish to maintain their executive positions will factor in an increased risk of loss of control via shareholder-nominated directors, who may run for the board in order to change management. By the same token, founders who wish to continue to focus on their company's business will face the increased distraction of public ownership not only from increased regulatory burdens, but potential management and board distraction from dealing with contested director elections. An even greater fear will be that dissident directors will be more easily able to gain seats, be detrimental to boardroom dynamics, cause management and board efficiency losses and harm the company's returns.

By discouraging companies from participating in public equity markets, the Proposal will also discourage capital formation. Because an illiquidity premium is built into the price of debt and private equity placements, companies cannot raise as much money issuing these securities as publicly-traded stock. Public equity markets are widely considered to be the most efficient markets, in terms of stock prices reflecting all available information. Debt markets are less liquid, with transactions in corporate debt securities often infrequent; they are less likely to be efficient in that, without transactions, prices cannot immediately react to news. Markets for 144A securities are yet less liquid, with no public information on prices. The Proposal will nonetheless drive firms away from the public equity markets toward the more costly debt and private placement markets.

VI. The benefits predicted by the SEC will be at best small, and possibly prove to be costly rather than beneficial

For the Proposed Election Contest Rules to overcome the many costs laid out above, the benefits would need to be substantial. Yet the three benefits predicted by the SEC range from small to simply implausible:

(1) The SEC predicts a reduction in the cost to shareholders of soliciting votes in support of a nominated candidate for election to the board of directors. However, the SEC itself estimates that savings at only $18,000, or 2% of the estimated $1,160,000 in costs that a company would incur due to having a shareholder nominee on the ballot.[64, 65]

(2) The SEC cites improved disclosure of shareholder-nominated candidates as enhancing transparency and facilitating better informed voting decisions.[66] While transparency is always a positive, we note that even the SEC does not attempt to quantify this benefit.

(3) The SEC conjectures that board performance may be improved, either by incumbent directors working harder to retain their seats or because shareholder nominees may improve board or corporate performance. However, this report has presented substantial evidence that the Proposal is likely to impair board and company performance. Contested elections will distract boards from other company business. Insurgent victories may result

[64] SEC Release No. 33-9046, pp. 183-184.

[65] Business Roundtable, "Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rules of the U.S. Securities and Exchange Commission," August 17, 2009, p. 110.

[66] SEC Release No. 33-9046, pp. 185-186.

in boards without the right skill and experience mix. Indeed, as discussed above, a number of studies show that dissident board representation has a negative impact on company returns.

VII. Conclusion

Our accounting of the costs of the Proposed Election Contest Rules in terms of effects on efficiency, competitiveness and capital formation reveals that the costs of this Rule, if adopted, will be substantially higher than acknowledged by the SEC. These costs overwhelm the few benefits posited by the SEC, some of which will be small and others of which are simply not credible.

In order to obtain modest savings for large, activist shareholders at the less than 1% of companies that face proxy fights or negotiations over board representation in any given year, the SEC would increase dramatically the frequency of contested elections. The SEC restricted its analysis to the number of companies with one or more shareholders eligible to nominate a director candidate. We note, however, that companies with market capitalization of $700 million or more have a median of 10 eligible shareholders. Moreover, more than one-third of these shareholders fall into the traditionally activist categories of hedge funds, union benefit or public pension funds. These companies will face frequent shareholder director nominations, as well as the specter of inefficient "races" among shareholders in order to win a place on the ballot, because only the shareholder who is first to make a nomination will gain a ballot spot.

Efficiency costs ignored by the SEC include the excessive nominations that would result from a subsidized option, significant negative effects on board quality, and the substantial costs that companies and shareholders will incur in dealing with the nomination and election of board candidates with special interest agendas and goals inconsistent with the traditional goal of maximizing shareholder value. We also believe that the SEC underestimates the costs that companies will face in vetting shareholder-nominated candidates because they do not appreciate the cardinal importance to companies of properly and thoroughly vetting board nominees.

The SEC also ignores the detrimental effects of the Proposal on the competitiveness of U.S. capital markets, by ignoring the fact that subsidized proxy contests add yet another negative factor to U.S. companies' decisions about whether to go public and to foreign companies' decisions about whether to list in the U.S. or overseas.

Finally, the Proposal risks undermining the competitiveness of U.S. companies. To the extent that U.S. companies are even further discouraged from going public than they are at present, and public companies are incentivized to go private, the Rule will raise their cost of capital, render them less competitive in global markets, and discourage capital formation.

Top 50 Companies by Market Capitalization:
Percentage of Shares Outstanding Held by Top 5 and 10 Institutions
March 31, 2009

		% Of Shares Outstanding Held by Institutional Investors	
Rank	**Company**	**Top 5**	**Top 10**
(1)	**(2)**	**(3)**	**(4)**
		--------------%--------------	
1	Exxon Mobil Corp.	14.1	19.2
2	Wal-Mart Stores Inc.	9.1	12.8
3	Microsoft Corp.	15.7	21.8
4	AT&T Inc.	17.2	24.4
5	Johnson & Johnson	15.9	21.7
6	Procter & Gamble Co.	17.0	22.0
7	Chevron Corp.	17.6	24.2
8	Berkshire Hathaway Inc.	7.6	9.9
9	International Business Machines Corp.	15.8	21.7
10	Google Inc.	17.3	25.8
11	General Electric Co.	13.7	18.7
12	Coca-Cola Co.	22.0	30.8
13	JPMorgan Chase & Co.	18.3	26.1
14	Apple Inc.	17.9	27.6
15	Pfizer Inc.	16.1	23.4
16	Cisco Systems Inc.	17.6	24.9
17	PepsiCo Inc.	14.9	21.1
18	Intel Corp.	15.9	22.2
19	Verizon Communications Inc.	19.7	26.7
20	Hewlett-Packard Co.	18.8	28.5
21	Oracle Corp.	17.1	24.7
22	Abbott Laboratories	15.4	23.1
23	Philip Morris International Inc.	21.1	29.4
24	QUALCOMM Inc.	17.8	27.3
25	Wells Fargo & Co.	23.7	34.5
26	McDonald's Corp.	22.3	31.0
27	ConocoPhillips	18.9	28.0
28	Wyeth	18.0	28.9
29	Merck & Co. Inc.	21.7	33.4
30	Visa Inc.	10.4	14.7
31	Goldman Sachs Group Inc.	20.1	31.1
32	Amgen Inc.	19.0	29.7
33	United Parcel Service Inc.	17.8	24.2
34	Schlumberger Ltd.	19.6	33.6
35	Occidental Petroleum Corp.	19.2	32.1
36	Bank of America Corp.	16.3	21.4
37	Bristol-Myers Squibb Co.	18.4	29.0
38	Gilead Sciences Inc.	23.2	38.0
39	Monsanto Co.	18.6	29.2
40	United Technologies Corp.	27.7	37.3

APPENDIX TABLE 1

Top 50 Companies by Market Capitalization:
Percentage of Shares Outstanding Held by Top 5 and 10 Institutions
March 31, 2009

Rank	Company	% Of Shares Outstanding Held by Institutional Investors: Top 5	Top 10
(1)	(2)	(3)	(4)
		-------------%	-------------
41	CVS Caremark Corp.	17.6	27.5
42	Comcast Corp.	17.7	24.6
43	Kraft Foods Inc.	22.2	27.8
44	Eli Lilly & Co.	33.5	44.6
45	Schering-Plough Corp.	25.4	36.9
46	Home Depot Inc.	17.9	27.6
47	Medtronic Inc.	21.4	33.1
48	3M Co.	19.3	25.8
49	Walt Disney Co.	18.3	27.7
50	Altria Group Inc.	16.5	24.8
	Average	18.4	26.7

Notes and Sources:

Institutional holdings data from Factset Research Systems, Inc. Shares outstanding data from Bloomberg, L.P. and SEC filings where unavailable.

NERA
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Business Roundtable

NACD National Association of Corporate Directors

niri

THE STA SECURITIES TRANSFER ASSOCIATION, INC.

SOCIETY OF CORPORATE SECRETARIES & GOVERNANCE PROFESSIONALS

COALITION VIEWS ON SHAREHOLDER COMMUNICATIONS

The time has come for the U.S. Securities and Exchange Commission ("SEC") to conduct a comprehensive evaluation of the existing shareholder communications system, which is cumbersome, circuitous, and overly expensive. New regulatory requirements and increasing shareholder activism have elevated the need for public companies to communicate more effectively with their shareholders. Moreover, advances in technology not only provide the opportunity for enhanced communication and efficiency in the proxy process, but also facilitate the decoupling of shareholder voting rights from shareholder economic interests. These developments must be addressed to protect the integrity of our corporate governance system.

The "Street Name" System

More than 75 percent of all public companies' shares are held in "street name," meaning that the actual shareholders are primarily brokers, banks, and other financial institutions. These third-party intermediaries hold a company's shares on behalf of their clients, the individual beneficial owners. Under state corporation laws, only the shareholder of record is provided the right to vote, as the "legal" owner of the shares. The voting rights of these third-party record holders are not passed on via proxy to their customers; instead, these financial intermediaries retain the right to vote the shares. Under SEC and stock exchange rules, brokers and banks or their agents deliver proxy materials to beneficial owners and request voting instructions. If voting instructions are not returned, brokers may vote on "routine" matters, where instructions have not been received 10 days before the meeting.

The "street name" system of share ownership was developed to enable securities transactions to be processed and cleared more efficiently. However, the shareholder voting process has been permitted to evolve in piecemeal fashion over many years. The current system is a complicated and multi-layered process routed primarily through financial intermediaries that are not the economic owners of corporate shares. The involvement of these third-party intermediaries increases the complexity and cost of processing proxy materials and tabulating votes. It also makes it more difficult for companies to communicate with the beneficial owners of their shares.

The Barriers between Public Companies and Their Beneficial Owners

As noted above, a resulting complication of street name registration is that public companies do not know the retail investors who are the beneficial owners of their shares.

Under rules adopted in the mid-1980's, brokers and banks are permitted to classify beneficial owners as either Non-Objecting Beneficial Owners ("NOBOs") or Objecting Beneficial Owners ("OBOs"), based on indications by the beneficial owners at that time or account opening. Public companies are not able to communicate directly with their OBO beneficial owners and communication with even NOBOs is expensive and not permitted with respect to proxy materials. Thus, the proxy process is oriented more to the efficiency interests of brokers and banks than to encouraging effective and efficient communication between companies and their shareholders.

The Lack of Competition in Proxy Processing Services

The overwhelming majority of brokers and banks have contracted out the processes of distributing proxy materials and tabulating votes to one company, Broadridge Financial Solutions. Brokers and banks accomplish this by transferring their proxy voting authority to Broadridge, which then mails proxy statements and voting instruction forms to beneficial owners. Broadridge does not transmit actual "proxies" to beneficial owners; instead it requests voting instructions from beneficial owners, while retaining the legal right to vote the shares. Pursuant to SEC and New York Stock Exchange ("NYSE") rules, companies are required to pay for the "reasonable expenses" of transmitting proxy materials at rates set by the NYSE. In other words, companies are required to pay for this service, even though they have no choice as to the service provider, nor any ability to negotiate fees with the service provider.

Share Lending Practices, Decoupling of Ownership and Proxy Voting Integrity

The problems with the current proxy voting system are exacerbated by share lending practices that may cause an "over vote," i.e., the receipt of more voting instructions than are in a financial institution's position, or other reconciliation problems in counting shares. Brokers and other financial institutions use different methodologies to address share reconciliation and tabulation issues. The result is that some shares may be voted multiple times and others not at all. What shares are counted and how they are counted need to be based on a uniform methodology that ensures accuracy, fairness, and democratic principles. Share lending agreements also generally assign voting rights to the borrower of the shares, causing a circumstance in which the person voting the shares may have little or no economic interest in the company. This so-called "empty voting" problem, in which investors have greater voting than economic ownership, arises from the ability of investors to use swaps and other equity derivatives to decouple voting rights from economic interests. And, under current SEC disclosure rules, investors often are able to avoid public disclosure of their enhanced voting power.

The Role of Proxy Advisory Services

A final problem with the shareholder communications system involves the role of proxy advisory services. These advisory services are able to wield enormous influence in corporate elections, but they are not subject to any disclosures or oversight with respect to their ability to control the outcome of a vote. Some advisory services also have an inherent conflict of interest in the voting process because they also provide related consulting services, such as corporate governance ratings, corporate governance advice, and other research services, in addition to providing voting recommendations on shareholder proposals submitted by their clients.

Recommendations for Reform

Communications between companies and their shareholders are an essential component of corporate governance. With increasing shareholder activism and focus on the proxy voting process, public companies need to be able to quickly, efficiently, and cost-effectively communicate with all of their shareholders, including beneficial owners of their securities held in "street" or nominee name. In addition, enhanced disclosure of ownership interests is necessary to address the decoupling of voting and economic interests.

The proxy voting process in use today was created prior to recent advances in computer technology, including the modernization of the stock transfer system and the creation of the Internet. A reformed shareholder communications system should make use of these advances to facilitate more efficient communications between companies and their beneficial owners.

For all the reasons noted above, the SEC should initiate a comprehensive evaluation of the shareholder communications process. This evaluation should include the following principles and recommendations:

1. Direct Communications with Individual Investors. The SEC should eliminate the NOBO/OBO distinction thereby giving companies access to contact information for all of their beneficial owners and permit companies to communicate with them directly.[1] Shareholders desiring to remain anonymous should bear the cost of maintaining their privacy, such as through the establishment of nominee accounts.

2. Voting By Retail Investors. The SEC should examine how to protect the vote of the retail investor, particularly in the case of unvoted shares. Institutional investors generally vote 100% of the time, in response to their legal responsibilities and facilitated by electronic systems. They also are aided, as noted above, by proxy advisory services. Retail investors have no similar voting facilitators or proxy advisory services, and, in fact, often have no motivation to vote their shares. Among the alternatives that the SEC should consider to protect the interests of retail investors are: (a) pass through of voting rights directly to beneficial owners; (b) proportional voting; and (c) client directed voting.

3. Competition among Proxy Service Providers. Brokers, banks, and other intermediaries should not stand in the way of direct communications between companies and the beneficial owners of their securities. Companies should have the ability to determine the distributors of their communications, and should not be forced to pay for

[1] Any improvements to companies' ability to identify and communicate with their shareholders should also be available to shareholders wishing to communicate with other shareholders.

the costs of a system in which the fees and the service providers are determined by third parties.

4. Proxy Voting Integrity. The SEC should consider additional steps to ensure that the proxy voting system is transparent and verifiable. In this regard, the SEC should examine its ownership disclosure requirements and consider requiring disclosure of both voting and economic ownership along with both positive and negative economic ownership.

5. Proxy Advisory Services. The SEC should review the role of proxy advisory services and the procedures used by these firms in generating recommendations.

Council of Institutional Investors
The Voice of Corporate Governance

The OBO/NOBO Distinction in Beneficial Ownership:

Implications for Shareowner Communications and Voting

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This white paper was commissioned by the Council of Institutional Investors to educate its members, policymakers and the general public about the OBO/NOBO distinction in beneficial ownership and the implications for investors of potential changes to that system. The views and opinions expressed in the paper do not necessarily represent the views or opinions of Council members, board of directors or staff.

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Executive Summary

Recent developments increase the likelihood of more meaningful, and contested, shareowner votes and the importance of shareowner communications. Shareowner voting and communications depend on both state and federal law. State law focuses on record ownership (i.e., the holder, whether or not the ultimate shareowner, shown on a company's books), whereas federal law reflects the interests of beneficial owners (i.e., the ultimate shareowners) in voting and receiving disclosure.

Under Securities and Exchange Commission (SEC) rules, companies mainly communicate with beneficial owners through broker or bank intermediaries. Intermediaries are prohibited from disclosing to a company the identity of beneficial owners who object to that disclosure (objecting beneficial owners or OBOs), and the company cannot contact OBOs directly. The company may contact directly shareowners who do not object (non-objecting beneficial owners or NOBOs), but SEC rules nonetheless require that proxy materials be forwarded to them by the intermediaries. The OBO/NOBO distinction impedes company communications with beneficial owners and communications among shareowners. Some market participants have proposed changes to this framework. The interests of the key players vary:

- Companies tend to favor the elimination of the OBO/NOBO distinction. They argue that, if shareowners can participate more directly in board elections through proxy access or other means, companies should be able to contact them directly. They also argue that a direct communication framework would increase shareowner participation and reduce costs.
- Shareowners are often said to have a privacy interest that is served by the current framework, but a 2006 survey casts doubt on this assertion. It is also unclear which information shareowners wish to keep private and from whom. Some may wish to keep their holdings or trading strategies confidential, while others seek to avoid unwanted solicitations. Shareowners seek to have unimpeded ability to communicate among the shareowner community. Shareowners also seek a level playing field with companies — to have equal access to lists of shareowners and to have their solicitation costs reimbursed as are those of management.
- Brokers and banks have several interests — maintaining the confidentiality of customer lists, preserving fee income derived from forwarding proxy materials, and preserving stock loan revenues, which could be at risk in a direct communications framework that allows greater transparency to customers about stock loan practices.
- Broadridge Financial Solutions is essentially the sole agent for intermediaries and companies and has an interest in preserving the fee income and cost reimbursements it receives under the current framework.

The SEC is likely to be cautious in seeking to change the current framework in significant ways, at least in the near term. Defining the objective is critical to developing a proposal. If the goal is to increase the ability of shareowners and companies to communicate directly, a number of incremental steps may be taken to address the OBO/NOBO distinction and facilitate direct distribution of proxy materials, without discarding the current distribution platform. Such an approach could lead to meaningful improvements, without seriously affecting the interests of many of the participants in the current framework, and we believe it has a greater chance of widespread support than more radical alternatives.

A more ambitious goal to ensure more reliable voting seems difficult to achieve without a direct communications framework with cascading executed proxies. This approach would, however, almost certainly be more contentious, since it would implicate complex strategic, cost, logistical and other considerations of critical importance to key players. Its practical benefits are also uncertain because they are likely to be limited to a minority of contested elections in which an end-to-end audit of the vote is critical to a reliable outcome. We also believe that this approach requires more detailed analysis by the various affected constituencies to obtain a clearer picture of the logistical changes, costs and potential disruptions it could entail.

On balance, we believe that the immediate interest of shareowners and companies in better communications would be better and more effectively served with an incremental approach that promotes less reliance on — or eliminates altogether — the OBO/NOBO distinction and otherwise increases the potential for direct communications.

Introduction

A shareowner's right to vote on matters as allowed under state or federal law, stock exchange rules or otherwise is a key right. Shareowner voting has also become an increasingly important element in the consideration of public company corporate governance. Recent developments have spotlighted the nature and quality of the communication process and its impact on shareowner voting and governance. These developments include adoption by a number of public companies, especially larger companies, of majority voting in uncontested director elections, the amendment of New York Stock Exchange (NYSE) Rule 452 to prohibit broker discretionary voting in uncontested director elections and the increased influence of activist shareowners and proxy advisory firms. The confluence of these developments has heightened the likelihood of more meaningful, and contested, shareowner votes and elevated the importance of shareowner communications in the context of voting and governance.

Issues of shareowner voting and communications depend on both state and federal law. State law focuses on record ownership (i.e., the holder shown on a company's books, whether or not the ultimate shareowner) because of administrative ease and certainty. Federal law, on the other hand, emphasizes regulation of communications by public companies for shareowner meetings and other matters, as federal regulators are more concerned with the interests of beneficial owners (i.e., the ultimate owners) in voting and receiving related disclosure. The record owner may also be the beneficial owner of the shares, but for shares held with financial institutions, the link between record and beneficial owners is not simple. A complex chain of intermediaries often separates the record owner from the beneficial owner. Companies typically do not know the identities of all beneficial owners of their shares, nor do beneficial owners know the identities of other beneficial owners generally. The information resides largely with the intermediaries. This information disconnect limits the ability of companies to communicate with their beneficial owners and of beneficial owners to communicate directly with each other.

While state law governs the rights of record owners, the SEC has focused on rules related to communications between companies and their owners, and among owners themselves. To address the gap between record and beneficial ownership, the SEC has created a framework in which companies primarily communicate with beneficial owners through broker or bank intermediaries. The framework requires brokers and banks to disclose to a company the identity of only those beneficial owners who do not object to such disclosure. Those who object are known as "objecting beneficial owners" (OBOs) under the SEC's rules. The company cannot contact OBOs directly. The company may, however, have direct contact with shareowners who have designated themselves "non-objecting beneficial owners" (NOBOs), owners who do not object to having their identity known to the issuing company. However, while companies may communicate directly with NOBOs, SEC rules require that proxies and proxy materials nonetheless be forwarded by broker and bank intermediaries, not by companies.

This paper provides a brief introduction to the OBO/NOBO system, its history, the consequences of its operation and possible alternative approaches or reforms. It is organized as follows:

- Section II describes the system of custodial stock ownership, the current communication framework and the practical application of the OBO/NOBO distinction;
- Section III provides a brief history of shareowner communications reforms, including the enactment of OBO/NOBO rules;
- Section IV highlights the consequences of the current framework;
- Section V describes the interests investors have in the current framework;
- Section VI discusses the interests that various other stakeholders have in the current framework;
- Section VII describes potential alternative approaches and reforms; and
- Section VIII offers recommendations with respect to reforms.

Custodial Ownership and the Current Communication Framework

Custodial Ownership: The Source of the OBO/NOBO Distinction

In the United States, few ultimate beneficial owners are holders of record. Instead, a chain of custodial ownership, which can be complex and operates through multiple levels, separates the record and beneficial owners. Under custodial ownership, a broker or bank intermediary holds legal title to shares on behalf of the beneficial owner, who retains full economic ownership. Often the beneficial owner will establish a custodial relationship through a nominee account, under which a nominee, often a partnership, holds legal title to the shares.[1] "Street name" refers to the form of nominee name brokers use to hold shares on behalf of the ultimate beneficial owners.[2] An estimated 70-80 percent of publicly-traded shares are held in street or nominee name according to the most recent data from 1997.[3] The custodians, in turn, hold the shares in accounts with The Depository Trust Company (DTC), the only central depository institution in the United States. DTC (or its nominee, Cede & Co.) is registered in a company's books and records as the record holder. DTC is thus the holder of record of a substantial majority of publicly-traded shares in the United States.[4]

The current shareowner communication framework applicable to proxy solicitations addresses the difference between record and beneficial owners principally by requiring a company to forward proxy materials to the broker or bank intermediaries, which must in turn forward them to beneficial owners, whether they are OBOs or NOBOs.

The framework does permit some direct communications between a company and its beneficial owners. For example, companies may mail their annual reports directly to NOBOs,[5] although in practice this does not occur since the annual report must accompany or precede the proxy statement (which as noted above must be sent by the intermediary).[6] A company also might choose to confirm with NOBOs that the relevant intermediary had in fact forwarded proxy materials as required or encourage NOBOs to vote.[7] To enable direct communication, brokers and banks must provide companies with a list of NOBOs upon request at any time.[8] Most brokers and banks delegate this responsibility to an agent, in almost all cases Broadridge Financial Solutions Inc. (Broadridge), the leading provider of U.S. outsourcing services regarding communications, document management and processing in connection with the proxy procedure.[9] Broadridge provides a single list of all NOBOs to the company in a standardized format. The NOBO list includes the name, address and securities position for each NOBO.[10] Because Broadridge does not disclose the identity of a NOBO's broker or bank intermediary, relying on Broadridge to provide the NOBO list allows brokers and banks to preserve the confidentiality of their customer lists from each other and from the company.

The company cannot communicate directly with OBOs,[11] so all communications with OBOs must be made through the relevant intermediary. Over 75 percent of customers holding shares in street name are OBOs,[12] and 52-60 percent of the shares of publicly-held companies in the United States are therefore held by OBOs.[13] In effect, the identity of the ultimate beneficial owner of more than half of all shares of publicly traded companies is behind a curtain.

How Shareowner Communications and Proxy Voting Work

The OBO/NOBO rules are only one component of the shareowner communication framework, which we summarize below. Additional details are provided in Annex A, which highlights the differences in the framework as it applies to brokers, on the one hand, and banks, on the other.

The distribution of proxy materials to a beneficial owner is a two-stage process as described below.

- In the first stage, the company gathers information about the number of beneficial owners in what is itself a multi-step process. This stage is illustrated in the attached Figure 1 (for brokers) and Figure 2 (for banks) in Annex B. The process by which a company obtains a NOBO list is illustrated in Figure 3 in Annex B.
  - The company requests from DTC a list of its participants (i.e., financial and other institutions with accounts at DTC) that hold company shares, to which DTC must respond "promptly."[14]
  - Upon receipt of the list, the company sends a "search card" to those institutions — the broker and bank intermediaries — at least 20 business days prior to the record date (i.e., the date as of which one must be a shareowner of record on the company's books to vote at a shareowner meeting), requesting the quantity of proxy materials and annual reports each requires for further distribution to beneficial owners.[15]
    - Brokers (or Broadridge as their agent) must respond to the company's inquiry no later than seven business days after receipt of the search card.[16]
    - Banks must respond to a search card inquiry in two ways. Because there are often several layers of "respondent banks" (i.e., smaller bank custodians which deposit shares on behalf of beneficial owners with larger bank intermediaries) between a DTC bank participant and the beneficial owner, banks must tell the company, within one business day, the names of respondent banks holding shares of the company through them.[17] The company then sends a search card to the identified respondent banks within one business day.[18] Those respondent banks must respond in turn within one business day with the names of their respondent banks holding shares of the company through them, and this respondent bank process continues through however many layers of respondent banks exist that hold shares of the company. All banks, including both the initial banks to whom the search card inquiry was sent and all respondent banks, must also respond no later than seven business days after their receipt of the search card regarding the quantity of proxy materials needed for distribution to beneficial owners.[19]
  - If a company wishes to communicate directly with NOBOs, it needs the NOBO list, which includes the name, address and securities positions of each NOBO. A company may request a NOBO list from broker or bank intermediaries at any time. The company requests a list of all NOBO holders as of a date it specifies. Often this date is the record date, but it can be any date the company specifies. The intermediaries must be given at least five business days to compile such lists.[20]
  - Broker and bank intermediaries must compile the NOBO lists as of the date requested by the company,[21] and must transmit to the company the NOBO list no later than five days after the date specified by the company.[22] Intermediaries generally respond through their agent Broadridge, which delivers a single standardized list of NOBOs to the company.

- In the second stage, the company forwards its proxy materials to the broker and bank intermediaries for further distribution.[23]
    - In the case of proxy materials, the broker or bank (or, more typically, Broadridge) *must* forward the materials.[24] The broker or bank (or Broadridge) must also forward the annual report, although it is excused from sending it to NOBOs if the company has indicated that it will do so directly.[25]

One important difference between distribution of proxy materials and voting rights is that, under state law, only the holder of record has the right to vote.[26] As a result, the company cannot send a proxy card and proxy materials directly to each beneficial owner, but must provide the proxy card to the record holder. To delegate voting authority under state law to the beneficial owner, first, as the record holder of shares held in street name, DTC executes an "omnibus" proxy in favor of all brokers and banks who hold the company's shares through DTC's facilities,[27] thereby authorizing each broker or bank to act as DTC's proxy and to vote the shares to the extent of the broker or bank's position in the company's securities held with DTC.[28] The executed omnibus proxy is sent to the company accompanied by a list that shows the number of shares each broker or bank holding through DTC may vote pursuant to the omnibus proxy.[29]

In turn, after being vested with voting authority, the brokers and banks have two options to facilitate voting by the ultimate owners of shares. The first, rarely used option is for a bank or broker (or Broadridge) to send an executed proxy to the beneficial owner, leaving the voting provisions of the proxy card blank and fully delegating voting authority to the beneficial owner. The beneficial owner then completes the proxy card and mails it to the company directly. The second option, which is used in the vast majority of cases, is for the intermediary to request voting instructions from the beneficial owner.[30] In the typical case, Broadridge sends the requests for voting instructions on behalf of the broker and bank intermediaries. The beneficial owners return instructions as to how the proxies should be voted to Broadridge, which then tabulates the voting instructions received and fills out a proxy for each intermediary broker or bank for which it acts as agent, aggregating the voting instructions received from beneficial owners holding through that intermediary.[31] Broadridge's process for aggregating and verifying voting instructions is not one that a company itself may verify.[32]

Finally, the bank or broker (or Broadridge) sends the proxies to the tabulator (i.e., the entity retained by the company to count votes), which is often the transfer agent (i.e., the agent the company hires to transfer its securities, as well as maintain a list of the shareowners of record), for final verification and tabulation. The tabulator verifies that the number of shares voted equals (or is less than) the number held by each DTC participant. The proxy voting process is illustrated in Figure 4 and Figure 5 in Annex B.

Some pension funds and other institutional investors rely on proxy advisory firms to respond to requests for voting instructions (or proxies), adding another layer of complexity. RiskMetrics Group, one of the leading proxy advisory firms, advertises a range of voting services: "We receive your proxy ballots, work with your custodian banks, execute votes on your behalf, maintain vote records…"[33] Although institutional investors typically retain ultimate voting authority in their arrangements with proxy advisory firms, some institutional investors may delegate their voting authority as well.[34]

The company pays broker intermediaries and Broadridge for the services they provide (including preparing NOBO and OBO lists, providing lists to Broadridge (and in the case of NOBOs to the company), costs of mailing and other actual costs) at levels fixed by the NYSE.[35] This fee schedule is also typically followed for services rendered by bank intermediaries.[36] For example, the company pays fees for NOBO lists (e.g., a broker may charge $ 0.065 per NOBO name).

History of the Shareowner Communication Framework

The shareowner communication framework, including the OBO/NOBO distinction, was developed in the mid-1980s. The framework represented a compromise purportedly designed to address two goals: (i) improved corporate governance through increased communication between companies and their ultimate owners, as management would be more accountable if beneficial owners were given more of a say in corporate voting,[37] and (ii) a Congressional mandate to immobilize stock certificates (i.e., to eliminate transfers of physical stock certificates), and create centralized clearing for securities transactions.[38] While the SEC wanted to improve communication between companies and their shareowners, it regarded the reliability of proxy distribution and securities clearing as paramount. The result was a layered approach to communications that impedes direct communications. This section highlights key changes in the evolution of the current framework. Further details are provided in Annex C.

The Decision to Immobilize Stock Certificates

One key development leading to the prevalence of street name ownership that set the stage for the OBO/NOBO distinction was the paperwork crisis during the bear market of the late 1960s. Stock exchanges experienced unprecedented trading volume in that period, and brokers and banks were unable to process the transaction volume on a timely basis.[39] The need to handle and deliver paper security certificates for many transactions and the lack of a centralized clearance and settlement system significantly exacerbated the problem. Citing the absence of nationwide clearance and settlement as the cause of the problem, Congress amended the Securities Exchange Act of 1934 (Exchange Act) to add Section 17A, which requires clearing agencies to register with the SEC[40] and directed the SEC to implement rules to immobilize share certificates.[41]

Congress also directed the SEC to study “street name” registration,[42] a practice some institutional investors had engaged in since at least the 1930s. While approximately 10 percent of the shares of public companies was held in street name accounts in 1937, that percentage had increased to 30 percent by the mid-1970s.[43] The purpose of the study was to determine whether street name registration was consistent with a system of “prompt and accurate” clearance of securities transactions, as well as whether steps could be taken to facilitate company and shareowner communications while simultaneously maintaining effective clearing systems.[44]

The SEC’s review of beneficial ownership resulted in the 1976 “Street Name Study,”[45] which found that street name holding facilitated clearance and settlement of securities transactions and noted its importance to the operation of securities depositories.[46] Increased use of securities depositories was thus an essential predicate to immobilization of share certificates. By affirming street name registration as essential for effective securities transaction clearance and settlement, the study paved the way for increased use of the practice. The Street Name Study also recommended against changes to the existing shareowner communication framework, finding that it “functioned reasonably well,” as shareowners generally received communications in a timely manner whether holding shares directly with the company or through an intermediary.[47]

History of the 1980's Communication Rules

The SEC soon revisited the communications framework. The stated objective of the Congressional and SEC actions of the late-1970s and 1980s was to better integrate beneficial owners into the communication framework, thereby potentially promoting more informed votes about corporate matters. As noted in the House Report for the Shareholder Communications Act of 1985:

> Informed shareholders are critical to the effective functioning of U.S. companies and to the confidence in the capital market as a whole. When an investor purchases common stock in a corporation, that individual also obtains the ability to participate in making certain major decisions affecting that corporation. Fundamental to this concept is the ability of the corporation to communicate with its shareholders.[48]

While the reforms of the 1980s were an improvement as compared with the prior system of shareowner communications, the framework instituted was circuitous and complex.

In 1977, the SEC initiated a "corporate governance proceeding," a review of corporate governance generally, including shareowner communications and shareowner participation in corporate elections.[49] The review lasted three years and resulted in the 1980 "Staff Report."[50] The impetus for the renewed review of corporate governance, including shareowner communications, was a variety of events in the mid-to late-1970s that cast doubt on the adequacy of processes to ensure corporate accountability.[51] The Staff Report noted that shareowners elect a board of directors to direct or oversee a company's management on their behalf.[52] In principle, the periodic election of directors holds the board accountable for pursuing the best interests of shareowners. However, the foreign bribery scandals of the mid-1970s, which ultimately led to the adoption of the Foreign Corrupt Practices Act, in which hundreds of companies disclosed illegal or questionable payments to foreign officials,[53] as well as disclosures regarding the collapse of several major companies and corporate non-compliance with environmental and other laws,[54] called into question the efficacy of the election process to promote the goal of corporate accountability.

The focus of the Staff Report differed from that of the Street Name Study. While the Street Name Study focused on whether street name ownership facilitated securities trading without the need for transfer of physical stock certificates,[55] the Staff Report addressed the impact of beneficial ownership and the prevailing shareowner communications regime on corporate governance.

A key recommendation in the Staff Report was that the SEC create an advisory committee to develop a system for companies to identify beneficial owners and establish a uniform proxy material distribution system.[56] In 1981, the SEC convened the Advisory Committee on Shareholder Communications to study the then-existing framework.[57] After an extensive review, the Advisory Committee recommended several changes, many of which are a part of the current framework.[58]

The Advisory Committee recommended limited direct communications between companies and their shareowners. The framework recommended by the Advisory Committee authorized direct communications for annual reports, but not for proxies, and introduced the concept of NOBO lists. In 1983, the SEC adopted rules reflecting the Advisory Committee's recommendations.[59] Direct communications by companies with beneficial owners were therefore not permitted for the delivery of proxy cards or materials. Since then, companies have not been able to send proxy materials or cards directly to beneficial owners, even NOBOs.

It is noteworthy that the Advisory Committee also considered a more comprehensive direct communication framework that would have allowed companies to send proxy materials directly to NOBOs,[60] but ultimately rejected this approach.[61] One concern was that companies would receive non-standardized NOBO lists and would be unable to process the lists to send out proxy materials in a timely manner.[62] More fundamentally, the Advisory Committee concluded — and the SEC agreed — that any additional benefits from direct communication were outweighed by the uncertainty of both the costs and effectiveness of any alternative system.[63] Instead, the Advisory Committee and the SEC concluded that problems with the communication framework could be sufficiently remedied through the incremental reforms that were adopted. As reflected in the summary of the rules in Annex C, a clear albeit unarticulated consequence of the system that was adopted was to preclude the possibility of direct communication with OBOs, who were of course not even identified to companies.

The SEC's rules implementing the Advisory Committee's proposals became effective in January 1986.[64] Implementation was delayed so brokers and companies could work out who would bear the costs of implementation and what costs companies would reimburse going forward.[65] Prior to effectiveness, the SEC approved a provision allowing brokers to delegate to an agent their obligations to respond to company requests for information about shareowners.[66]

The Advisory Committee also recommended legislation giving the SEC regulatory authority over bank nominees, which were then and still are intermediaries for the majority of the shares held by beneficial owners.[67] After receiving a legislative proposal from the SEC,[68] in 1985 Congress passed the Shareholder Communications Act, which amended Exchange Act Section 14(b) to give the SEC authority to regulate bank intermediaries with respect to shareowner communications.[69] The SEC adopted Rule 14b-2 almost immediately thereafter, which imposed obligations on banks comparable to those applicable to brokers.[70]

Consequences of the OBO/NOBO Distinction

The most important consequences of the OBO/NOBO distinction are that it further impedes a company's direct communications with shareowners and direct communications among shareowners. Either the company must forward solicitation materials through intermediaries for a fee, as is true for OBOs, or rely on lists compiled by intermediaries and incur "per name" fees, in the case of NOBOs. This expensive and time-consuming process may deter companies from communicating with shareowners more than the minimum required by law. Similar impediments exist with respect to communications among shareowners, including in connection with contested matters that also involve the use of the current framework.

Shareowner communications are particularly critical in the solicitation of proxies. The solicitation process is aimed not only at informing shareowners about matters subject to a vote, but also at encouraging them to vote, and generally to vote a particular way. Companies have a clear interest in persuading shareowners to vote and to vote in the manner they recommend, including where applicable for the slate of directors they recommend. Companies also have a further interest in at least some cases in participation by shareowners. For example, the company must obtain a quorum to conduct business at a meeting.[71] Even where a quorum exists, the voting standard may be rigorous (e.g., supermajority provisions or provisions requiring the affirmative vote of a majority of the outstanding shares) and necessitate frequent communications to assure a favorable vote. Shareowners who are engaged in soliciting proxies or otherwise encouraging voting have an equally strong interest in effective communications to gain support for their objectives, whether promoting their own director nominees, promoting or opposing others' director nominees, or supporting or opposing shareowner or other proposals.

Recent developments in corporate governance will place more pressure on voting outcomes and increase the need for both companies and shareowners to have an effective and reliable framework for communications. These developments include the following:

- increase in proxy contests, including short slate proxy contests;
- rise of "vote no" campaigns;
- amended NYSE Rule 452; starting January 1, 2010, it prohibits brokers from using their discretion to vote uninstructed customer shares in uncontested director elections;
- adoption, mostly by big companies, of majority voting in uncontested director elections;
- widespread use of shareowner proposals to effect governance and other changes;
- Delaware General Corporation Law and Model Business Corporation Act amendments to clarify the permissibility of bylaw changes to effect proxy access or reimbursement of shareowner proxy costs; and
- the SEC's proposals to implement "proxy access" rules to permit shareowner access to the company's proxy statement.

Interests of Investors in the OBO/NOBO System and Modifications

Investors are a diverse group that includes individuals, company, union and public sector pension funds, mutual funds, hedge funds and insurance companies, among many others. While on any given matter their interests may diverge, in the context of the shareowner communications framework, they generally share two core interests — privacy and a level playing field with companies regarding communications with other shareowners in connection with proxy solicitations and other matters.

Privacy

Privacy is an interest often cited as important to investors. Indeed, the OBO/NOBO distinction was driven in significant part by this interest, and a policy decision on the part of the SEC that investors wishing to preserve anonymity should be allowed to do so.[72] Recent data casts doubt, however, on the importance of privacy as a motivation for retaining the current framework. A survey undertaken in 2006 on behalf of the NYSE Proxy Working Group revealed that only 36 percent of retail customers would choose to be OBOs if they understood the consequences, with the percentage declining to 14 percent if a $25 annual fee were charged to maintain OBO status, and to 5 percent if the annual fee were $50.[73]

Within the overall context of a privacy interest, it is also unclear which information investors may wish to keep private and from whom. Smaller retail investors simply might not want their information disclosed to avoid being bombarded with mailings, phone calls and possibly electronic communications in connection with proxy solicitations.

Some investors may also want to keep their investments private from other investors. Any shareowner can request a NOBO list. Under Delaware corporate law, a shareowner may request a stock list at any time, and the company must deliver it so long as the shareowner can show it intends to use the information for a “proper purpose.”[74] The stock list includes the NOBO list if the company has obtained such a list.[75] A company need not provide a NOBO list if it has not requested one for its own use, however.[76] An investor may be concerned that activist shareowners with access to other investor names may use the information either to expose the investor’s investment in a controversial company as a tactic to promote an agenda or to inundate shareowners with unwanted communications. While the “use” limitation provides some protection against these concerns,[77] the potential for abuse may be sufficient to drive this rationale for maintaining anonymity.

Investors may favor anonymity to keep their holdings or trading strategies confidential from companies, other investors, markets generally, regulators and others, a goal that may be of particular actual or perceived competitive importance to investors such as hedge funds. While the federal securities laws require disclosure when an investor acquires beneficial ownership of over 5 percent of a class of voting equity securities,[78] investors may still desire to maintain privacy or to control any public or private disclosure with respect to smaller positions. Some have raised the concern that companies might “track trading” if the companies could have access to a list of all beneficial owners at any time.[79] Some investors may have an interest in maintaining privacy to shield potentially controversial trading practices or ownership strategies from scrutiny.[80]

Access to NOBO Lists and the Ease of Shareowner Communications

One concern for investors is the ease of communicating with other shareowners. Both the cost and speed of such communications are important. Under the current SEC proxy rules, if a shareowner wants to communicate with other shareowners in connection with a proxy solicitation, the company must either (i) provide the requesting shareowner the list of record and beneficial owners, or (ii) mail the shareowner's communications, at the shareowner's cost.[81] The company may delegate such responsibilities to an agent, typically Broadridge. Many shareowners have found that relying on Broadridge to mail communications with respect to proxy solicitations to be cost effective and sufficiently fast to suit their purposes. Even if a company decides to send a requesting shareowner the list of record and beneficial owners, the shareowner can still contract with Broadridge to distribute such communications, and hence can still take advantage of any cost savings or efficiencies Broadridge provides.

Even if a company opts to mail a shareowner's communications, a shareowner may still likely gain access to NOBO and shareowner lists through state law means. Under Delaware law, for example, a company must deliver a shareowner list, including the NOBO list if the company has requested it, to a shareowner (including the beneficial owner) so long as the latter can show that it intends to use the information for a "proper purpose."[82] It is clear that "proper purposes" include communication with other shareowners about the company, whether or not in connection with a proxy solicitation.[83] If the company refuses to provide the list or fails to respond within five business days after the demand is made, the shareowner may seek an order to compel delivery from the Delaware Court of Chancery.[84] In such a case, after the shareowner has established its status and shown that it has made a proper demand, the company bears the burden of establishing that the request was for an improper purpose.[85] Given the weight of precedent, which favors shareowners seeking to communicate with each other as noted above, anecdotal evidence suggests that companies rarely challenge demands for shareowner lists.

Competing with the Company — The "Battle of the Coffer"

The current general restriction on a shareowner's access to corporate funds to finance its solicitation and other communications efforts may affect some investors' views of changing the OBO/NOBO system to foster direct communications by companies and shareowners with beneficial owners. One consequence of the elimination of OBO/NOBO status would be the potential for more frequent communications between a company and its shareowners. The recent evolution of governance practices and related rules would be likely to drive this trend. Shareowners have a similar interest, but while they should have the same access to the shareowner lists as the company,[86] they must pay for communications (and other solicitation costs) while incumbent managers have access to corporate funds to conduct solicitations.

Incumbent directors and managers typically may be reimbursed for expenses related to proxy contests, regardless of the outcome, so long as the expenses are reasonable and related to deciding a matter of principle or policy.[87] Shareowners involved in a proxy contest, on the other hand, must pay their own expenses, including the cost of communications. A board may authorize reimbursement of such expenses but, as a practical matter, reimbursement is only likely where the shareowner has been successful in electing a majority of the board or in reaching an agreement with the company.

A recent Delaware case illustrated the board's ultimate authority over a decision to reimburse and the limits shareowners may place on the board's ability to fulfill its fiduciary duties in that regard. In *CA, Inc. v. AFSCME Employees Pension Plan*,[88] the Delaware Supreme Court held that a proposed shareowner bylaw that would require the board to reimburse a shareowner's reasonable expenses when that shareowner sought to elect less than 50 percent of the board (i.e., a short slate) and succeeded in electing at least one director was invalid on its face because it could require reimbursement of a shareowner's expenses in circumstances that would force the board to violate its fiduciary duties. In response to *CA, Inc.*, in April 2009, the Delaware General Assembly adopted Delaware General Corporation Law Section 113 to clarify that a bylaw to allow reimbursement of shareowners' expenses is permissible.[89] In the absence of a bylaw or if a challenging shareowner failed to meet the conditions of the bylaw, the *CA, Inc.* result would continue to apply in maintaining the discretion of the board with respect to reimbursing shareowner expenses. (The extent to which a bylaw could limit the ability of a board to exercise its fiduciary duties is unclear.)

Interests of Various Other Stakeholders

Companies

Companies tend to favor more comprehensive shareowner communications reform proposals. In April 2004, the Business Roundtable (BRT) filed a Request for Rulemaking with the SEC urging revision of the shareowner communications rules and proposing a direct communications framework.[90] In response to SEC proposals regarding proxy access, the BRT filed comment letters in both 2003 and 2009, again urging revision of the current framework to allow direct communications.[91] Other industry groups reflecting company, management and director interests, such as the Shareowner Communications Coalition,[92] have supported the BRT's reform proposals, and it is a fair assumption that the BRT's position reflects the public company perspective (or at least the perspective of large public companies) more generally.

In advancing a direct communications framework, companies have two key objectives:

- **Direct Communications.** Companies have asserted their strong interest in direct communications as a matter of symmetry — if shareowners are able to participate more directly in board elections through proxy access or other means, companies should be able to contact them directly as well. The practical arguments are two-fold. First, given the rise in the number of meaningful and contested voting matters, companies have a more urgent need to communicate with shareowners. Second, as the BRT has argued, if proxy access is adopted and opposition candidates appear on the company's proxy card, the board would have a fiduciary duty to take actions it considered necessary or appropriate to promote the nominees best suited for the job, including additional communications with beneficial owners.[93] In those cases, companies may have an interest in communications with shareowners beyond what are today the customary proxy materials, for example to promote the company slate or to "get out the vote."
- **Costs of Communications.** Companies (or, more precisely, their shareowners) bear the costs of forwarding proxies at levels set by the NYSE,[94] and the potential for direct communications could reduce those costs. Companies have complained that under the current system, the other participants (including Broadridge as agent, banks and brokers) have no incentive to reduce costs, since their expenses are fully reimbursed.[95]

Broker-Dealers and Bank Intermediaries

Broker and bank intermediaries tend to favor the status quo with respect to shareowner communications. When the BRT proposed reforms in 2004, the Securities Industry Association (a broker-dealer trade association that since merged with the Bond Market Association to form the Securities Industry and Financial Markets Association, or SIFMA), strongly opposed the proposal.[96] The stated reason for opposition was that the current framework had proven to be reliable and did not warrant comprehensive overhaul.

In taking this position, the interests of brokers and banks appear to include the following:

- **Competitive Interest in Confidentiality of Customer Lists.** Because Broadridge does not disclose the identity of a NOBO's broker or bank intermediary in the NOBO list under the current framework, delegating authority to Broadridge to compile NOBO lists allows brokers and banks to maintain the confidentiality of their customer lists.[97]
- **Preservation of Fee Income From Forwarding Communications.** The prospect of eliminating or reducing the role of intermediaries would reduce the fee income they earn both for forwarding proxy materials and for providing NOBO lists.[98]
- **Preservation of Stock Loan Revenues.** Direct communications could affect the securities lending market. A customer with a margin account agrees that the broker may lend the customer's shares, but at least retail customers (and potentially some institutional customers) are typically not entitled to any fees the broker earns from stock loan transactions[99] and are almost always unaware that their shares are on loan. The current practice is for brokers to lend securities from an unidentified pool of shares, not specifying which particular customer's shares are on loan.[100] With a direct communications framework, however, if the broker were also required to execute a proxy in favor of the specific holder entitled to vote each share, the broker would need to identify which particular customer's shares were on loan (and to whom). As a result, there might be pressure from retail and institutional customers on brokers to curtail lending activity, identify it or share stock loan fees.[101]

While brokers and banks have their own interests to advance, their interests may also to some degree reflect those of the beneficial owners who are their customers. Beneficial owners are not a homogenous group, however, and they may have diverging interests with respect to the current system and reform. The distribution of investor types across intermediaries is not random. Brokers tend to have hedge funds and retail investors as customers,[102] while banks act more typically as custodians for mutual funds, pension funds, insurance companies, endowments and trusts.[103] As the interests of these groups diverge, so may the expressed interests of their respective intermediaries.

Broadridge

Broadridge has a strong interest in preserving the current framework, since it is essentially the sole central agent providing "investor communications, document management and proxy processing services" in the United States.[104] Indeed, its current business model is driven by the current framework under which it both earns agency fees and is reimbursed for its other costs.

Possible Reform of the OBO/NOBO Regime

Approaches to reform of the current OBO/NOBO framework range from minor incremental changes to a comprehensive overhaul. Any reform must advance the goal of operational reliability — or at least not appear to further impair the reliability of the current framework. One important question of course is the degree of reliability of the current framework, which is the subject of some debate.[105] There is no systematically gathered information regarding reliability. Broadridge and intermediaries express the view that reliability is high. There is some anecdotal evidence of breakdowns in reliability, including NYSE examination results and the 2008 under-reporting by Broadridge of withheld votes for certain directors of Yahoo.

Customer preferences

Customers do not express an overwhelming preference to be OBOs. In the NYSE Proxy Working Group survey, 64 percent of retail customers responded they would prefer to be NOBOs, when advised of the consequences of the OBO/NOBO distinction, with the percentage preferring NOBO status increasing on the imposition of fees to maintain OBO status.[106] Based on this data, NOBO status would seem to be the preferred default preference among customers, and one incremental reform could require intermediaries to set NOBO as the default in customer account documentation and even mandate a system of more informed and affirmative election of OBO status. If the data from the Proxy Working Group is an accurate reflection of investors generally, the percentage of shares held by OBOs likely would be reduced significantly.[107] This reform would not, however, address a company's ability to send proxies directly to beneficial owners, nor the costs associated with the current framework.

Such an approach would be in line with the SEC's original intentions in implementing the OBO/NOBO distinction. The rules require brokers and banks to disclose the information of all beneficial owners "who have not objected to disclosure of such information."[108] This language suggests that the SEC explicitly intended the standard to be one of non-objection, not one of affirmative permission to release information.[109]

Cost of Maintaining OBO Status

Under the current framework, companies must pay brokers or banks and their agents for distributing proxies and NOBO lists. A company must not only pay the actual distribution costs, but also is charged an additional fee for these services, costs that are ultimately borne by shareowners.[110] If a shareowner's OBO status makes a company's communications more expensive, other shareowners in fact subsidize that cost.

An alternative would be to impose the cost of OBO status more directly on OBOs themselves. This approach could be implemented in a variety of ways. One option would be to charge a fee to any customer who wanted to be an OBO, similar to the fee payable for an unlisted landline telephone number. Another option, which addresses the cost question but leaves open the other issues that could be addressed by more far-reaching reform, would be to abolish the OBO/NOBO distinction and require any customer seeking privacy to open a nominee account to maintain confidentiality.[111] Opening and maintaining a nominee account has fees beyond those charged for a typical brokerage account. Under either option, a shareowner's privacy interest is respected, but at the shareowner's expense.

Direct Communications

A more comprehensive approach to reform would entail a movement to a direct communication framework. This approach would combine the elimination of the OBO/NOBO distinction with the elimination of all mandatory communications through broker and bank intermediaries and Broadridge. These intermediaries and Broadridge could still play a role, albeit a different one. The BRT presented one such approach in its 2004 request for rulemaking.[112] This reform approach is illustrated in Figure 6 in Annex B. Another direct communication reform approach, proposed by the Altman Group, is discussed in endnote 112, *infra*.

The BRT proposal relies on two key changes — the elimination of the OBO/NOBO distinction and SEC rulemaking to authorize companies to mail all proxy materials directly to beneficial owners. Under this approach, a cascading series of executed proxies would form the basis of the shareowner vote. First, DTC would execute an omnibus proxy in favor of its participant broker and bank intermediaries, thereby entitling the participants to vote the number of shares on deposit as of the record date, as it does now. Next, in contrast to the current framework, intermediaries would execute an omnibus proxy entitling those customers holding shares through the intermediaries to vote, and so forth down the chain of ownership until the proxies reached beneficial owners. As the end result of this series of omnibus proxies, each beneficial owner would receive a proxy card that it had full authority to vote, which it would complete and return directly to the company.

Under the BRT proposal, brokers and banks would still maintain a list of the names, addresses and securities positions of beneficial owners,[113] and Broadridge might still be engaged to create a standardized, integrated list that compiled this information for *all* beneficial owners. Broadridge's involvement could thus continue to make it possible for bank and broker intermediaries to maintain the confidentiality of their separate customer lists. This list would provide the company with information as to who was entitled to vote its shares for verification purposes and would be available to both the company and shareowners (presumably for a fee payable by the requesting party).[114] Beneficial owners would return their proxies directly to the company (or the tabulator acting on the company's behalf), instead of forwarding voting instructions to the intermediaries or Broadridge. Importantly, both companies and shareowners could also communicate directly with shareowners to solicit proxies, seek support for their positions and "get out the vote."

The BRT proposal would likely increase the degree of transparency of beneficial ownership to companies and shareowners, while preserving the flexibility of beneficial owners to shield their identities through the use of nominee accounts. Given the costs associated with nominee accounts and shareowners' stated preference not to pay an annual fee to maintain their privacy, the likely result of a direct communication framework is that only a minority of shareowners would use nominee accounts and thereby shield their identities from companies. The proposal creates uncertainty with respect to costs and also raises a concern that the system will not operate as effectively as the current framework, which essentially relies on the centralization of information distribution through Broadridge. The BRT proposal also raises the concerns described above that, because of the expense to shareowners unless there is company reimbursement, the greater advantages of direct communication on contested matters accrue to companies.

The potential costs associated with implementing a new framework could be a significant obstacle to reform. In the case of the 1982 reforms, huge disparities in cost estimates, as well as uncertainty about ongoing cost-savings, were an important reason the Advisory Committee did not recommend direct communications.[115] Even implementing the current framework required a one-year delay to allow brokers and companies to allocate start-up costs and resolve fee and expense reimbursement issues.[116]

Today, brokers and banks have in place procedures that could facilitate direct communications, particularly Broadridge's standardized beneficial owner list. However, any changes to the framework would doubtless entail start-up costs, the level of which is somewhat uncertain given the availability of electronic delivery and voting options.

The reliability of a direct communications framework is also not likely to be accepted as incontrovertible fact, notably by intermediaries. When the BRT proposed direct communications in 2004, the Securities Industry Association (now SIFMA) opposed the proposal, noting the efficiency, reliability and accuracy of the existing framework and the years of development and investment required to achieve those standards.[117] Similar arguments persuaded the SEC not to adopt direct communications in 1982. The switch to a new delivery system would entail some degree of execution risk as companies assumed the responsibility of delivering proxy materials. Given the SEC's longstanding concern about fairness towards retail investors,[118] a particular concern would be whether companies could assure timely delivery to that segment of investors. Any proposal for direct communications would have to address this concern with specificity. The fact that the infrastructure that supposedly ensures reliable communications is in place and could be adapted to a direct communications system, coupled with huge advances in technology since the 1980s, suggests that reliability concerns may be addressed in an objective manner.

The following table summarizes the reform proposals discussed above.

NOBO Status	Fee to Maintain OBO Status	Business Roundtable Proposal	Altman Group Proposal
▪ Keep OBO/NOBO distinction ▪ Require NOBO to be set as "default" in broker customer account documentation ▪ Investors may retain privacy if they choose at no cost to them ▪ Direct communication only to NOBOs ▪ Proxy materials still must be distributed through intermediaries ▪ No change to costs of distributing communications and proxy materials	▪ Keep OBO/NOBO distinction ▪ Investor must pay a fee to be an OBO ▪ Investors may retain privacy if they choose, but for a fee ▪ Direct communication only to NOBOs ▪ Proxy materials still must be distributed through intermediaries ▪ No change to costs of distributing communications and proxy materials	▪ Eliminate OBO/NOBO distinction ▪ Access to list of beneficial owners at any time ▪ Investor may still use nominee account to maintain privacy ▪ Direct communication to all beneficial owners ▪ Proxy materials sent directly to beneficial owners, returned directly to company (or tabulator) ▪ Costs of distributing communications and proxy materials potentially lower	▪ Replace OBO/NOBO distinction with "ABO" status ▪ Access to "ABO" list permitted only for annual and special meetings, limited number of other circumstances ▪ Mandatory disclosure of all beneficial owners, including of those shares held in nominee accounts ▪ Direct communication to all beneficial owners ▪ Does not take position on whether proxy materials should be sent directly to beneficial owners ▪ Costs of distributing communications and proxy materials potentially lower

Recommendations

The compelling and competing interests we describe above are likely to make the SEC cautious in seeking to change the communications framework in significant ways, at least in the near term. These interests will also likely present issues that would probably constrain, or at least delay, the SEC's ability to achieve significant change if it decides to try. Further, the caution that we would expect from the SEC will be particularly marked on the subject of proposed changes that could face strong opposition from the perspective of cost or reliability. That said, some change is all but inevitable given the emerging consensus that the limitations of the current framework are increasingly unworkable in an era of rising investor activism and more meaningful shareowner voting.

Defining the objective is critical to developing a proposal. If the goal is to increase the ability of shareowners and companies to communicate directly, a number of incremental steps may be taken individually or together, without discarding the current platform. Such an approach could enhance communications without seriously affecting the interests of many of the participants in the current framework.

A more ambitious goal to ensure not only improved communications, but also more reliable voting seems difficult to achieve without a more radical solution that is (or approaches) a pure direct communications framework with cascading executed proxies. Implementing such an approach would, however, almost certainly be more contentious, since it would implicate complex strategic, cost, logistical and other considerations of critical importance to key players. In addition, while the SEC is likely to pursue investor education initiatives in light of the continuing large retail shareowner base, the elimination of uninstructed broker voting and falling retail investor participation, the SEC might well conclude that such efforts would have to be more substantial, and changes take longer, if it pursued a more radical change in proxy mechanics. Moreover, the SEC could conclude that facilitating direct communication is more in line with its disclosure mandate than improving the reliability of voting and facilitating end-to-end audit trails for shareowner votes. On balance, we believe that an incremental approach that promotes greater transparency around shareowner lists and more opportunity for direct communications by shareowners and companies alike has a greater chance of widespread support than more radical alternatives.

A first step could be to address the OBO/NOBO distinction, preferably by eliminating it. This discrete change would likely increase the number of shareowners with whom other shareowners and companies could communicate directly in some ways, while preserving the logistical apparatus now used to compile shareowner lists and distribute communications. This step could itself, if desired, have a phased implementation starting with a mandate to make NOBO the default status for customer accounts, with full disclosure about the consequences of selecting OBO status. Election of OBO status could be coupled with a charge to defray the costs of maintaining a platform to support OBO status. Eventually, the OBO/NOBO distinction could be eliminated, with customers able to preserve their anonymity through nominee accounts at their own expense.[119] We do not believe that proposals that eliminate the possibility of anonymity altogether are workable, at least in the near term, since they do not accommodate the strong privacy interest of many retail and institutional investors.[120]

A second step could be to relax restrictions on the ability of companies and shareowners to distribute proxy materials and solicit proxies directly and to streamline the process for both companies and shareowners to obtain shareowner lists. We would not recommend that this step be achieved through eliminating the intermediary-agent platform altogether, since to do so could raise concerns about the reliability of communications[121] and would likely face significant opposition from some players whose business model depends at least in part on aspects of the current framework. Instead, this step could be achieved in a less intrusive way through regulatory changes that would permit direct distribution and solicitation, but maintain the intermediary-agency platform as an alternative. Even in a world where direct communications are fully permissible, we believe that companies will continue to use agents for purposes of compiling shareowner lists and particularly document distribution given the advantages of large scale fulfillment in terms of cost and reliability. Similarly, we believe shareowners will continue to use the agent platform for document distribution in at least some circumstances, even as the ability to communicate directly will provide advantages in other circumstances. Preserving the role of intermediaries in this approach would continue to accommodate customer and intermediary preferences for anonymity. Likewise, preserving a "neutral" agent as the centralized repository of shareowner lists may also provide comfort to shareowners who, we understand, find the current system for requesting shareowner lists from Broadridge (or another agent) to be relatively easy and inexpensive.

A full direct communications framework in which companies control the shareowner lists, but all parties have easy access to the list and may communicate directly with each other, could also ultimately be workable.[122] The desirability of this approach would depend on whether it would protect shareowners from the risk that companies prevent or limit access to the shareowner list. If shareowners in fact have ready access to shareowner lists under existing state law, the utility of this additional step is uncertain. Even in the case of a direct communications framework, we would recommend that the framework continue to permit reliance on fulfillment services provided by Broadridge and other agents. We would note that, although not central to our analysis, taking steps to permit and facilitate direct communications by shareowners and companies alike could lead to a more competitive environment around intermediaries' and agents' services, including increasing pressures for competitively negotiated (and possibly lower) fees.

Other reforms would be needed to achieve reliable end-to-end audit trails, such as the cascading series of executed proxies from DTC to the beneficial owner resulting in the beneficial owner having exclusive authority to vote. The proxies returned would bear the names of the beneficial owners, allowing the tabulator to compare the votes with the list of all beneficial owners on file with the company. Without this reform, Broadridge would still verify and tabulate the majority of votes, as most beneficial owners would still return their voting instructions to Broadridge. Companies would have to rely on Broadridge to ensure that only those shareowners entitled to vote do so, as is the case under the current system. Without access to Broadridge's procedures and results in aggregating votes, companies cannot effectively audit Broadridge's verification process, and could not do so even if they knew who all of their beneficial owners were.[123]

Whether the practical benefits of coupling a direct communications framework with cascading executed proxies would outweigh the costs is uncertain. The benefits are likely to be limited to a minority of contested elections in which an end-to-end audit of the vote is critical to a reliable outcome. It may be worthwhile to have more data, particularly about director elections in the wake of the elimination of uninstructed broker voting in uncontested director elections and other recent developments and the practice that emerges if the SEC adopts a proxy access regime, before moving to this more comprehensive type of solution. We also believe that this approach requires more detailed analysis by the various affected constituencies to obtain a clearer picture of the logistical changes, costs and potential disruptions it could entail.

Given the time required for that exercise, we believe that the immediate interest of shareowners and companies in better communications would be better and more effectively served with the incremental approach that promotes less reliance on — or eliminates altogether — the OBO/NOBO distinction and otherwise increases the potential for direct communications.

The SEC has indicated that it will address the OBO/NOBO issue and ask whether the distinction is needed in a concept release to be drafted in the coming months.[124] Each of the potential reform proposals raises issues for particular groups of stakeholders. The interplay of these stakeholder interests will influence the direction of any reforms. Moreover, in considering any reform proposal with respect to shareowner communications, it is important to keep in mind the emphasis the SEC has placed historically on reliability of proxy delivery.[125] Even where the SEC agrees with the conceptual underpinnings of a particular proposal, the details of implementation will receive significant scrutiny involving both practical and political issues.

Operation of the OBO/NOBO Rules

The following summarizes the operation of the shareowner communication rules for broker and bank intermediaries. While the process is similar for these intermediaries, differences remain, largely attributable to the more limited scope of the SEC's authority over banks.

In both cases, communicating with beneficial owners requires that the company determine how many beneficial owners hold its securities and details of NOBOs and distribute proxy materials. While all proxy cards and proxy statements must be distributed through the broker or bank intermediaries, annual reports and other communications may be sent to NOBOs directly. All communications with OBOs occur through the intermediaries.

Broker Intermediaries

Company contacts broker for information regarding beneficial owners. After a company receives information from DTC about participants that hold its shares held in street name,[1] it sends a "search card" to the broker nominee holders in which it seeks information relevant to the proxy distribution process, including the number of proxy cards, proxy solicitation materials, annual reports or other materials it must print.[2] A company must send such a search card when soliciting proxies, seeking consents in lieu of a meeting[3] or mailing information statements.[4] In the search card, the company must indicate whether it intends to distribute the annual report directly to beneficial owners, as it is permitted to do under Rule 14a-13(c).[5] The initial search card inquiry must be made at least 20 business days prior to the record date[6] (or, if impracticable, a shorter period as far in advance of the record date as practicable).[7]

Broker responds to company's request for information. Brokers must respond to the company's inquiry within seven business days of receipt of the search card.[8] The broker must indicate: (i) the approximate number of its customers who are the beneficial owners; (ii) the number of OBOs;[9] and (iii) the identity of any agent designated to fulfill the broker's Rule 14b-1(b)(3) obligations.[10] Almost all broker custodians delegate their Rule 14b-1(b)(3) obligations to Broadridge Financial Solutions (Broadridge).[11]

Broker provides company with NOBO list. If requested, the broker (or its agent) must provide the company with the names, addresses and securities positions of NOBOs.[12] The list need not identify the broker with which each NOBO holds its shares. Indeed, one benefit of delegating responsibility for the NOBO list to Broadridge is the broker's ability to keep such data private. The NOBO list must be transmitted to the company no later than five business days after the record date.[13]

Company sends proxies and other information materials to broker for distribution. The company must provide each broker intermediary with enough proxy materials to enable the broker to comply with its distribution obligations.[14] The company must send proxy cards and proxy solicitation materials through the broker or its agent, but it may send the annual report or other information materials directly to NOBOs.[15] Effective in 2007, the broker must send a "Notice of Internet Availability of Proxy Materials" to beneficial owners if the company is relying on the e-proxy rules.[16]

Broker forwards proxy and other information materials to beneficial owners. The broker must forward proxy and other information materials to beneficial owners no later than five business days after receiving them (other than the annual report in the case of NOBOs, if the company has indicated its intention to send that document directly).[17] Brokers may delegate the forwarding of proxy materials to an agent, and almost all use Broadridge for this purpose. The company must reimburse Broadridge's distribution expenses,[18] and the NYSE and the Financial Industry Regulatory Authority (FINRA) have established applicable fee schedules.[19] Because voting depends on record ownership, the broker (as the holder of record for voting purposes) must either (i) provide the beneficial owner with an executed proxy card or (ii) a request of voting instructions.[20] Generally, brokers choose the latter option.

Proxies are forwarded to the company. If a broker requests voting instructions from beneficial owners, it typically delegates the task of collecting and forwarding completed proxies to its agent, Broadridge. If a broker forwards an executed proxy to a beneficial owner, that beneficial owner could return a completed proxy to the company directly.

Bank Intermediaries

Company seeks information regarding beneficial owners from bank intermediary. After receiving information about bank custodians holding shares at the DTC, the company sends a search card to bank nominee holders seeking information from the bank.[21]

Bank intermediary identifies respondent banks. By contrast to the broker framework, the information-gathering process is more complex in the case of banks because many smaller bank custodians hold shares for beneficial owners through custodial accounts at larger banks (e.g., such as Bank of NY Mellon, JP Morgan, State Street or Citigroup). The larger banks only have records of the holdings by the smaller "respondent banks," not of the ultimate beneficial owners.[22] Sometimes there can be three or four tiers of respondent banks. A bank intermediary must identify all its respondent banks holding the company's shares within one business day of receipt of the company's search card.[23]

Company sends search card to respondent banks. Within one business day of receipt of information identifying respondent banks, the company must send the same search-card inquiry to the respondent banks.[24] The respondent banks have the same response obligations as the original bank intermediaries.

Bank responds more generally to company's request for information. Like brokers, a bank has seven business days to indicate: (i) the approximate number of beneficial owners who hold shares directly with the bank;[25] (ii) the number of NOBOs;[26] and (iii) the identity of any agent acting on behalf of the bank in providing NOBO lists. A bank intermediary may delegate its responsibility to respond to an agent, which is typically Broadridge.

Bank provides company with NOBO list. Upon request, banks (or their agent) must provide NOBO details no later than five business days after the date specified by the company,[27] but this obligation only applies to accounts opened after Dec. 28, 1986.[28] For accounts opened on or before Dec. 28, 1986, the disclosure is only required if a customer affirmatively consents.[29] Banks are required to make a good faith effort to obtain consent.[30]

Company sends proxy materials to bank intermediaries. The company has the same responsibility to forward proxy and other information materials to bank intermediaries as it has for broker intermediaries.[31]

Bank forwards proxies to beneficial owners. As in the case of brokers, banks either forward an executed proxy to the beneficial owners or request voting instructions.[32] (As with brokers, most banks use voting instructions.) Proxy materials must be forwarded no later than five business days after receipt,[33] and banks may use agents to distribute voting materials and collect votes. Banks (or their agents) may be reimbursed for their expenses and typically follow the rates set by the NYSE.[34] For respondent bank holders, banks execute an omnibus proxy in favor of the respondent banks within five business days after the record date.[35] Respondent banks in turn execute the omnibus proxy in favor of the next layer of respondent banks, and so forth. The final layer of respondent banks follows the same procedure for acquiring the proxies of the beneficial owners (generally using voting instructions) as set out above.

Diagrams of Shareowner Communications and Proxy Voting

Figure 1. Shareowner Communications: Broker Intermediary

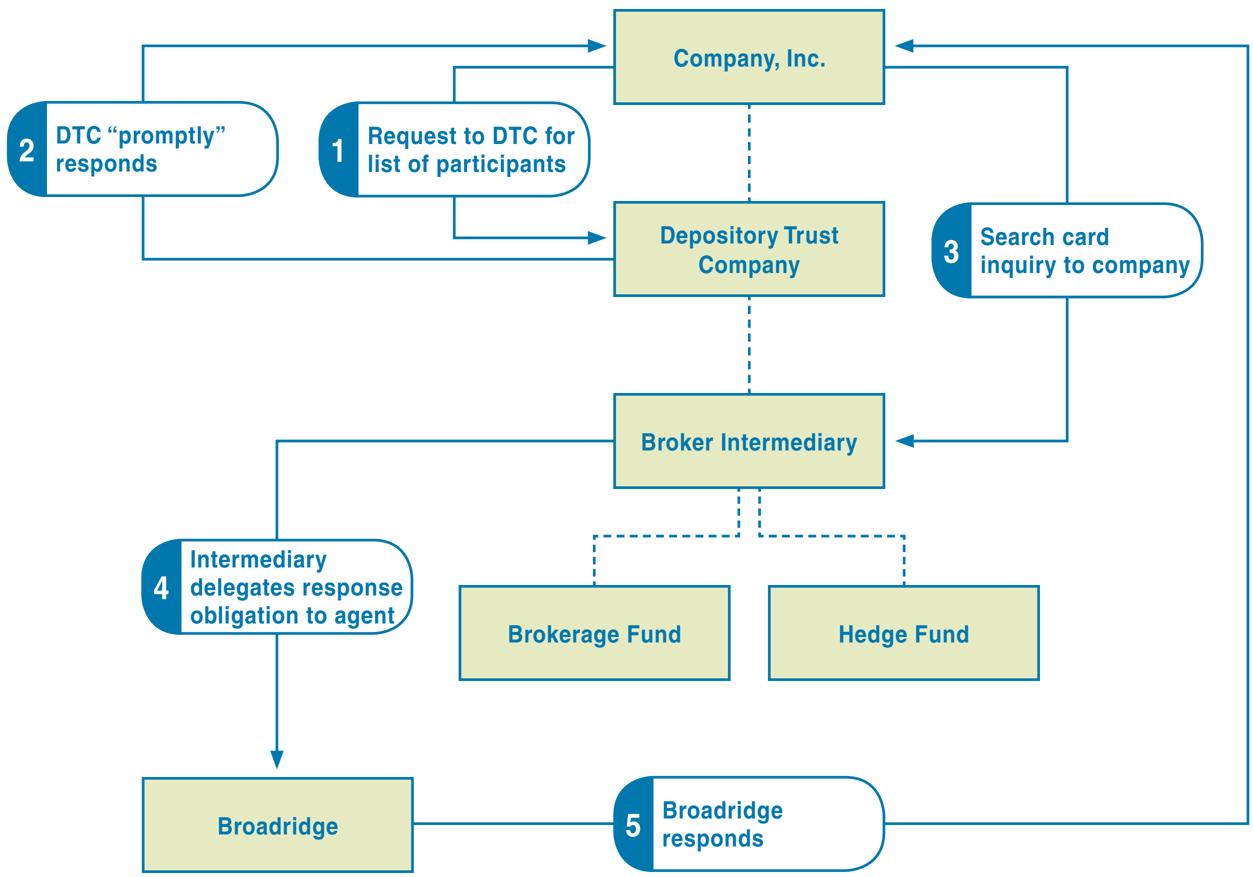


Figure 2. Shareowner Communications: Bank Intermediary

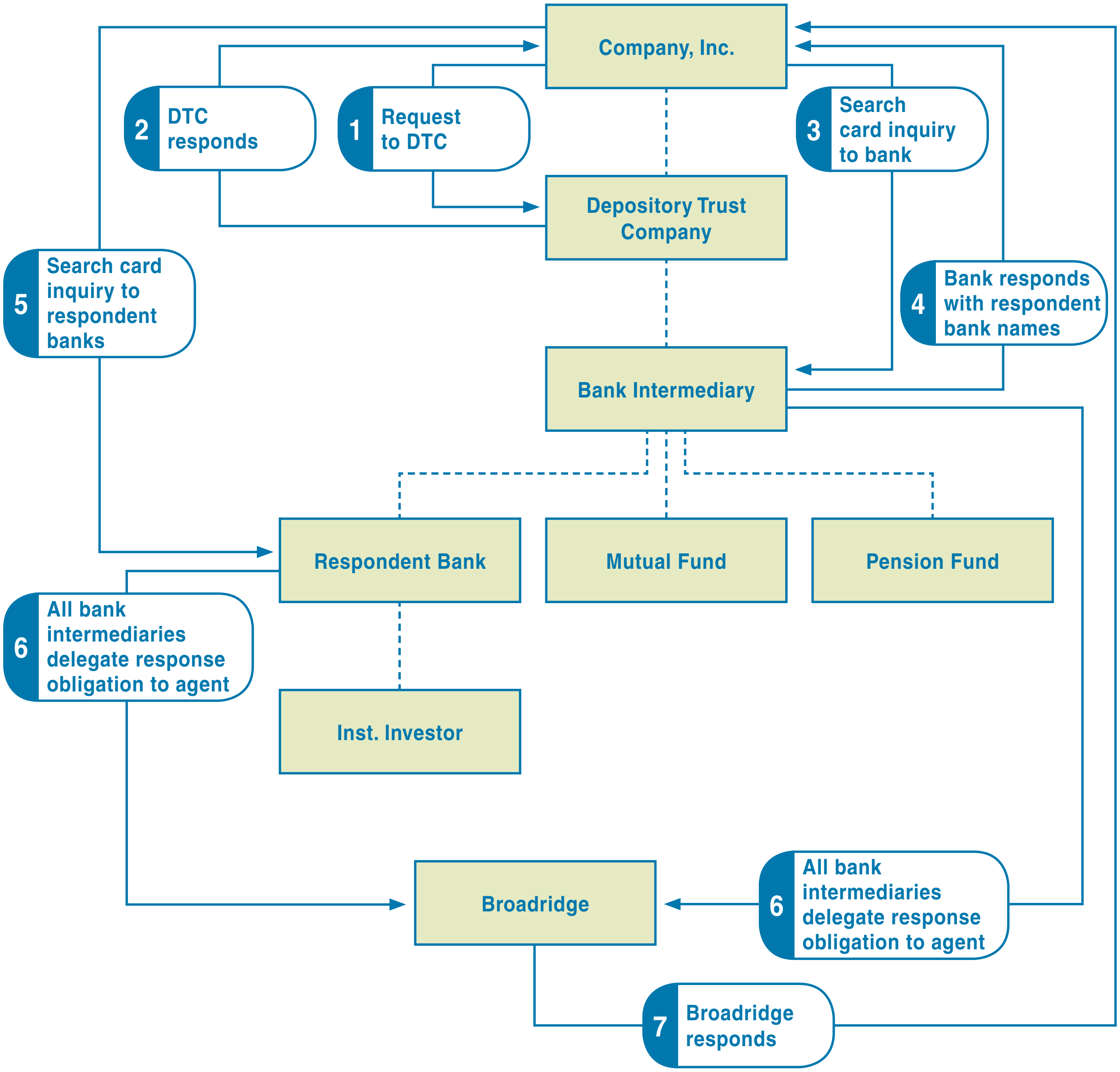


Figure 3. Shareowner Communications: NOBO Lists

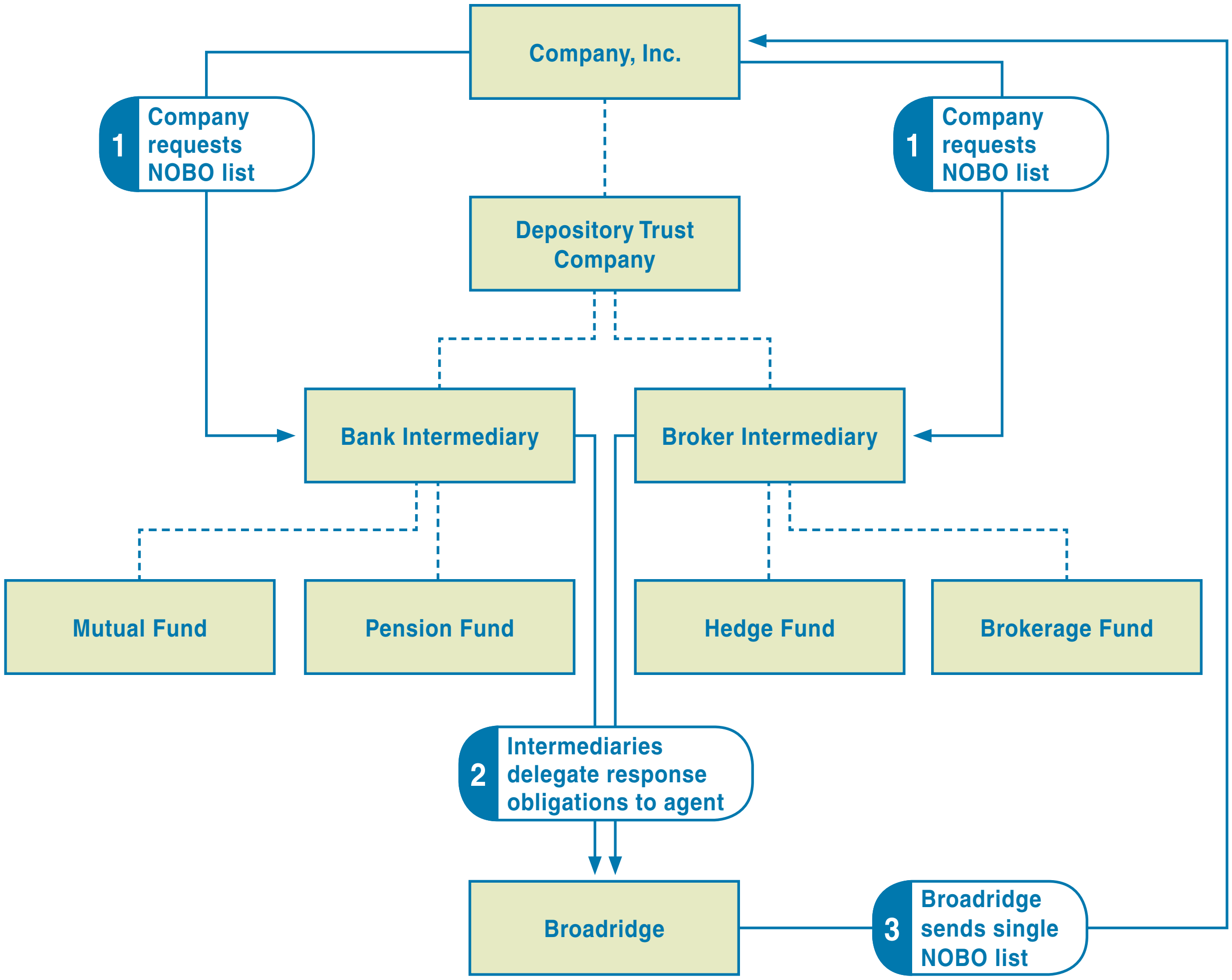


Figure 4. Proxy Voting: Part One

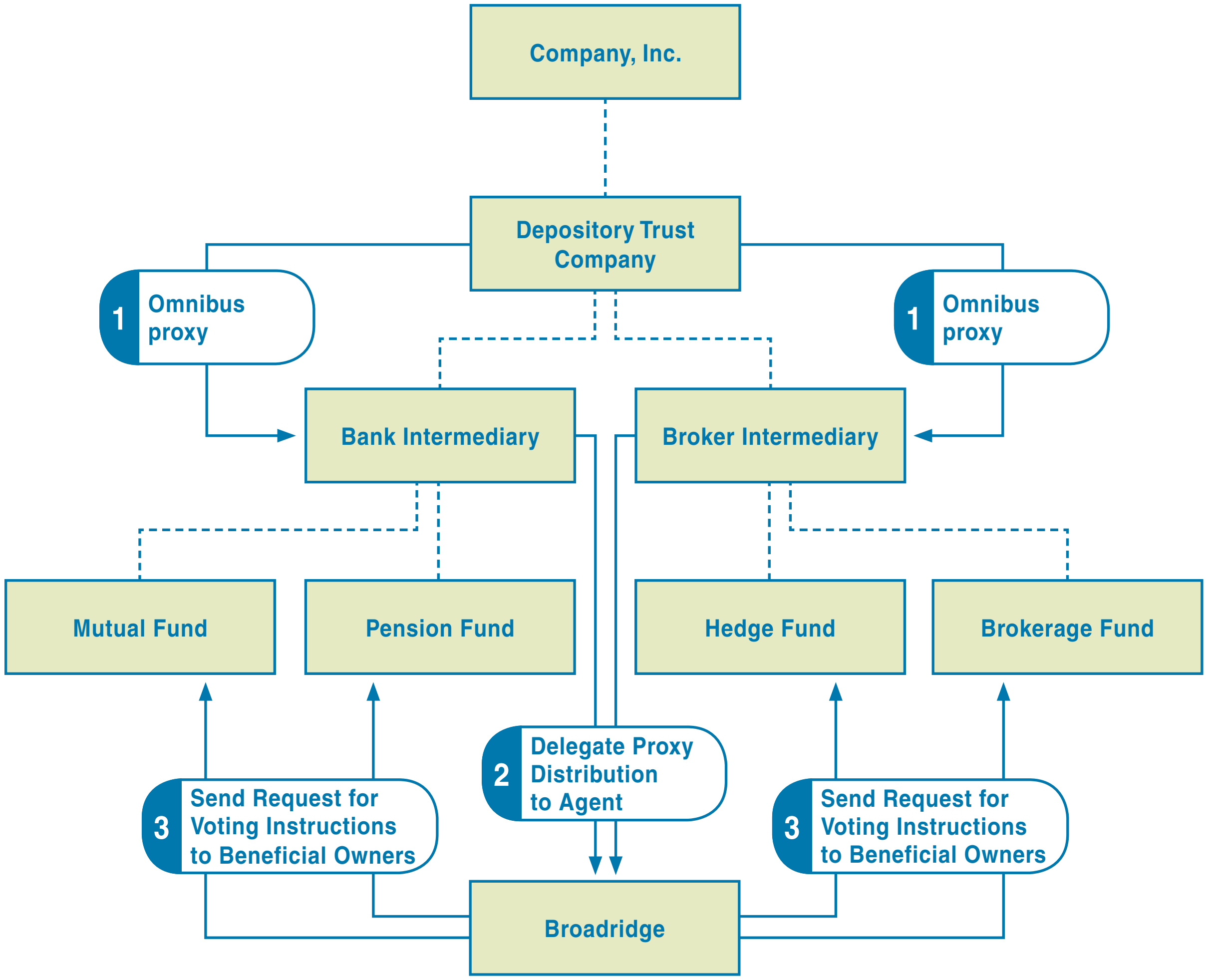


Figure 5. Proxy Voting: Part Two

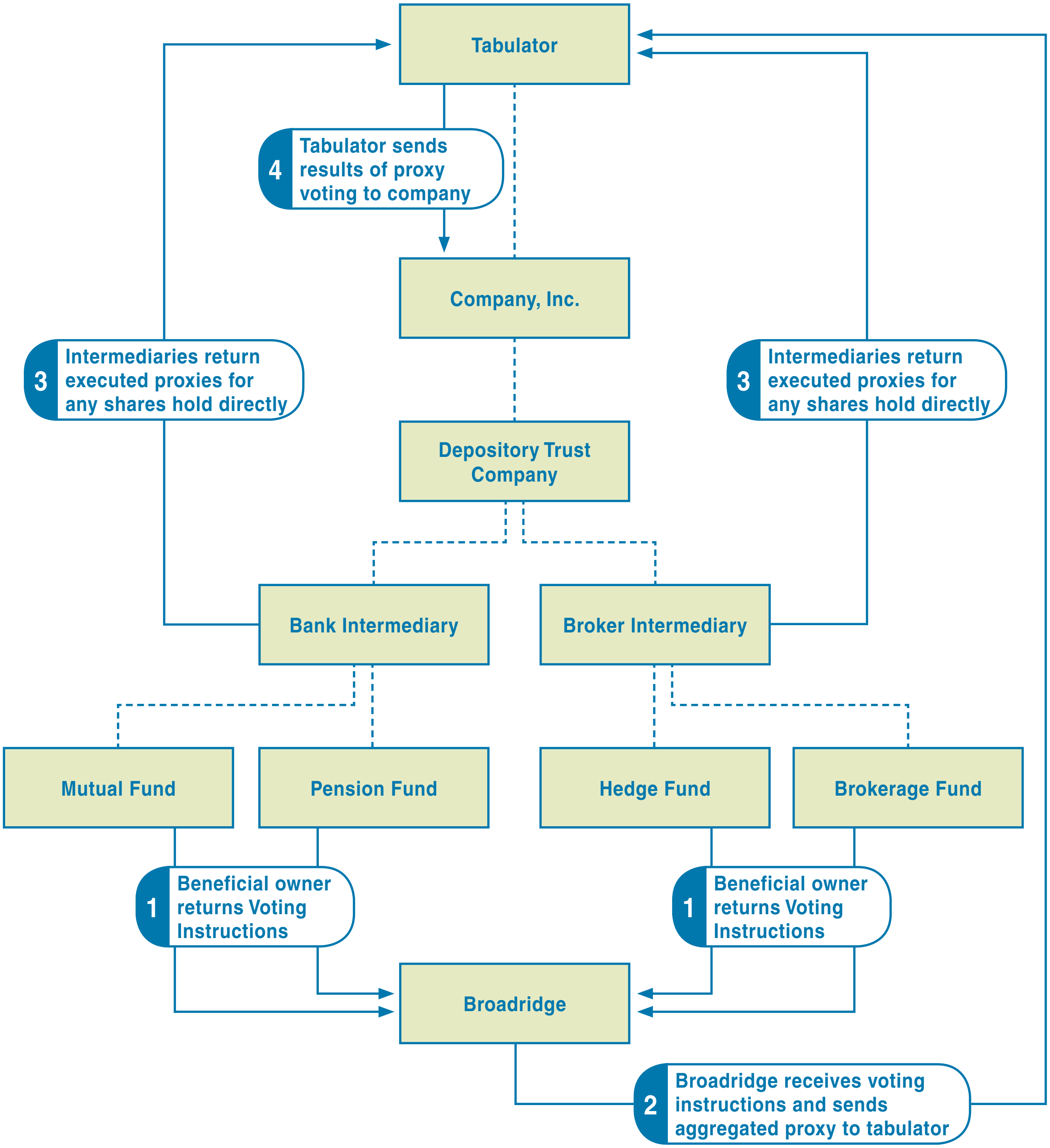
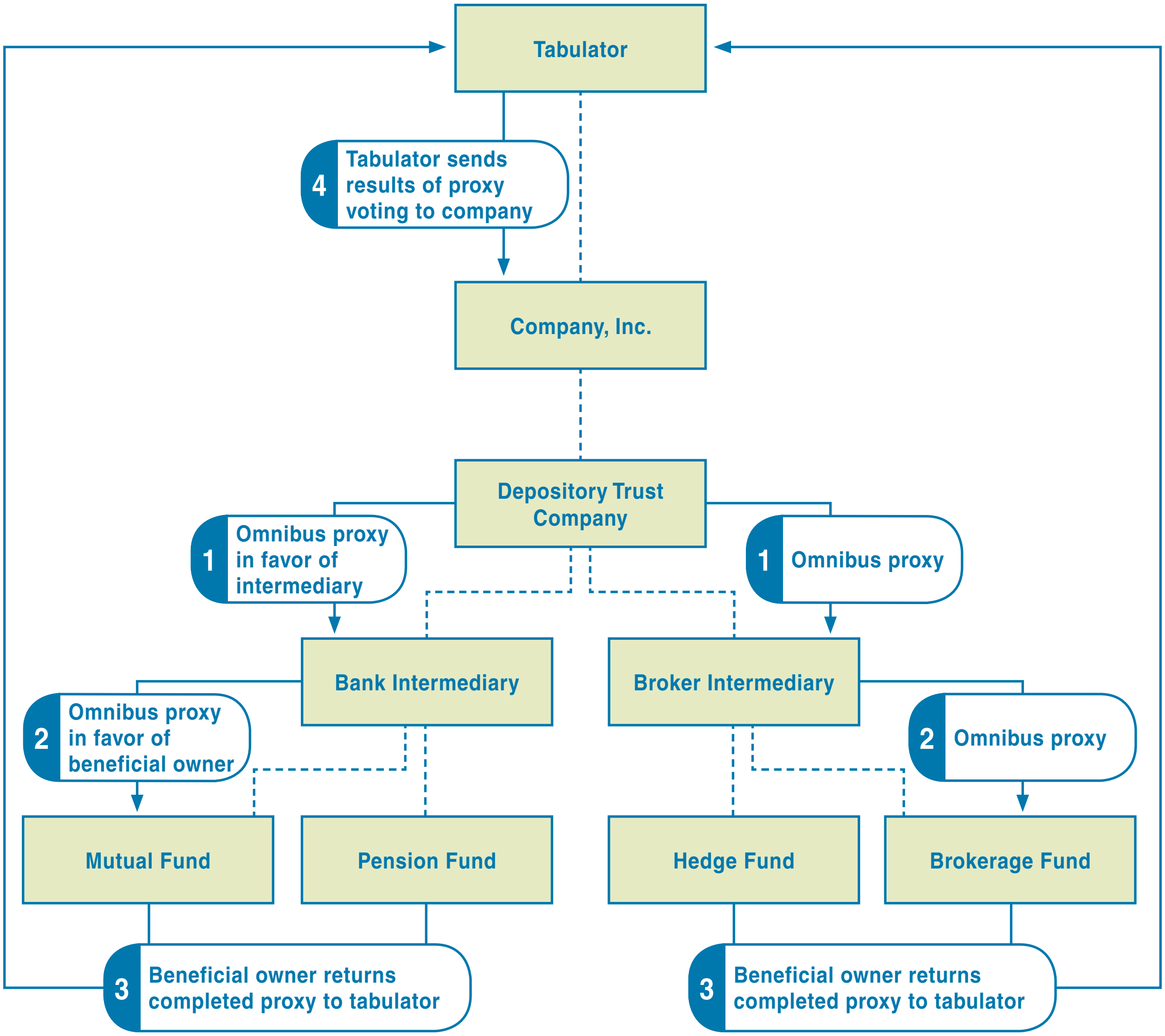


Figure 6. Proxy Voting: BRT Proposal



Shareowner Communication Framework

Exchange Act Section 14(b)[1]

Section 14(b) makes it unlawful for a broker-dealer or bank intermediary to give or refrain from giving a proxy or other information statement in a manner that violates SEC rules and grants the SEC regulatory authority with respect to communications involving the company, broker and bank intermediaries and beneficial owners.

Section 14(b) was enacted as part of the passage of the Exchange Act in 1934,[2] with the aim of addressing the concern that brokers were voting customer shares without first consulting them. The SEC did not use its rulemaking authority under this section due to questions about the scope of its authority, particularly whether it could force broker-dealers to distribute proxies.[3] Congress amended Section 14(b) in 1964 to clarify that the SEC could regulate brokers in this regard and require them to distribute proxy materials.[4]

The Shareholder Communications Act of 1985 extended the SEC's rulemaking authority with respect to proxy distribution to cover bank intermediaries.[5] Bank regulatory authorities had authority, but refused to implement rules with respect to shareowner communications, despite SEC requests to do so.[6] The 1985 amendments distinguished between the SEC's authority to require banks to produce lists of beneficial owners depending on whether a customer's account with the bank was (i) opened on or before Dec. 28, 1985 or (ii) opened after Dec. 28, 1985. For the latter, the SEC had the same authority as it had for brokers (i.e., it could require disclosure of a NOBO list). For the former, it could only require disclosure of the beneficial owners for customers who affirmatively consented to such disclosure. This was a compromise to address banks' concern about existing customers' expectation of privacy.[7]

In 1990, Section 14(b) was amended to extend the proxy forwarding requirements to securities issued by investment companies covered by the Investment Company Act of 1940.[8]

Exchange Act Rule 14a-13[9]

Rule 14a-13 outlines a company's obligations with respect to shareowner communications, particularly proxy solicitations, including its responsibilities to gather information from broker and bank intermediaries[10] and to forward sufficient quantities of proxy materials to permit distribution by intermediaries to beneficial owners.[11] The rule permits direct communication between the company and NOBOs in the limited form of the annual report.[12]

Rule 14a-13 was adopted in January 1986[13] and consolidated prior regulatory provisions. Concurrently with the adoption of Rule 14b-2, Rule 14a-13 was amended to reflect the incorporation of banks into the communications system as regulated by the SEC.[14] In 1992, Rule 14a-13 was amended to cover investment company securities.[15]

Exchange Act Rule 14b-1[16]

Rule 14b-1 outlines broker obligations to respond to information requests from companies about shares held in street name and requires brokers to forward proxy materials to beneficial owners.[17] Rule 14b-1(b)(3) requires brokers to provide NOBO lists.

Rule 14b-1 was adopted in 1977, but did not take its current form until the 1983 amendments.[18] The SEC proposed amended Rule 14b-1 in December 1982,[19] with a view to facilitating communications between companies and beneficial owners, allowing direct communication in some cases. In part to retain the existing framework, which it found workable and facilitated the immobilization of share certificates,[20] the SEC adopted a system that incorporated direct communications with NOBOs into a general system of communication with beneficial owners through intermediaries. The proposed rules were scheduled to become effective on Jan.1, 1985,[21] but effectiveness was deferred for one year to Jan.1, 1986[22] to address broker concerns, particularly about cost. During the deferral, the SEC approved a provision allowing brokers to delegate their forwarding obligations to an agent and set time periods for brokers to respond to companies' information requests.[23] In 1992, the SEC amended Rule 14b-1 to impose on brokers comparable information and proxy-forwarding requirements with respect to registered investment companies.[24] In 2007, the SEC added subsections (d) and (e) to address distribution requirements for companies using the e-proxy rules.[25]

Exchange Act Rule 14b-2[26]

Rule 14b-2 extends the communication obligations of broker intermediaries to banks and generally imposes the same requirements. Differences exist that reflect the more limited scope of the SEC's regulatory authority. See Annex A for the differences in the two approaches.

Rule 14b-2 was adopted in November 1986 and became effective July 1, 1987.[27] As in the case of Rule 14b-1, the SEC amended Rule 14b-2 in 1992 to impose on banks comparable information and proxy forwarding requirements with respect to registered investment companies[28] and, in 2007, to reflect adoption of the e-proxy rules.[29]

Exchange Act Section 14(c)[30]

Section 14(c) requires a company that is not seeking proxies, consents or other authorizations from its shareowners to forward to all record holders information statements containing "information substantially equivalent to the information which would be required to be transmitted if a solicitation were made."[31] Companies must comply with SEC rules in distributing information.

Congress adopted Section 14(c) as part of the 1964 amendments to the Exchange Act with a view to allowing the SEC to regulate the distribution of information statements. The SEC was concerned that some companies were avoiding the proxy disclosure rules by choosing not to solicit proxies.[32]

Exchange Act Rule 14c-7[33]

Rule 14c-7 regulates a company's obligations with respect to shareowner communications and generally mirrors Rule 14a-13, but relates to materials that are "substantially similar" to those distributed with a proxy card, but that a company might distribute when not soliciting proxies.

Rule 14c-7 was first adopted in January 1986, consolidating all of a company's obligations with respect to the distribution of information statements into one rule.[34] Rule 14c-7 was amended concurrently with the adoption of Rule 14b-2 to reflect the integration of bank intermediaries into the shareowner communications system.[35]

Exchange Act Rule 17a-3(a)(9)[36]

Rule 17a-3(a)(9) facilitates the shareowner communication system by requiring members of national securities exchanges and registered broker-dealers to keep records of the names and addresses of customers who hold cash or margin accounts. The intermediary must also record OBO/NOBO status. The rule only applies to broker intermediaries, as the SEC does not have authority with respect to the books and records of banks.

Exchange Act Rule 17Ad-8[37]

Enacted in 1979, Rule 17Ad-8 also facilitates the shareowner communication system by requiring registered clearing agencies to furnish a company with a position listing on request.[38] The Depository Trust Company (DTC) is the sole U.S. depository institution and the holder of record for shares immobilized with it, including shares held in street name through its participants. In particular, the rule allows a company to determine which broker and bank intermediaries that are DTC participants hold shares in street or nominee name.

Endnotes

Sections I – VIII

[1] *See* J. Robert Brown, Jr. *Shareholder Communication Rules and the SEC: An Exercise in Regulatory Utility or Futility?,* 13 J. Corp. L. 683, 687-88 (1988). Banks most typically use nominee partnerships to hold shares on behalf of their customers. See Louis Loss et al., Securities Regulation 664 (4th ed. 2006).

[2] *See* Loss et al., *supra* note 1, at 664.

[3] *See* Order Granting Approval to Proposed Rule Change Relating to a One-Year Pilot Program for Transmission of Proxy and Other Shareholder Communication, SEC Release No. 34-38406 (Mar. 14, 1997), at n.5.

[4] *See* Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Governance*, 96 Geo.L.J. 1227, 1237 (2008).

[5] *See* 17 C.F.R. § 240.14a-13(c) (2009).

[6] *Id.* § 240.14a-3(a). Brokers typically forward the proxies using first class mail. *See* Brown, *supra* note 1, at 761-62. A company choosing to forward the annual report directly also would have to use first class mail to ensure it met the requirement of preceding the proxy. As a result, the company likely would not realize cost savings if it choose to forward the annual report directly.

[7] *See* SEC, Report of the Advisory Committee on Shareholder Communications, Improving Communications Between Issuers and Beneficial Owners of Nominee Held Securities 70 (1982) (Advisory Committee Report).

[8] *See* 17 C.F.R. § 240.14b-1(b)(3)(i) (brokers); *Id.* § 240.14b-2(b)(4)(ii)(B) (banks).

[9] Because Broadridge is the agent for essentially all intermediaries in the proxy process described herein, we refer to the intermediaries' agent as Broadridge in this memorandum.

[10] *See* 17 C.F.R. § 240.14b-1(b)(3)(i) (brokers); *Id.* § 240.14b-2(b)(4)(ii) (banks).

[11] As noted, the standard for disclosure under the OBO/NOBO regime is that one must affirmatively object to disclosure for the broker to withhold a beneficial owner's information from the company. See Facilitating Shareowner Communications, SEC Release No. 34-19291, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,282 at 10 (Dec. 10, 1982) (SEC 1982 Release). However, in the case of bank intermediaries, the standard of consent differs between customer accounts opened on or before December 28, 1986 (the effective date on which the standard of consent in respect of accounts held at bank intermediaries was modified), and those opened after. For the former, the customer must affirmatively consent to such disclosure, as opposed to simply not objecting. 17 C.F.R. § 240.14b-2(b)(4)(ii)(A). Please refer to Annex A for more details.

[12] *See* Report and Recommendations of the Proxy Working Group to the New York Stock Exchange 11 (2006), *available at* http://www.nyse.com/pdfs/PWG_REPORT.pdf (PWG Report).

[13] Bus. Roundtable, Request for Rulemaking Concerning Shareholder Communications, Petition 4-493, Apr. 12, 2004, at n.2, http://www.sec.gov/rules/petitions/petn4-493.htm (BRT Proposal).

[14] *See* 17 C.F.R. § 240.17Ad-8(b).

[15] *See Id.* § 240.14a-13(a)(1), *id.* § 240.14a-13(a)(3). If the 20 days proves impracticable, the company must act as many days before the record date as is practicable. *Id.* § 240.14a-13(a)(3). Note that in Delaware, the record date must be not more than 60 days but not less than 10 days prior to the meeting date. Del. Code Ann, tit. 8, § 213 (2009).

[16] *See* 17 C.F.R. § 240.14b-1(b)(1).

[17] *Id.* § 240.14b-2(b)(1)(i). Under SEC Rules, "respondent bank" is defined as "any bank, association or other entity that exercises fiduciary powers which holds securities on behalf of beneficial owners and deposits such securities for safekeeping with another bank, association or other entity that exercises fiduciary powers." *Id.* § 240.14a-1(k).

[18] *Id.* § 240.14a-13(a)(2).

[19] *Id.* § 240.14b-2(b)(1)(ii).

[20] *Id.* § 240.14a-13(b)(2).

[21] *Id.* § 240.14b-1(b)(3)(i) (brokers); *Id.* § 240.14b-2(b)(4)(ii) (banks).

[22] *Id.* § 240.14b-1(b)(3)(ii) (brokers) ("no later than five business days after the record date or other date specified by the registrant"); *Id.* § 240.14b-2(b)(4)(iii) (banks) ("no later than five business days after the date specified by the registrant").

[23] *Id.* § 240.14a-13(a)(4).

[24] *See Id.* § 240.14b-1(b)(2) (rule requiring brokers to forward a company's communications); *Id.* § 240.14-2(b)(3) (rule requiring bank intermediaries to forward a company's communications).

[25] *See Id.* § 14a-13(c) (companies may forward annual report directly to NOBOS); *Id.* § 240.14b-1(c)(2)(ii) (brokers need not forward annual report to NOBOs if company indicates its intention to do so); *Id.* § 240.14b-2(c)(2)(ii) (banks need not forward annual report to NOBOs if company indicates its intention to do so).

[26] *See, e.g,* Del. Code Ann, tit. 8, §212 (2009).

[27] *See* Kahan & Rock, *supra* note 4, at 1247.

[28] *See* SEC, 94th Con., 2d Sess., Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in other than the Name of the Beneficial Owner of Such Securities 15, House Comm. on Interstate and Foreign Com. (Comm. Print 1976) (Street Name Study).

[29] *See* R. Franklin Balotti et al., Meetings of Stockholders § 10.7 (3d. ed. 1996 & Supp. 2002).

[30] 17 C.F.R. § 240.14b-1(b)(2) (for brokers); *id.* § 240.14b-2(b)(3) (for banks).

[31] *See* Balotti et al., *supra* note 29, at § 10.7. See Kahan & Rock, *supra* note 4, at 1247.

[32] Concerns have been raised about whether Broadridge always properly accounts for revoked votes and how it adjusts internally for overvoting. *See Id.* at 1253-54. It appears that the inability to audit Broadridge's verification process may be a function of state law. Under Delaware law, for example, election inspectors are limited in what they may examine to determine the validity of proxies, and in particular may only go beyond the proxy card in the limited circumstance of overvoting in cases of nominee holders. Del. Code Ann, tit. 8, § 231(d) (2009) ("In determining the validity and counting of proxies and ballots, *the inspectors shall be limited to an* examination of the proxies, any envelopes submitted with those proxies, any information provided in accordance with § 211(e) or § 212(c)(2) of this title, or any information provided pursuant to § 211(a)(2)(B)(i) or (iii) of this title, ballots and the regular books and records of the corporation, except that the inspectors may consider other reliable information for the limited purpose of reconciling proxies and ballots submitted by or on behalf of banks, brokers, their nominees or similar persons which represent more votes than the holder of a proxy is authorized by the record owner to cast or more votes than the stockholder holds of record (emphasis added).") .

[33] *See* RiskMetrics Group, Proxy Voting Services for Institutional Investors, at 2, *available at* http://www.riskmetrics.com/sites/default/files/GS2-Proxy%20Voting%20Services.pdf (last visited Nov. 30, 2009).

[34] *See, e.g.,* Egan-Jones Proxy Services, About Our Services, http://www.ejproxy.com/services.aspx ("Egan-Jones offers automated voting services for a small additional fee to eliminate the hassle and expense of handling this increasingly important aspect of the investment process. Plus, clients retain the ability to over-ride Egan-Jones's recommendations if desired."). Egan-Jones is another prominent proxy adviser in the U.S. market.

[35] *See* NYSE Inc., Rule 465 Supplementary Material; FINRA Inc., Rule 2260 Interpretive Material. NYSE Rule 465 specifies reasonable reimbursement rates members may charge companies, both listed and unlisted, for forwarding communications. Given that all broker intermediaries are members of NYSE, as is Broadridge, the NYSE fee schedule is the applicable one in almost all cases.

[36] Reimbursement of an amount no greater than that brokers are permitted to charge for reimbursement is deemed a reasonable amount. *See* NYSE Inc., Rule 465 Supplementary Material; FINRA Inc., Rule 2260 Interpretive Material for approved fee schedules.

[37] *See* Brown, *supra* note 1, at 715.

[38] *Id.* Under the old system of trading, shareowners held physical stock certificates registered with the issuer. To execute a trade, these certificates would be delivered to the transfer agent after sale and endorsed to the buyer of the stock. *See* Kahan & Rock, *supra* note 4, at 1237.

[39] *See* Brown, *supra* note 1, at 720.

[40] 15 U.S.C. §78q-1 (2009).

[41] *Id.* § 78q-1(e).

[42] Of course, in most cases today, the record holder is DTC. *See supra* note 4 and accompanying text.

[43] *See* Brown, *supra* note 1, at 693.

[44] *See Id.* at 721.

[45] *See* Street Name Study, *supra* note 28.

[46] *Id.* at 3.

[47] *Id.* at 42. The SEC found that 11 days prior to meetings, similar numbers of record and street name holders received proxies. *Id.* at 17. The SEC also found that companies with the highest percentage of street name ownership had the highest percentage of voting participation. *Id.* at 21.

[48] H.R. Rep. No. 181, 99th Cong., 1st Sess. 2-3 (1985) (emphasis added).

[49] *See* SEC Staff Report on Corporate Accountability, Division of Corporate Finance 7 (1980) (Staff Report).

[50] *Id.*

[51] *See Id.*

[52] *See, e.g., Id.* at 544. State corporate law in most, if not all, states provides that the board of directors manages the affairs of the corporation on the shareowner's behalf. *See, e.g.,* Del. Code Ann., tit. 8, § 141(a) (2009).

[53] *See* Brown, *supra* note 1, at 715 – 16.

[54] *See* Staff Report, *supra* note 49, at 29.

[55] *See* Street Name Study, *supra* note 28, at 2.

[56] *See* Staff Report, *supra* note 49, at 374-75.

[57] *See* Brown, *supra* note 1, at 735.

[58] *See* Advisory Committee Report, *supra* note 7, at 25-29.

[59] *See* Facilitating Shareholder Communications Provisions, Exchange Act Release No. 34-20021 (Aug. 3, 1983) (SEC 1983 Release).

[60] *See* Advisory Committee Report, *supra* note 7, at 55, 58-60.

[61] *See Id.* at 69.

[62] *See Id.* at 62-63. The issue of non-standardized lists is of course soluble; for example, Broadridge currently provides a standardized NOBO list to companies.

[63] *See Id*. at 69.

[64] *See* Facilitating Shareholder Communications, SEC Release No. 34-22533, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,930 (Oct. 15, 1985) (SEC 1985 Release).

[65] *See Id.*

[66] *See Id.*

[67] *See* Advisory Committee Report, *supra* note 7, at 29-31.

[68] *See* Brown, supra note 1, at 743.

[69] *See* Pub. L. No. 99-222, §2, 99 Stat. 1737 (1985).

[70] *See* Shareholder Communication Facilitation, SEC Release No. 34-23847 (Nov. 25, 1986). These rules became effective in 1987.

[71] In Delaware, quorum is a majority as a default, but can be set as low as one-third in the charter. Del. Code Ann., tit. 8, § 216 (2001).

[72] *See* Advisory Committee Report, *supra* note 7, at 68; SEC 1982 Release, *supra* note 11, at 10.

[73] *See* PWG Report, *supra* note 12, at ex. B at 3, 21.

[74] *See* Del. Code Ann., tit. 8, § 220 (2009). *See also* Model Bus. Corp. Act § 1602 (2005). The Model Business Corporation Act also requires shareowner lists to be available to all shareowners two days after notice of a meeting is given. *See* Model Bus. Corp. Act § 720.

[75] *See Shamrock Associates v. Texas American Energy Corp.,* 517 A.2d 658, 661 (Del. Ch. 1986).

[76] *See R.B. Associates of New Jersey v. Gillette Co.,* 1998 Del. Ch. LEXIS 40, *21 (Del. Ch. 1988).

[77] *See* 17 C.F.R. §240.14a-13(b)(4) (requiring companies to only use the list for "corporate communications"); *Shamrock Associates v. Texas American Energy Corp.,* 517 A.2d 658 (Del. Ch. 1986) (applying restrictions on companies with respect to use of NOBO lists to dissident shareowners using the same lists).

[78] *See* 17 C.F.R. § 240.13d-1.

[79] *See* The Altman Group, Practical Solutions to Improve the Proxy Voting System, Oct. 21, 2009, at 10, available at http://www.altmangroup.com/pdf/PracticalSolutionTAG.pdf.

[80] *See* Brown, *supra* note 1, at 766-67.

[81] *See* 17 C.F.R. § 240.14a-7 (2009).

[82] *See* Del. Code Ann., tit. 8, § 220 (2009). *See also* Model Bus. Corp. Act § 1602 (2005). The shareowner's request is a written demand made under oath that also provides evidence of beneficial ownership if the shareowner is not the record owner.

[83] *See Marathon Partners L.P. v. M&F Worldwide Corp.,* 2004 Del. Ch. LEXIS 101, *30, *37 (Del. Ch. 2004) (communication with other stockholders "to effectuate a change in management policies" held to be a proper purpose); *Conservative Caucus Research, Analysis & Educ. Foundation, Inc. v. Chevron Corp.,* 525 A.2d 569, 571 (Del. Ch. 1987) (communication with other stockholders regarding the economic risks of a company's business activity in Angola and a resolution that was proposed to be submitted in connection with an annual meeting held to be a proper purpose); *Weiss v. Anderson, Clayton & Co.,* C.A. No. 8488 (Del. Ch. May 22, 1986) (communication with other stockholders to encourage them to dissent from a merger and seek appraisal held to be a proper purpose). Under Delaware law, a "proper purpose" is defined as "a purpose reasonably related to such person's interest as a stockholder." *See* Del. Code Ann., tit. 8, § 220(b).

[84] *See Id.* § 220(c). *See also* Model Bus. Corp. Act § 1604 (2005). There is no reliable data on which to estimate the costs of litigating the propriety of a demand in these circumstances, but depending on the circumstances, the cost could be meaningful in amount.

[85] *See Id.*

[86] *See Shamrock Associates,* 517 A.2d 658.

[87] *See, e.g., Hibbert v. Hollywood Park, Inc.,* 457 A.2d 339, 345 (Del. 1983) (court held reimbursement acceptable for "reasonable expenses" in a proxy contest actually involving "substantive differences about corporation policy"); *Rosenfeld v. Fairchild Engine & Airplane Corp.,* 128 N.E.2d 291 (N.Y. 1955).

[88] 953 A.2d 227 (Del. 2008).

[89] Del. Code Ann., tit. 8, § 113 (2009). *See* 145th Delaware General Assembly, "An Act To Amend Title 8 of The Delaware Code Relating To The General Corporation Law," *available at* http://delcode.delaware.gov/sessionlaws/ga145/chp014.shtml. Any bylaw a company adopted likely would have to ensure the board had sufficient discretion over reimbursement such that it could satisfy its fiduciary duties, as Section 113 does not seem to trump the holding in *CA, Inc.,* and merely clarifies that propriety of a bylaw allowing reimbursement under Delaware law. The Committee on Corporate Laws of the Section of Business Law of the American Bar Association has proposed a similar amendment to the Model Business Corporation Act.

[90] *See* BRT Proposal, *supra* note 13.

[91] *See* Letter from Alexander M. Cutler, Chairman and Chief Executive Officer of Eaton Corporation and Chair, Corporate Leadership Initiative, Business Roundtable, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Aug. 17, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-267.pdf; Letter from Henry A. McKinnell, Chairman, Business Roundtable, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf.

[92] *See* Letter from Niels Holch, Shareholder Communications Coalition Executive Director, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n (Aug. 8, 2009), *available at* http://shareholdercoalition.com/SCCLettertoSECChairmanMarySchapiroAug2009.pdf (SCC Letter). The Shareholder Communications Coalition consists of the Business Roundtable, the National Association of Corporate Directors, the National Investor Relations Institute, the Securities Transfer Association, and the Society of Corporate Secretaries and Governance Professionals.

[93] *See* BRT Proposal, *supra* note 13, at 6.

[94] *See* NYSE Inc., Rule 465 Supplementary Material.

[95] Small companies might not realize these cost-savings, however, because any scale effect of lower costs per distribution might not outweigh the fixed costs of implementing such a system.

[96] Letter from Donald D. Kittell, Executive Vice President, Sec. Indus. Ass'n, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (June 24, 2004), *available at* http://www.sifma.org/regulatory/comment_letters/comment_letter_archives/30454888.pdf (SIA Letter).

[97] *Cf.* Brown, *supra* note 1, at 725.

[98] *See* NYSE Inc., Rule 465 Supplementary Material for fee schedules.

[99] *See* Kahan & Rock, *supra* note 4, at 1240. Although retail customers holding shares in margin accounts and some institutional investors do not share securities lending fees, many institutional investors already share in such fees. *See Id.* at 1239. The amounts institutional investors may earn from securities lending fees can be substantial. For example, for the year ending in March 31, 2006, one institutional investor made $129.4 million from securities lending. *See Id.*

[100] *See Id.* at 1240.

[101] *See Id*. at 1273.

[102] *See Id*. at 1240.

[103] *See Id*. at 1238.

[104] *See* Broadridge, http://www.broadridge.com/about.asp (last visited Nov. 7, 2009).

[105] *See* Balotti, et al., *supra* note 29, at § 13.15.4; Kahan & Rock, *supra* note 4, at 1254.

[106] *See* PWG Report, *supra* note 12, at ex. B at 3.

[107] Currently, between 70-80 percent of street name holders are OBOs. *See supra* note 3 and accompanying text. If customers acted in line with their stated preferences in the PWG survey and investors generally shared similar preferences to retail investors, that would mean that only 36 percent of customers would be OBOs, or half the current number.

[108] 17 C.F.R. § 240.14b-1(b)(3)(i) (brokers); *Id.* § 240.14b-2(b)(4)(ii)(B) (banks). This standard is applicable only to customer accounts at banks opened after Dec. 28, 1986. Affirmative consent is required for customer accounts at banks opened on or before Dec. 28, 1986. *Id.* § 240.14b-2(b)(4)(ii)(A).

[109] *See* SEC 1983 Release, *supra* note 59, at 8.

[110] *See* NYSE Inc., Rule 465 Supplementary Material (list of fees that brokers and their agents may charge for provision of various services related to the proxy and communication distribution process). Banks typically follow the NYSE rules when determining the fees to charge.

[111] Given the retail customer response to an annual fee for privacy as noted previously, see *supra* note 73 and accompanying text, it seems unlikely that many retail holders would choose to invest via nominee accounts under such a system.

[112] *See* BRT Proposal, *supra* note 13. See Kahan & Rock, *supra* note 4, at 1271-72 for a summary. The BRT proposal is just one approach to a system of direct communications. Alternatives have been presented, many of which differ in minor respects from BRT's proposal. *See, e.g.,* SCC Letter, *supra* note 92. As one example, the Altman Group has proposed a system under which companies have access to the information of all beneficial owners (ABOs), but may only request the "ABO" list a limited number of times a year. This proposal contemplates a variety of alterations to the system of distributing proxy materials. *See* The Altman Group, *supra* note 79, at 12-13.

[113] *See,* e.g., 17 C.F.R. § 240.17a-3(a)(9) (requiring brokers to maintain records regarding information about the beneficial owners of an company's shares).

[114] The BRT proposal does not specify who would pay what fees under their communications framework and also does not state the specific requirements a shareowner must meet to be able to get the list for the purpose of soliciting support for its proxy proposal. However, in the latter case, likely the standard would be similar as that under state law currently. *See supra* notes 74-77 and accompanying text.

[115] *See* Advisory Committee Report, *supra* note 7, at 66.

[116] *See* SEC 1985 Release, *supra* note 64, at 2-3.

[117] *See* SIA Letter, *supra* note 96.

[118] *See*, e.g., *supra* note 48 and accompanying quote. Retail investor participation is a current issue of concern to the SEC. See Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Address to the Practicing Law Institute's 41st Annual Institute on Securities Regulation 7 (Nov. 4, 2009), *available at* http://www.sec.gov/news/speech/2009/spch110409mls.htm (Schapiro Speech).

[119] In the absence of legislation, the option to elect OBO status would presumably be retained for customer accounts maintained by banks and opened on or before Dec. 28, 1985. *See infra* Annex C, note 7 and accompanying text.

[120] While not directly germane to the communications framework, we note that the current large shareholder reporting threshold under Exchange Act Section 13 (beneficial ownership individually or as a part of a group of 5 percent or more of a company's voting securities) is probably too high. Both companies and other shareowners have a legitimate interest in knowing the identities of large investors, and for many companies that threshold is probably 3 percent or even 1 percent. It is noteworthy that the SEC incorporated lower ownership thresholds (1percent for large accelerated filers and 3 percent for accelerated filers) among the conditions for shareowner nominations of directors in its most recent proxy access proposal. Facilitating Shareholder Director Nominations, SEC Release Nos. 33-9046; 34-60089, IC-28765 (June 10, 2009).

[121] *See supra* note 62 and accompanying text.

[122] A single list is also an important step towards end-to-end audits of shareowner votes. Otherwise, votes from record holders who are also beneficial owners can be directly audited, but the number of votes of shares held in street name may only be compared against the number of shares held by record holders. *See* Kahan & Rock, supra note 4, at 1253.

[123] *See Id.* at 1253-55.

[124] *See* Schapiro Speech, *supra* note 118, at 7.

[125] Reliability of the proxy distribution system continues to be an emphasis of the SEC. *See Id.*

ANNEX A

[1] *See* 17 C.F.R. § 240.17Ad-8 (2009).

[2] *Id.* § 240.14a-13(a)(1)(i).

[3] *See Id.*

[4] *See Id.* § 240.14c-7(a)(1).

[5] *See Id.* § 240.14a-13(a)(1)(ii)(A). For distribution of an information statement not in connection with a proxy, *see Id.* § 240.14c-7(a)(1)(ii)(A).

[6] *Id.* § 240.14a-13(a)(3).

[7] *Id.* § 240.14a-13(a)(3)(i). A company also may be allowed a shorter period if a securities exchanges allows. *Id.* § 240.14a-13(a)(3)(iii).

[8] *Id.* § 240.14b-1(b)(1).

[9] This requirement is only applicable if the company has indicated under *Id.* § 240.14a-13(a)(1)(ii)(A) or *Id.* § 240.14c-7(a)(1)(ii)(A) that it will distribute the annual report to NOBOs.

[10] *Id.* § 240.14b-1(b)(1). A broker may inform a company in advance to forward such communications to its appointed agent.

[11] Broadridge used to be ADP Brokerage Services Group before it was spun off by ADP in 2007.

[12] 17 C.F.R. § 240.14b-1(b)(3)(i).

[13] *Id.* § 240.14b-1(b)(3)(ii). The company may also specify a date other than the record date. *See Id.*

[14] *Id.* § 240.14a-13(a)(4).

[15] *Id.* § 240.14a-13(c); *Id.* § 14c-7(c).

[16] *Id.* § 240.14b-1(d).

[17] *Id.* § 240.14b-1(b)(2).

[18] *Id.* § 240.14a-13(a)(5).

[19] *See* NYSE Inc., Rule 465 Supplementary Material and FINRA Inc., Rule 2260 Interpretive Material for approved fee schedules.

[20] 17 C.F.R. § 240.14b-1(b)(2).

[21] *Id.* § 240.14a-13(a)(1)(i). *See also Id.* § 240.14c-7(a)(1)(i) (forwarding information statements when not soliciting proxies).

[22] "Respondent bank" is defined at *Id.* § 240.14a-1(k).

[23] *Id.* § 240.14b-2(b)(1)(i).

[24] *Id.* § 240.14a-13(a)(2).

[25] *Id.* § 240.14b-1(b)(1)(ii)(A).

[26] *Id.* § 240.14b-2(b)(1)(ii)(B). This requirement is only applicable if the company has indicated under *Id.* § 240.14a-13(a)(1)(ii)(A) or *Id.* § 240.14c-7(a)(1)(ii)(A) that it will distribute the annual report to beneficial owners who do not object. Note that the relevant standard for consent depends on whether a customer account was opened on or before or after Dec. 28, 1986. For accounts opened on or before Dec. 28, 1986, the bank should indicate how many beneficial owners have affirmatively consented to disclosure of their names, addresses and securities positions. *Id.* § 240.14b-2(b)(1)(ii)(B)(1). For those accounts opened after Dec. 28, 1986, the relevant standard is customers who have not objected to disclosure of their information. *Id.* § 240.14b-2(b)(1)(ii)(B)(2).

[27] *Id.* § 240.14b-2(b)(4)(iii).

[28] *Id.* § 240.14b-2(b)(4)(ii)(B).

[29] *Id.* § 240.14b-2(b)(4)(ii)(A).

[30] *Id.* § 240.14b-2(b)(5).

[31] *Id.* § 240.14a-13(a)(4).

[32] *Id.* § 240.14b-2(b)(3).

[33] *Id.*

[34] *See Id.* § 240.14b-2(c)(3).

[35] *Id.* § 240.14b-2(b)(2)(i).

ANNEX C

[1] 15 U.S.C. § 78n(b) (2009).

[2] H.R. Rep. No. 1838, 73d Cong., 2d Sess. 16 (1934).

[3] *See* J. Robert Brown, Jr., *Shareholder Communication Rules and the SEC: An Exercise in Regulatory Utility or Futility?,* 13 J. Corp. L. 683, 700 (1988).

[4] *See Id.* at 711.

[5] *See* Pub. L. No. 99-222, §2, 99 Stat. 1737 (1985).

[6] Section 12(i) of the Exchange Act did require bank regulatory agencies to issue "substantially similar regulations to regulations and rules" that the SEC issued with respect to some provisions of the Exchange Act. See 15 U.S.C. § 78l(i) (1982). Section 14(b) was not one of the covered sections, however.

[7] *See* Brown, *supra* note 3, at 744.

[8] *See* Pub.L. No. 101-550, Title III § 302(b), 104 Stat. 2721(1990).

[9] 17 C.F.R. § 240.14a-13 (2009).

[10] *Id.* § 240.14a-13(a)(1).

11 *Id.* § 240.14a-13(a)(4).

12 *Id.* § 240.14a-13(c).

13 *See* Facilitating Shareholder Communications, SEC Release No. 34-22533, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,930 (Oct. 15, 1985) (SEC 1985 Release).

14 *See* Shareholder Communication Facilitation, SEC Release No. 34-23847 (Nov. 25, 1986) (SEC 1986 Release).

15 *See* Shareholder Communication Rules, SEC Release No. 34-30147 (Jan. 10, 1992).

16 17 C.F.R. § 240.14b-1 (2009).

17 *Id.*

18 *See* Facilitating Shareholder Communications Provisions, Exchange Act Release No. 34-20021 (Aug. 3, 1983) (SEC 1983 Release).

19 *See* Facilitating Shareholder Communications, SEC Release No. 34-19291, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,282 (Dec. 10, 1982).

20 *See* Brown, *supra* note 3, at 735-36.

21 *See* SEC 1983 Release, *supra* note 18.

22 *See* SEC Release No. 34-21339 (Sept. 21, 1984).

23 *See* SEC 1985 Release, *supra* note 13.

24 *See* Shareholder Communication Rules, *supra* note 15.

25 *See* Internet Availability of Proxy Materials, SEC Release No. 34–55146 (Mar. 30, 2007).

26 17 C.F.R. § 240.14b-2 (2009).

27 *See* SEC 1986 Release, *supra* note 14.

28 *See* Shareholder Communication Rules, *supra* note 15.

29 *See* Internet Availability of Proxy Materials, *supra* note 25.

30 15 U.S.C. § 78n(c) (2009).

31 *Id.*

32 *See* Brown, *supra* note 3, at 712.

33 17 C.F.R. § 240.14c-7 (2009).

34 *See* SEC 1985 Release, *supra* note 13.

35 *See* SEC 1986 Release, *supra* note 14.

36 17 C.F.R. § 240.17a-3(a)(9) (2009).

37 *Id.* § 240.17Ad-8.

38 *Id.* § 240.17Ad-8(b).

Selected Resources

1. Securities Exchange Act of 1934
    a. 15 U.S.C. § 78n(b) (2009) (Section 14(b))
    b. 15 U.S.C. § 78n(c) (Section 14(c))
2. Rules under the Securities Exchange Act of 1934
    a. 17 C.F.R. § 240.14a-1 (2009)
    b. 17 C.F.R. § 240.14a-13
    c. 17 C.F.R. § 240.14b-1
    d. 17 C.F.R. § 240.14b-2
    e. 17 C.F.R. § 240.14c-1
    f. 17 C.F.R. § 240.14c-7
    g. 17 C.F.R. § 240.17a-3(a)(9)
    h. 17 C.F.R. § 240.17Ad-8
3. Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Governance, 96 Geo. L.J. 1227 (2008)
4. J. Robert Brown, Jr., Shareholder Communication Rules and the SEC: An Exercise in Regulatory Utility or Futility?, 13 J. Corp. L. 683 (1988)
5. Report and Recommendations of the Proxy Working Group to the New York Stock Exchange (2006), available at http://www.nyse.com/pdfs/PWG_REPORT.pdf
6. Bus. Roundtable, Request for Rulemaking Concerning Shareholder Communications, Petition 4-493, Apr. 12, 2004, http://www.sec.gov/rules/petitions/petn4-493.htm
7. Letter from Niels Holch, Shareholder Communications Coalition Executive Director, to Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n (Aug. 8, 2009), available at http://shareownercoalition.com/SCCLettertoSECChairmanMarySchapiroAug2009.pdf
8. The Altman Group, Practical Solutions to Improve the Proxy Voting System, Oct. 21, 2009, http://www.altmangroup.com/pdf/PracticalSolutionTAG.pdf

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