August 17, 2009

Via Email: rule-comments@sec.gov

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 Release No. 34-60089
Facilitating Shareholder Director Nominations

Dear Mr. Murphy:

The Commission has proposed important reforms in how it treats proxy access for shareholder nominees to corporate boards in the above-referenced release (the "Proxy Access Proposal"). I believe that the Proxy Access Proposal is a major step forward from the status quo. It would significantly increase the accountability of corporate boards. However, the Commission could do better. The Proxy Access Proposal is too inflexible. In this letter I suggest two alternatives that would be preferable. The first would be to scrap proposed Rule 14a-11 but go forward with the proposed changes to Rule 14a-8. This would allow shareholders to develop individualized proxy access programs for their own corporations through bylaw proposals. The second alternative would follow proposed Rule 14a-11, but allow shareholder bylaws to modify the 14a-11 scheme in any direction that shareholders desire, not just in directions that increase the ease of shareholder access as the Proxy Access Proposal provides. This alternative also would give shareholders full flexibility to develop individualized proxy access programs. The difference between these two alternatives is in the default rules of proxy access that would apply in the absence of a shareholder bylaw.

I develop my argument against the status quo and for these two alternatives in several steps. First, I identify the leading principles that should guide rulemaking in this area: accountability, appropriate respect for board authority, and flexibility that allows for experimentation and tailoring to the needs of differing companies. Second, I explain why the need for greater accountability makes the Proxy Access Proposal clearly preferable to the status quo. Third, I explain why lack of flexibility makes the Proxy Access Proposal less than optimal. Fourth, I explore the two alternatives described above, showing why they are both improvements upon the Proxy Access Proposal and arguing that the second of the two alternatives is the best available option.

Guiding Principles

Several principles should guide rulemaking in this area: accountability, appropriate respect for board authority, and flexibility.

A central purpose of both state corporate law and federal securities law is to ensure adequate accountability for the directors and officers who make decisions in public corporations. The well-known separation of ownership and control that occurs within corporations with a dispersed shareholder base makes this an ongoing problem for most of this country's major businesses. Ultimately boards are supposed to be accountable to the shareholders who elect them. However, collective action problems make it hard for shareholders to be actively involved in holding boards accountable. Although these collective action problems cannot be completely overcome, a major trend of corporate law in recent years has been the search for ways to help shareholders play a somewhat greater role in overseeing the performance of corporate boards.

Shareholder proxy access is a major step forward in that search for greater accountability. The ability to elect directors is the single most important power that shareholders have. However, dominance of the electoral system by incumbent boards has destroyed the practical significance of that power except in cases of attempted hostile takeovers, where enough is at stake to motivate shareholders to engage in costly proxy contests. Most of the time, the costs of proxy solicitation are just not worth it even to engaged shareholder organizations. Thus, reducing the costs of involvement in board elections is crucial to making the leading power of shareholders more meaningful. Proxy access, whereby the corporation bears the costs of solicitation through including shareholder nominees in the corporate proxy, is a leading way to accomplish that.

A second guiding principle is appropriate respect for board authority. In a large public corporation it is inevitable that shareholders cannot be involved in the vast majority of decisions, even important decisions—there are just too many shareholders, they have too little at stake, and the costs of disseminating information, processing that information, and reaching agreement are way too large. Corporate law quite rightly vests decisionmaking authority in the board, which in turn delegates much of that authority to officers. Moreover, board authority also helps protect non-shareholder constituencies and minority shareholders. Achieving the proper balance between accountability and authority is the defining tension of corporate law.

The third guiding principle is flexibility. Allowing corporations and their shareholders some meaningful choice in how to govern themselves is useful for at least two reasons. One, not all corporations are the same, and rules that work well for some corporations may not work as well for others. We want corporations to be able to tailor the rules to suit their own circumstances. Two, what rules are best for most corporations is not at all obvious much of the time. If we allow for experimentation across corporations, we will be able to observe the experience of companies that adopt differing rules and see what works and what does not.

The Proxy Access Proposal Improves upon the Status Quo

Applying these three principles, the Proxy Access Proposal clearly improves upon the status quo. It would importantly improve board accountability. It would limit board authority, but in an appropriate way. It is no less effectively flexible than the current system.

The Proxy Access Proposal would clearly increase the accountability of directors to shareholders. The main system for such accountability is board elections. However, as noted above, that system currently provides no contest for incumbents in all but the most extreme of situations. The recent introduction of majority voting now allows for just vote no campaigns, which are a step forward. However, having a system allowing for real choice in director elections, with nominees who are not all chosen by potentially objectionable incumbent boards, would obviously shift power to shareholders and give them more ways to punish boards which they do not believe are doing their jobs properly.

As with virtually any increase in accountability, there is a corresponding decrease in board authority. However, the damage done to board authority by this Proposal is as limited and as un-objectionable as can be for any meaningful improvement in accountability. After all, no one seriously argues that we should not have a system of shareholder election of directors. Even those most opposed to accountability measures grant that board elections are one appropriate mechanism. Board elections do not constantly interfere with board decisionmaking, but rather grant shareholders a periodic chance to review the overall performance of directors. Proxy access simply gives this well-established system of review a little more bite. If any increase in accountability to shareholders can be justified, this is it. And given the performance of corporate boards in recent years, it is hard to maintain with a straight face that no increases in accountability whatsoever are justified.

The biggest plausible fear of proxy access seems to be that it will give too much power to special interest shareholders such as union and public employee pension funds, which form a large part of the leading shareholder activist organizations. However, these funds will not be able to get their nominees elected unless they can persuade their fellow shareholders to vote for them over board nominees. The board nominees have the full resources of the corporation behind them in making their case, and if they think their opponents are pursuing special interests that will hurt other shareholders, they can easily make that case. Board nominees will be in serious danger of losing their positions only where there are major doubts about the performance of the incumbent board and where the challengers can credibly commit to a dedication to act in the interests of a majority of all shareholders. And that, of course, is precisely when board nominees should lose.

As I shall argue next, the Proxy Access Proposal is most suspect on the principle of flexibility. However, that is not an effective argument against it as compared with the current status quo. Under the current system, it is true that boards may choose to implement proxy access systems as they please. However, very, very few choose to do so, despite years of advocacy for such systems from the leading shareholder organizations. Perhaps the shareholders are all just completely wrong about their own interests and the boards are right that proxy access is bad for shareholders. But, a more

likely explanation for the lack of proxy access is that incumbent boards find it threatening, and their evaluations of the merits of proxy access are colored (consciously or not) by their self-interest. Under these circumstances, the current system provides very little real flexibility.

For something like this that threatens the personal interests of directors, real flexibility only comes through providing shareholders some choice to act without board approval. At the moment, state law does allow for shareholders to act through shareholder-enacted bylaws. The recent Delaware Supreme Court decision in *CA, Inc. v. AFSCME* and the subsequent enactment of the new section 112 of the Delaware General Corporation Law makes that clear in Delaware, and a similar recent change to the Model Business Corporation Act will make that clear in other states if and when states come to adopt that change. However, shareholders are practically precluded from proposing and enacting such bylaws because of the costs of engaging in a proxy solicitation. The Commission's recent re-writing of Rule 14a-8 to enforce its longstanding interpretation of the "relates to an election" basis for exclusion allows boards to exclude shareholder proxy access bylaw proposals. Thus, the current system offers little real flexibility for shareholders in devising proxy access systems, so the Proxy Access Proposal's own lack of flexibility is not a compelling argument against it when compared with the status quo.

I thus conclude that, all things considered, the Proxy Access Proposal is a major and welcome step forward over the status quo. If those were the only two alternatives available, I would stop there and simply endorse the proposal. Indeed, I would not have written a separate letter, I would simply have signed on to the law professors' letter organized by Lucian Bebchuk, which I think is right as far as it goes.

The Proxy Access Proposal Lacks Flexibility

The big problem with the Proxy Access Proposal comes with the third guiding principle: the Proposal lacks flexibility. To be sure, it does not lack all flexibility. The Proposal modifies Rule 14a-8 to allow for shareholder proposals that would provide for proxy access on more lenient grounds than proposed Rule 14a-11. That is a welcome feature on grounds of both flexibility and accountability. The flexibility benefits are obvious. As to accountability, the complex rules of proposed Rule 14a-11 engage in a balancing act, and do impose some significant limits on would-be shareholder nominators. Perhaps most significant are the limits on the number of persons that may be nominated under the proxy access system, but also notable are the percentage voting power and duration requirements. It can be argued that these provide shareholders with too little influence, so if shareholders in some companies want to experiment with a more lenient system, that will be interesting to observe. It will force boards to pay attention to a wider group of shareholders than in companies which follow the 14a-11 requirements.

But the flexibility in the Proxy Access Proposal is only one-way flexibility. It allows shareholder proposals that provide for more lenient access terms, but not for proposals that provide for stricter access terms. This is a problem. I think the rules in proposed Rule 14a-11 strike a pretty plausible balance between accountability and

deference to board authority. However, the Commission and I may be wrong about that. It may turn out that Rule 14a-11 makes it too easy for shareholders to propose nominees, leading to too many costly contested elections. The dispute resolution system in the Rule may turn out to be awkward and unworkable. Experimentation in companies that vary from these rules may show us better alternatives. Even if the Rule turns out to be good for most companies, it may not be good for all, so that some companies would benefit from tailoring to their particular circumstances.

Why not allow shareholders to agree on variations from the Commission's Rule? After all, as Joseph Grundfest has forcefully pointed out (letter submitted to Commission on July 24, 2009), if we trust shareholders to vote on nominees in contested elections, then why not trust them to vote on alternative systems to govern proxy access? I think that Grundfest goes too far in labeling the Proxy Access Proposal as logically inconsistent and arbitrary and capricious, but he certainly poses a strong challenge.

If there is a justification for the limitations of the Proxy Access Proposal, it must be on accountability grounds. As the Bebchuk law professors' letter notes, we do often provide for mandatory minimum shareholder protections, then allow for companies to choose stronger protections. However, the essence of proxy access is giving shareholders more say in corporate governance. It does seem at least odd to limit their ability to govern themselves in the midst of such an initiative. If the shareholders of a company think that Rule 14a-11 goes too far in holding the board accountable to their interests, why on earth not allow them to approve a system that they believe will serve their interests better?

Two Better Alternatives

The Proxy Access Proposal can be improved by giving it more flexibility. Shareholders should be given full room to devise proxy access rules that they believe are best for their corporations. This would allow for greater shareholder voice and autonomy at the level of rulemaking than does the Proxy Access Proposal, although in some companies it may lead to less shareholder involvement in nominating directors. Thus, giving shareholders more ability to approve a range of proxy access systems is clearly superior to the Proxy Access Proposal on flexibility grounds. It is in some ways an improvement on accountability grounds as well, insofar as it gives shareholders more choice over the basic governance structure. It also is better on grounds of respect for board authority—boards would have more room to propose proxy access systems that they think are best, subject to shareholder approval.

Thus, on all three of our guiding principles, it would be better to give shareholders more choice in devising proxy access rules than the Proxy Access Proposal does. However, there are several different ways one could do that. Here are what I see to be the two leading alternatives. First, one could not adopt at all proposed Rule 14a-11, but adopt instead the proposed changes to Rule 14a-8. This would give shareholders full flexibility to propose bylaws that set proxy access rules as they please. In the absence of such a shareholder bylaw, the default rule would be no proxy access. There would still

need to be rules for disclosure about nominators and nominees for companies which adopt a proxy access system—the disclosure rules in the Proxy Access Proposal strike me as roughly appropriate (and a significant improvement over the disclosure rules in the Commission's 2007 proposal, which were overly burdensome). I will call this the Shareholder Choice/No Access Default alternative.

The other alternative would be to adopt Rule 14a-11 as proposed, but allow shareholders in bylaw amendments to vary the rules set by 14a-11 in any direction they please, not just in a more lenient direction as under the current proposal. I will call this the Shareholder Choice/Some Access Default alternative.

These two alternatives are identical in giving shareholders a full choice to devise proxy access rules as they see fit, and making the Rule 14a-8 shareholder proposal apparatus available to them in proposing such rules. In this, they are both strong improvements over both the status quo and the Proxy Access Proposal. Both alternatives also fit better with the existing state law approach (*see* Delaware State Bar Association comment letter, submitted July 24, 2009), which allows shareholders to enact bylaws setting proxy access rules as they see fit.

The two alternatives differ in the default rule that applies in the absence of a shareholder bylaw. In the Shareholder Choice/No Access Default alternative, the default rule is no proxy access. In the Shareholder Choice/Some Access Default alternative, the default rule is the proxy access regime of the Proxy Access Proposal. I have already argued why I think both alternatives are better than the Proxy Access Proposal and than the status quo. What remains to be considered is which of the two alternatives is better.

There are some good arguments for each of the alternatives. The trick here is how to go about determining an optimal default rule for proxy access. Let us first discard a bad argument for the No Access Default over the Some Access Default. In his otherwise impressive submission, Professor Grundfest briefly considers the choice between these two alternatives, and rejects the Some Access Default, arguing that the Commission would be assuming without evidence that shareholders prefer the Commission's proposed rule over no proxy access (Grundfest letter at p. 13). However, the No Access Default makes the same sort of presumption: that a majority of shareholders would prefer no access to the access rules devised by the Commission. Both alternatives allow shareholders to decide the rules for themselves; they merely differ as to the result if shareholders do not explicitly choose any rules. Grundfest presents no evidence or arguments as to why no access would be the preferred outcome.

The most common approach to determining optimal default rules is to use the so-called majoritarian default. That is the rule which shareholders in a majority of affected companies would choose if they could costlessly decide which rule should bind them. Of course, figuring out the majoritarian default is easier said than done. Would the majority prefer no access, the level of access in the Proxy Access Proposal, or some level of access that is either more or less lenient than the Proxy Access Proposal? Empirically we find very few corporations having a proxy access system, which gives some evidence in favor

of the No Access Default. But it is very weak evidence, for reasons given above—the current system gives shareholders little effective choice in this area, and boards are likely to be driven by self-interest in setting up the rules. But still, shareholders have gotten along more or less well without proxy access for the history of American corporations to date, so perhaps that's not a bad guess as to the majoritarian default.

However, I seriously doubt that no access is the majoritarian default today. Shareholders today are more focused on having some involvement in corporate governance, including a greater role in choosing directors. I strongly suspect that if the Shareholder Choice/No Access Default alternative were in place, within five or ten years most corporations would have adopted rules providing for some proxy access. I suspect the flurry of activity would resemble what has happened over the last several years with majority voting proposals. If so, that would demonstrate that no access was not in fact the majoritarian default.

However, this thought experiment as to how corporations would react to this proposal does suggest another, stronger argument in favor of the No Access Default alternative. I think we would see many proxy access rules proposed at many corporations. There would naturally be some standardization—forms of bylaws have already been published, and more will probably follow. However, I would expect to see a fair degree of variation. Even if shareholders settle in on fairly standard forms of bylaws, they would probably have variations over numerical elements such as how many shares one must hold in order to be able to nominate, or how many directors can be nominated using proxy access. Variation is good—it would allow us to observe how different rules work, and get a good idea of what works and what doesn't. In contrast, with the detailed and quite reasonable rules under the default regime of the Some Access Default alternative, I suspect that we would see a lot fewer proposals successfully opting out. Although one can quibble with the exact choices made within that proposal, it may be close enough to right that shareholders and boards would not bother trying to fine tune the system.

If I'm right about that, though, it in turn suggests a major argument favoring the Some Access Default: it may well be the majoritarian default, or at least pretty darn close. I suspect that the various numerical thresholds in the Proxy Access Proposal get the balance pretty close to right, and probably reflect prevailing shareholder sentiment (for some evidence of this, *see* the Council of Institutional Investors comment letter, submitted August 4, 2009).

Another argument also favors the Some Access Default over the No Access Default. Boards can act more easily than shareholders, due to the collective action problems the latter face. A major goal in this area is to protect shareholders. Thus, for reasons of both accountability and flexibility, when in doubt one should set defaults that favor shareholders over boards. If those defaults are indeed optimal, they will probably stick. If it is better to have less strongly pro-shareholder rules, then the board can more easily act to opt out of the default than can shareholders, so even with an overly strong pro-shareholder default, we will still wind up with optimal rules in the end. In our case

here, if we choose the Some Access Default and it turns out those rules allow too many disruptive shareholder nominations, then boards can easily propose less lenient rules, and shareholders should agree to them if the default rules are indeed inefficient. By contrast, with an overly pro-board default regime, the costs of shareholder action may prevent opting out to better rules. In our case, with a No Access Default, shareholders in some large number of corporations may not find it worthwhile to engage in even the modest costs of a Rule 14a-8 proposal when they would prefer a regime where they have some proxy access.

I find it a fairly close call between the two alternatives. However, on balance, I think the Shareholder Choice/Some Access Default is the better of the two, both because it is likely closer to what shareholders in a majority of corporations would currently choose if they could act costlessly and also because both accountability and flexibility suggest that when in doubt, we should choose a default rule that leans in favor of shareholders over boards.

Thus, the Commission's best choice would be to move ahead with the basics of the Proxy Access Proposal, but modify it to allow shareholders to opt out of the proxy access default rules established under the Proposal in any direction which shareholders choose, including opting out to set access rules that are stricter than that in the Proposal.

Thank you for the opportunity to submit these comments.

Sincerely,

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