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January 18, 2010
Ms. Elizabeth M. Murphy
Secretary of the Securities and Exchange Commission

Re: Facilitating Director Nominations (S7-10-09)

Dear Ms. Murphy,

Thank you for the opportunity to comment on this important initiative. Lemonjuice.biz is a web service that provides information and analysis on corporate governance.

In this letter, we comment on two of the documents for which the SEC requested comments: The Business Roundtable / NERA paper and the Corporate Library letter. The central issue in both documents is private ordering -- as it should be. Without impediments to private ordering to do the job, any regulation would be ill advised. Unlike other, prescriptive regulations, shareholder rights regulations put responsibility on the owners to provide control through choosing (ordering) business leaders. Our basic premise is that monitoring is best done by owners.

The key question to answer is whether in fact, there exists a significant want of private ordering in the status quo to prompt this regulation.

The Business Roundtable contends that private ordering is doing its job. They site new state laws, especially the new Delaware law, that enables shareholder rights to be adopted voluntarily. They also cite the cases of three companies (the proxy adviser Risk Metrics among them) that have independently adopted some form of proxy access for director nominations. Finally, the Business Roundtable argues that the regulation can overshoot and create a rigid "one size fits all" requirement on all companies regardless of the optimal choice private parties would want to take.

The Corporate Library sites extensive obstacles to private ordering that would preclude anything other than the proposed regulation, which would require all companies to have the same access and nominating regime. They site, among other things, unreasonable supermajority rules, inability of shareholders to change bylaws in many companies, multiple class shareholder structures, broker non-votes, as well as the legal rigidity in many states that may preclude the adoption of proxy access even if companies choose to do so.

In this letter, we discuss point-by-point the economic arguments in these two documents. Time permitting, we will provide another letter with comments on the other documents upon which the Commission requested more comment. Our key conclusions are as follows:

- There is clearly an enormous want of private ordering both in choosing directors and in enacting proxy access by companies voluntarily. Furthermore, this justifies a regulatory requirement for proxy access.

- We also find that a properly crafted opt-out provision must be adopted in order to optimize the private ordering mechanisms for most circumstances. Proxy access with an opt-out provision will significantly improve private ordering in the equity markets.

The Corporate Library's paper on limits to private ordering:

Opting In

In effect, the paper contents that opting in would be the same as not having regulation, leaving shareholders to content with all the existing obstacles to implementing such a resolution. Indeed, insiders are rationally motivated to preclude shareholders from nominating directors because this would be a challenge to their personal interests. Numerous tools are available to them to prevent the adoption of any such proposal from shareholders. These include, among other things:

- *Impossible supermajority provisions prevent shareholders from enacting changes.* Supermajority provisions in some companies require a vote of 80% of shares outstanding (as opposed to votes participating in the meeting). Even a supermajority of votes participating in the meeting is an unreasonable requirement. Furthermore, a small percentage of companies (about 3%) do not allow shareholders to change bylaws at all.

- *Rigidity of state laws with regard to the ability of shareholders to enact proxy access for board nominations.* Indeed, as the Commission is criticized for rigidity, the State laws obscure the ability of public companies to adopt regulations that optimize the private choice of their own shareholders. In fact, the Delaware law permitting such proposals was ratified mainly in response to the efforts of the SEC to enact proxy access. If a state law were "enabling," as the roundtable likes to state, why would state law a-priori prevent choice and have to adopt provision enabling the specific choice of allowing proxy access? As The Corporate Library correctly pointed out, many states other than Delaware have significant barriers or outright prohibitions on such proposals.

- *Multiple class structures prevent the adoption of the majority wishes of the share capital.* We do not view multiple classes as necessary an argument that private choice is wanting. First, in the absence of cumulative voting, even if proxy access were the rule, a multiple class structure would defeat any candidate not supported by the super-voting class. Second, in the US, multiple class structures where normally adopted at the time of the IPO. This was transparent when shares were initially acquired. This was clearly a private choice, and there is no reason to interfere with it. While arguably, multiple class structure can be a bad practice, it also can be used in a positive way to impose the burden of vigilance on shareholders with a high degree of personal exposure to the company. After all, monitoring is best done by owners.

We should also point out some other impediments to private choice in addition to the above; some companies outside of Delaware can reverse shareholder changes to bylaws. Additionally, as the Business Roundtable letter implied (pp 49,50), many companies are not strangers to aggressively impeding shareholder proposals by submitting no-action letters or even legal challenges.

Opting Out

The Corporate Library objects to the opting out provision based on the multiple class issue (addressed above) and on the probable distortion from broker non-votes. The Corporate Library assumes that when the board proposes an opt-out, non-voting shares would be voted, usually in alliance with the management. However, this issue can be easily overcome. A simple guidance from the SEC that opt-out proposals should not be treated as ordinary business would be enough to prevent broker non-votes. To make this stronger, SEC can include such guidance in the regulation.

In our opinion, an opting out provision will preserve an important ability of companies to make a choice that is alternative to the regulation, providing a critical sweet spot where instead of rigidity, the regulation will in fact facilitate private ordering. We would expect that most opt-out proposals would be adjustments to the standard rule instead of opting out completely. Even if the opting out proposals are only introduced by the boards, the boards will have to assure adoption of their proposals by the shareholders. Directors will have to think hard about selling their version to the shareholders as truly a more appropriate one for the company instead of just something that frees them of the burden.

It is true that the super-voting class of shares in a dual class structure will have the sway over opting out, as it would over any other business of the company. However, imposing an access provision in the few cases when it would even make any difference in companies with two classes is a lesser good than providing for the maximum private choice in all companies. To be sure, proxy access for board nomination in companies with dual class of shares would only make sense if there were also a cumulative voting provision. Without cumulative voting, the super-majority class effectively appoints the board.

The Business Roundtable Paper (Paper)

Distracting the Management

One of the themes that prevails in the Roundtable Paper is that shareholder access will distract the management and the board from the important business of managing the corporation or that the "*Time-Consuming And Politicized Director Elections Will Deter Qualified Directors From Serving On Boards of Directors.*" We disagree with this assessment.

Anyone who has ever had a boss or a client knows all about this distracting, pesky thing of having to defend and report on your progress, activity and achievement. Who wouldn't like to be left alone to be a maverick? It is absurd, but also telling that titular managers and board members feel that defending their record is an unnecessary distraction.

We develop this issue further in discussing Special Interests and the Paper's references to the opinions of Stephen M. Bainbridge (Paper's footnotes 64 and 66).

"Short-Termism"

The Business Roundtable contends that proxy access encourage "short-termist" behavior by shareholders, which in turn contributes to uneconomic results. We agree that short-term approach to business is uneconomic, but the reality is that insiders accusing shareholders of short-termism is like the pot calling the kettle black.

Is it not surprising that in fact the alleged "short-termist" shareholder activists and the dreaded proxy advisors are the ones clamoring for long-term management compensation? Boards overall have failed in the task of properly structuring the management compensation for long-term incentives, instead farming this important function to the "on-size-fit-all" compensation advisers. The "short-termism" problem was not from the shareholders, but from the managers, seeking to collect on "short-term" compensation at the expense of the long term.

Unlike personal horizons of the insiders, equity shares do not expire. Share value reflects the present value of the expected future earnings. Many US stocks trade at 100 or more times the current earnings and have not paid a dividend in decades. **It makes no economic sense for shareholders to have a short-term view even if their investment horizons do not match that of the corporation.** NERA are the valuation experts. They should know this, but conveniently forgot. It is even more surprising that the Business Roundtable, a conservative organization that supposedly clamors for the free market solutions on one hand, conveniently forgets to recognize the free market paradigm of basic valuation principles.

Despite this fundamental valuation principles, the Paper commits an **ambiguity fallacy** by confusing the short-term profit focus with the short-term investment horizon in its discussion of the "Aspen Principles" (footnote 57), among other places in the document. Once again, short-term profit focus is wrong for the market valuation of stock or business unless, of course, the management convinces the shareholders that the current profit is a good indication of the future prospects of the company.

A counter-argument can be that the markets are not efficient enough to apply good valuation principles, and instead irrationally focus on short-term profits. However, the Paper also appeals to the private choice among state laws and charters. It contends that this one-time-only choice efficiently contracts the behavior of all insiders in perpetuity. This contention is an appeal to a much stronger form of market efficiency and market rationality than how the market values equity. If you believe that the market chooses law and charter efficiently and rationally, you must believe that it does the same for share valuation.

The contradiction, described above, is ever more delicious as the paper relies on the July 8, 2009 Op Ed in the Financial Times by Lawrence Mitchell in order to support its claims (footnotes 3 and 6). Professor Mitchell's logic and assertions go so much against the free market logic that they should scare the Business Roundtable a whole lot more than do the dreaded proxy advisors. Here are some of the bases of his claims:

"…fund managers have increased their pay by putting pressure on corporate managers to increase short-term stock price at the expense of long-term business health." Do NERA or the Business Roundtable really believe that stock prices consistently increase at the expense of business health?

Or do they believe this: "*Another flaw in these approaches is the assumption that these institutions somehow are investors*."

Or do they really want more prescriptive regulation (presumably strengthening Sarbanes Oxley), so long as these regulations do not subject insiders to the private ordering process with shareholders: *"… it would be far more effective to strengthen the rules that regulate sloth and theft than to risk choking the engine of real economic production. Managers, not shareholders, are expert at running our businesses. Shareholder rights are simply wrong."*

Mitchell gets it all wrong. Even his reference to Alfred Chandler is out of context: "…[as] *Alfred Chandler, demonstrated, the American corporation has succeeded in large part because it is a wonderfully constructed bureaucracy.* " Chandler demonstrated that businesses adapt to the economic and technological circumstances by choosing an optimal way to function. He did not endorse corporate bureaucracy as something to be cherished. We would hope that the great business consultants at NERA and the members of the Business Roundtable would not prefer bureaucracy to innovation and competition. Yet, relying on Mitchell's conclusions also implies the agreement with the logic of how he derived that conclusion.

Alas! Professor Mitchel is a great lawyer. He can be excused on economic issues. Business Roundtable and NERA speak primarily on economic and business policy. How could they be complicit with such an uneconomic argument? The only explanation could be that it serves them… at least in the short-term.

Cost

The main cost of proxy solicitation is still in the distribution of proxy materials, and in addressing challenges to the proxy from the board, which has all of company's resources at hand. This is a big barrier for many institutional investors' participation in the governance of companies. It is much more efficient for the shareholders to use the company proxy and deal with the board's objections before the proxy is distributed.

"State Law Development Regarding Proxy Access Renders the Proposed Election Costs Rules Unnecessary."

As discussed above, excluding Delaware, many states actually prevent shareholder proposals to affect proxy access for board nominations. The mere fact that Delaware even needed to pass the law allowing such proposals reflects the rigid approach by states in what kinds of proposals shareholders can make to the meeting of shareholders.

In addition, the new Delaware law, enabling the adaptation of tailored access provision does not address the multitude of impediments, which insiders place on the ability of shareholders to change bylaws. We agree that there is a need to allow companies to choose to change or remove nomination provisions. Our proposed opt-out rule would address this need, while overcoming the impediments to shareholders' ability to affect such change. The board can always propose to the shareholders to change the rules. However, instead of blocking the shareholders from changing bylaws by one of the methods mentioned in the discussion of the Corporate Library letter, the board will have to propose a change to the default rule that would be acceptable to the shareholders.

"Sweeping Corporate Governance Reform Obviate the Need for The proposed Election Contest Rules"

This section refers to the increase in some good practices, such as majority provisions, annual elections, and director independence. However, it is important to point out that:

First, the majority and annual election provisions have been hard-won by shareholder activists, and mostly due to liberalized proxy access rules, opposed by the Business Roundtable in the past.

Second, while some boards conceded on these provisions under pressure, insiders usually have fought against these provisions. Hence, the statement that "*Companies and shareholders alike recognized the merits of majority voting…*" is another **appeal to the ambiguity** because the paper often uses board of directors and Company interchangeably. Vast majority of boards did not support provisions to improve corporate governance. The incentives of the directors with respect to their personal interests, despite fiduciary responsibility, are to protect their positions. Incentives of the Company theoretically should be to procure the best possible management of its affairs.

Third, “independent directors” are not truly independent of CEOs for re-nomination. Multiple studies have shown that independent directors are often very much dependent on the CEO’s power to re-nominate them.

Finally, this section argues against legislative or regulatory fiat in favor of enabling state corporate law provisions. However, as indicated earlier, state laws often rigidly limit the ability of shareholders to change charters or propose certain changes. In order to avoid rigidly regulating governance by the SEC or any legislature, we propose opt-out clause to the proxy access regulation.

“*Shareholders Already Have the Power to Effect Change in Board composition Through Other Means.*”

The paper sites “vote no” campaigns as an effective tool for change. However, “vote no” campaigns, are important, but inadequate. “Vote no” campaign provides no alternative and leaves the board to decide what to do with the vacated position. In most companies, boards can ask the voted-out director to stay. They can also nominate an equally unqualified or objectionable director. Shareholders should be able to dictate to the board their choice.

Special Interests

NERA contends that proxy access would provide the ability of special-interest directors to assert the interests of unions or socially oriented investment funds. However, this is far from reality. Even if such director candidates were nominated, they would need to be elected by the majority of shareholders. The dominant majority of shareholders are institutional investors, motivated by the share value (and perversely so according to Professor Mitchell), and not by special interests. To be sure, the proxy advisors would pick up such candidates and point them out. Finally, the feared union boogey man on the board is a red hearing. Union-sponsored pension funds have to operate under ERISA rules that require them to act in the best interests of pensioners. If pension funds use their voting power to try to blackmail the company into a Union agenda, it would be obvious and a violation of the managers’ fiduciary duties under ERISA.

To support its argument, the Paper references Stephen M. Bainbridge (footnotes 64 and 66) to show that “*Unions previously have used the shareholder proposal process to obtain results in ‘corporate governance’ campaigns against management.*” It cites the case of Safeway, which first took place before the new ERISA rules; second, the union appealed to shareholders based on bad governance practices, such as the chairman and CEO combination; third, the union campaign lost anyway because the majority of shareholders were rightfully suspicious of the union’s motives.

However, this reference is particularly interesting. Professor Bainbridge in his critique of shareholder rights, “Director Primacy and Shareholder Disempowerment” disputes the argument that other shareholders would vote against value decreasing proposals. Why? Because, according to him, risk-fearing managers are easily blackmailed, and hence might acquiesce the union demands (or accept other forms of blackmail) rather than stand a chance of losing votes on a shareholder proposal. That is a possibility. Upon further examination, however, this point only strengthens our view. Here is why:

Bainbridge’s argument suggests that the majority of managers and directors in US companies are so weak in character as to allow themselves to be blackmailed to do the wrong thing, and therefore they should better be left alone, without the wrath of shareholders lest they might sell themselves out to wrong demands. However, if the corporate leaders are so weak that they cannot lead, they should be dislodged in a storm of activism.

We have a generally more positive view of most corporate leaders. Most likely, they have climbed their corporate ladders. At every step, they encountered that thing called corporate politics, where internal competitors make their case. In fact, corporate politics can get ugly, and there are winners and losers. Yet, no company has ever ruled: “well, politics is distractive and tests people’s characters, so we will not have internal competition in order to promote stability.” Alas, having won the corporate game and climbed their corporate ladders, corporate leaders want to be on solid footing without market-driven challenges to their power. That is rational on individual basis, but not best for their companies or the economy. We believe that most are capable of leading and making their case to the shareholders. The ones incapable of leading and willing to accept anything a small group of shareholders might throw at them must be dislodged by the market. Director nomination by shareholders and other shareholder rights rules will affect that.

To be fair, in his essay and other works Bainbridge opens many interesting issues on corporate governance, arguing both from the market point of view and on intricacies of how corporate governance is conducted. He argues for what he calls “board primacy” and corresponding regulation at the cost of all shareholder rights, except in extreme situations. His contention is that *“these incentives work tolerably well,”* so we should conclude that investors prefer “board primacy.” His argument against shareholder rights is that there are many impediments to information, analysis, investment horizon, and general investor interest in the proxy process. However, to this date he fails to identify these facts:

1. Most institutional investors need to analyze and evaluate companies as a part of their duty to investors to select the best investments.

2. In recent years, as the Roundtable Paper states by the way, shareholder activism brought about a lot of change in corporate governance practices of many companies. This contradicts the claim that there is no interest in shareholder activism unless it is perverse.

3. Changes in technology together with changes in governance practices created an industry that specializes in assisting investors in making choices without spending great resources. These include, among others, proxy advisors, such as Risk Metrics and Corporate Library, along with "brand voting" companies such as Maxi Votes, that allows passive shareholders to select activists who would vote their shares.

4. As we already discussed, personal investment horizon is irrelevant to shareholder's assessment of value because the value of liquid shares reflects the expected future returns. Hence, even an investor with the horizon of two weeks would consider in his best interests a positive NPV investment with the duration of twenty years.

Shareholder-nominated director will have "no fiduciary duties to other shareholders"

This theme repeats itself in the paper quite a bit, starting on page 16. However, this is plain wrong. All board members have fiduciary duty to all shareholders. This kind of argument feels like the desire to assure that monitoring is not done by owners, but by completely disinterested parties. We contend that monitoring is best done by owners, motivated by company value.

"The proposed Election Contest rules Will Hinder The Ability of Companies to Satisfy Board Composition Requirements."

In the section devoted to this argument, the Paper sites various listing and regulatory requirements for board composition. It contends that shareholders might replace a qualified candidate with an unqualified candidate. Logically, it is possible that shareholders might nominate and elect an unqualified candidate. However, this is highly unlikely, and in the very few remote cases when this might happen, there are remedies.

The first line of defense against an unqualified candidate is that it would take an act of a sizeable investor to nominate a candidate. We see little reason why a rational investor would nominate a candidate without the requisite skills. Even a special interest activist would seek to nominate a qualified candidate for the likelihood that an unqualified candidate will not attract votes.

The second line of defense is the actual election: even if a large shareholder will nominate an unqualified candidate, it is doubtful that such a candidate will be elected. Not only will there be many opportunities for the board to point out the candidate's qualifications, the proxy advisors will point them out. And we already discussed the notion that insiders might be too weak to acquiesce to bad proposition.

However, let us suppose that all fails and the shareholders actually end up appointing and electing unqualified candidates. This might happen in extremely outlying cases. In such a case, the board still has the ability to expand board size and add qualified members in order to satisfy the requirement. Yes, generally it is not efficient to have more board members. However, this would occur in very few cases. The economic cost of such possible cases is greatly outweighed by the economic benefit of increased ability of shareowners to exercise oversight. Besides, should shareholders actually elect an unqualified candidate in place of a supposedly qualified board member, the company may have bigger problems than the mere size of its board. Such act would be a signal that the company needs to review its leadership capabilities.

"The Proposed Election Contest Rules Will Exacerbate Voting Integrity Issues."

Reasonable people on all sides of shareholder rights debate would agree with the Roundtable on the need to reform the current holding and proxy voting system. However, the need to reform what the Paper calls the "*byzantine and inadequate*" holding and proxy voting system does not excuse the need to reform the byzantine and inadequate system of electing the directors. The current voting system can err in either favor and is arguably more skewed in favor of the insiders. However, the actual resulting voting error has a very low likelihood of affecting the outcome. This should not be the excuse for stopping shareholders from exercising oversight.

The point about borrowed shares, however, is a red herring. The shares are lent for voting in much the same way as proxies could be granted. Hedge funds will solicit support from shareholders for their efforts, and shareholders will grant such support by either voting or lending shares or awarding proxies.

Ability to Modify Election Contest Rules

We agree that the shareholders should have the ability to modify election contest rules by voting on an opt-out proposal, as we discussed above. Any other form of modifying contest rules would not work (also discussed above).

We believe that the proposed opt-out provision would be "enabling" for companies and provide for the maximum private ordering, instead of "one size fits all," which is established by State laws and the Roundtable is advocating.

Changes Proposed in the Paper

We believe that the following rules, advocated in the Paper should **not** be default rules. However, shareholders can always vote for such modification under the opt-out provision.

1. *"Election Contest Rules should apply only where there is objective evidence of a need for greater director accountability."* Election contest will occur where directors are not performing. One-size-fit-all "triggering events" that would flag a lack of performance do not exist. This is a market-driven judgment, which should not be defined rigidly or arbitrarily.

2. "*Meaningful Ownership Threshold and Holding Period*." It seems that the Roundtable is trying to make the proposed rule ineffective by slipping-in impossible conditions. The Paper proposes a threshold of 5% if there is one shareholder and 10% if there is more than one nominating shareholder. Strangely, insomuch as the Roundtable is concerned about the use of the election contest rules for change in corporate control or special interests, they are willing to give a single shareholder twice the power of a group of unrelated shareholders. If we examine the shareholder structure of large companies, most do not have a shareholder with a 5% or higher stake for obvious regulatory reasons. Under the Roundtable proposal, the single largest shareholder would not be able to nominate a director, and therefore a combined ten percent would be required. Working down the list, we find this nearly impossible to do. The Paper's example of a Yahoo shareholder pulling together 33% dissatisfaction vote by uploading Youtube videos is irrelevant because the difficulty in coordinating the nominating shareholders would be a horrendous task, which was not required in a vote campaign. Furthermore, if the Paper's proposals for the "*meaningful holding period*" and "*meaningful ownership threshold*" were combined, finding 10% of shareholder interest who held shares for two years would be practically impossible. Adding further the Paper's proposed requirement that all nominating shareholders must commit to holding shares for two years in the future would be 100% impossible because no institution (no matter how long-term focused) is able to commit to holding shares for two years in the future.

The paper's appeal to "short-termism" was addressed above, which is why we do not feel that the Roundtable truly believes in the Paper's stated concern about the nominating shareholders pursuing short-term interests that are different from long-term interests. Instead, the real goal, pursued by the Paper, is to assure the impossibility of any shareholder to nominate a candidate.

3. "*Limit The Right to Nominate Candidates in Successive Years*:" This should not be a default rule because advocacy may take several election cycles. A qualified shareholder should be able to nominate a candidate if it means all other sensible rules.

4. *Require Attendance at Shareholder Meeting*: We generally agree that a nominating shareholder is required to attend the meeting. However, if there is more than one nominating shareholder, only one of the nominating shareholders should be adequate in attendance. Otherwise, such rule would create an additional unreasonable barrier to nomination.

5. "*Prohibiting Relationship Between The Nominee, The Nominating Shareholder And The Company*." We agree on prohibiting the relationship between the nominee and the company, but **not** between the nominee and the shareholder. The paradigm that oversight is best done by owners is a simple, capitalist, and correct approach. Large shareholders who are directors (or nominate their employees as directors) are the best guardians because they are motivated by the company value. Here again, it is telling how hard the Paper appears to advocate against the motivated owners having oversight responsibility by thinking-up unrelated problems. The Paper's appeal to "special interest" and "single issue" directors is wrong. First, vast majority of shareholders are motivated by the company value. Of course, this maybe the single issue.

Second, a majority of the shareholders would have to vote to elect a candidate. Third, the fiduciary responsibility of the director would be to all shareholders, not to one.

6. *Excluding a nominee who does not meet objective qualification standards*: There are very few companies that unequivocally rule out board participation based on objective qualification standards. If a company has such standards, it can always impose own rules by opting-out of the default rules, as discussed above.

7. "*Require Nominees To Satisfy Subjective Independence Standards:*" Providing rights to disqualify a candidate subjectively would enable insiders to eliminate any nominee. That said, an opt-out provision would facilitate this choice as well.

8. "*Further Limitation on The Number of Shareholder Nominees:*" limiting nominees to one, rather than 25% sounds more like an attempt to limit the impact of the rule on the Roundtable members, rather than any kind of logical justification for this limit.

Conclusion

While we could not possibly address every point raised from every possible angle, we addressed many. We understand the apprehension some business leaders feel about shareholder nominations, but we find that many of Roundtable's arguments either have logical flaws or lack the understanding of valuation principles or can be overcome by an opt-out provision.

Having poured over all the arguments proposed we find that the only logical conclusion is that the lack of private ordering exists. It can be best addressed by an enabling regulation, which would facilitate director nominations by shareholders, as well as an opt-out by shareholders in order to reflect each company's unique needs.

Kind Regards,

Alexander Krakovsky
Publisher