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Davis Polk

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Re: ***Facilitating Shareholder Director Nominations***
Release Nos. 33-9046; 34-60089; IC-28765 (June 10, 2009)
File No. S7-10-09

August 11, 2009

Ms. Elizabeth M. Murphy
Secretary
US Securities and Exchange Commission
100 F Street NE
Washington DC 20549

Dear Ms. Murphy:

Over the past two months we at Davis Polk have been engaged in a broad outreach to clients and friends of the firm with respect to the Commission's most recent proposal to facilitate shareholder director nominations. The discussions have included boards and management teams at public companies large and small, financial institutions, investment management organizations and other large institutional shareholders. We are participating in a letter with other law firms providing a detailed analysis of the proposal, and we have also helped our clients think through and create their own comment letters. It might seem that everything that needs to be said by us on this topic has been said. But we think there is some value in providing a brief comment letter in our own name, with the goal of distilling the insights we have gained in this process and suggesting a constructive way forward.

In summary, we think that the Commission has recognized a genuine problem and has proposed two solutions, one good and one bad. We believe the proposed amendments to rule 14a-8, by facilitating shareholder participation in the development of ground rules for proxy access, can accelerate the creative ferment that has for the past decade characterized the governance of American public companies. Proposed rule 14a-11, by contrast, would in important respects cause this creative process to grind to a halt, impose a single set of complex rules on thousands of varying fact patterns, and perhaps irrevocably upset the balance between state and federal law. This would seem to us a bad bargain for American companies and shareholders even if proposed rule 14a-11 were well crafted and carefully thought out. But we think that the proposed rule suffers from grave defects, as if reflecting a hurried compromise.

So our suggestion is that the Commission:

- amend rule 14a-8 to permit shareholders to use the rule for proxy access proposals,
- shelve proposed rule 14a-11 for now,
- closely monitor the broad trial-and-error process that will inevitably develop as companies and shareholders work though a variety of approaches to shareholder nomination of directors, and

- revisit the issue from time to time to determine whether further adjustments to the proxy rules are appropriate.

The balance of this letter is in three parts. The first part summarizes the case for the program outlined above. Recognizing, however, that the Commission may conclude to proceed with proposed rule 14a-11 in some form, the second part itemizes, and suggests ways of addressing, what we think are some of the most important defects in the rule as proposed. The third part questions whether the Commission has made the showing as to efficiency, competition and capital formation that is required by statute to justify the proposal.

Facilitating Innovation and Shareholder Choice

The Commission's starting point in developing proposed rule 14a-11 seems to be a world view in which governance rules are frozen in time and space, in which remote boards of directors ignore the views of helpless shareholders, and in which shareholders yearn for a simpler time of annual meetings that resemble New England town meetings.

As advisers to a large and diverse group of US public companies we can assure you that this is not the world we live in. The past decade has seen unprecedented upheaval in corporate governance, as one company after another reacts to or anticipates shareholder input by declassifying boards, implementing majority voting, dismantling rights plans, revising equity and other compensation plans, and considering a dynamic menu of other governance initiatives. Shareholders have developed sophisticated methods of communicating with and influencing boards and managements and other shareholders, including sponsoring governance monitoring organizations, organizing information campaigns, and demanding (and getting) regular meetings with their portfolio companies. Far from ignoring shareholders, the boards we advise tend to focus closely on governance issues and to have an acute sense of where they stand relative to their peer companies. And from our vantage point it seems clear that shareholder participation in the nomination process is one of the next big issues that boards and governance committees and shareholders are beginning to grapple with.

We think it a useful thought exercise to consider two multiple-year scenarios.

In the first scenario proposed rule 14a-11 is <u>not</u> adopted. Given the combination of recent Delaware law amendments, the assumed adoption of the Commission's proposed rule 14a-8 amendments, and interest generated by the broad debate over proxy access, we think it is highly likely that the coming proxy season would see a range of approaches to director nomination and proxy access, and that the following season would see even more proposals. Some of these will be bylaws adopted by boards, often in consultation with major shareholders. Various flavors of proposals will come from different categories of shareholders. All of these will be closely monitored by institutions and governance groups.

Some of the approaches will turn out to be unworkable and will be voted down or otherwise abandoned. Others will gain traction and will be refined over time. Within a fairly brief period – say, three to five years – the marketplace of ideas and investor choice will do its work, best practices will emerge, and the great bulk of companies will have evolved in response. The form in and pace at which this evolution occurs at any particular company will reflect its own circumstances.

This scenario is grounded much more in experience than in speculation. We are simply suggesting that director nomination and proxy access would follow the pattern set by a host of other governance issues over the past several years.

In the second scenario rule 14a-11 is adopted as proposed, and a series of predictable consequences follow:

- The rule will be challenged in federal court as beyond the Commission's power, and might even be enjoined pending resolution. We are aware of substantial efforts underway in this direction, and we think the bases for challenge are serious. Even if such a dispute is ultimately resolved in the Commission's favor, the uncertainty and potential delay will impair the achievement of the rule's objectives.

- The Staff will be consumed with a high volume of disputes to resolve and questions to answer on matters large and small, all on short notice. Companies and shareholders will be frustrated by the response cycle. The Staff will be frustrated by being forced to mediate what will seem to be an endless cycle of bickering. Deadlines will be missed. Fingers will be pointed. Expenses will mount.

- A wide variety of technical errors, policy miscalculations and other unintended consequences will emerge as the rule is applied at thousands of public companies. Some of these will be addressed in interpretive releases and FAQs and no-action letters. Some will become the stuff of lore and eagerly passed on as Staff positions, or discussed only within the governance bar. But others will require further amendments of the rule: public meetings, proposing releases, comments, litigation...

- In the meantime innovation in this area, whether from companies or shareholders, will effectively cease. Boards are likely to take the view that no further change is advisable until the rule has developed in practice over time, and that the rule's approach of setting a "minimum" means that a company with its own different rules would in effect be forced to administer two rules at once.

We think the wiser course is to put proposed rule 14a-11 on the shelf and to permit companies and shareholders to innovate. Failing that, we would suggest at least that the proposed rule be revised to allow companies to opt-out through a shareholder vote and for the rule to be inapplicable where the shareholders of the company approve an alternative form of proxy access, whether by means of a shareholder proposal or a management proposal. In any event, to permit adequate time for the Commission to consider and debug this complex proposal, and for companies to plan for any new rule, the Commission should not attempt to force rule 14a-11 through in time for the 2010 proxy season.

Fixing Proposed Rule 14a-11

We will not repeat the long list of technical and policy issues contained in the law firm letter to which we are a party, but here is a short list of major points that we think would require attention if the Commission determines to move forward with proposed rule 14a-11:

1. Lengthen the notice period to avoid contributing to a crisis atmosphere.

Proposed rule 14a-18 sets up a timetable that in many cases will be too short, that will foster uncertainty, and that will lead to disparate treatment of similarly situated companies. We think the Commission could achieve its objectives in a manner that is much less likely to exacerbate what will already be a stressful situation for companies.

Consider the common situation of a company that has a 90 day advance notice bylaw and that usually sends its proxy statement to shareholders 30 days in advance of the meeting. Under proposed rule 14a-18, this company could have only 60 days from receipt of a shareholder nomination to the date it must file its proxy statement. Even if the Staff were willing to waive the deadline set forth in proposed rule 14a-11(f)(7), under which a company that determines it may exclude a shareholder nominee must notify the

Commission 80 days before filing its proxy statement (in other words, 20 days before the deadline that applies to the nominating shareholder), the company would still be required to give the nominating shareholder 14 days to correct deficiencies. This would leave, at most, 46 days for the Staff to resolve disputes. In the 2009 proxy season, the Staff often took 50 or more days to respond to no-action requests under rule 14a-8. The Staff will be handling rule 14a-11 disputes at the same time.

We believe that a better approach would establish a window period for nominations and would key the deadlines off of a known date: the date the prior year's proxy materials were mailed. For certainty, we suggest that rule 14a-18 be revised to require the submission of shareholder nominations during a period selected by the company that begins on a Monday that is at least 180 days after the date the prior year's proxy materials were mailed, and ends on the Friday of the fourth week thereafter. Similar to current rule 14a-5, the company could be required to disclose the relevant dates in the proxy statement.

We think this approach would give companies sufficient notice to handle the process in an orderly way, which could include invoking the dispute resolution process or negotiating with the nominating shareholder, or both.

2. The ownership thresholds for nominating shareholders should be higher, and should be consistent across companies.

Proxy access would provide a means for shareholders to initiate a low-cost alternative to a traditional proxy contest, but the costs to be borne by the company – cash expenses such as proxy solicitation, public relations and legal fees, and the harder-to-quantify cost of a distracted management and board – will be just as significant as in a traditional proxy fight. Balancing an intent to provide shareholders with a way to exercise their nomination rights against the burdens to the company, the Commission has recognized that only shareholders who hold a significant financial interest in the company should be permitted access to the company proxy. However, the data analyzed by the Commission do not justify the 1, 3 and 5% thresholds in proposed rule 14a-11(b)(1) (or any other particular threshold), because the proposal places no limits on the number of shareholders who can aggregate their holdings. At best, these are arbitrarily selected thresholds designed to make it easier for shareholders of larger companies to trigger proxy access, and more difficult for shareholders of smaller companies to do so.

Why place a heavier burden on larger companies? Our experience with rule 14a-8 proposals and "just vote no" or "withhold" campaigns against directors shows that it is the larger, more high-profile companies that are the usual targets of shareholder campaigns, so we doubt that the Commission needs to adopt a lower threshold for larger companies in order to ensure that they draw their fair share of rule 14a-11 nominees. While the Commission might conclude that a larger company is better able to bear the cash costs of a proxy fight, there is no reason to believe that the non-cash costs of management and board distraction will be any lighter for a larger company than for a smaller company. Indeed, because a proxy contest at a larger company is more likely to be played out in the media, the intangible costs for a larger company may well be much higher.

We would look at the problem of selecting the appropriate threshold from a different viewpoint: what level of ownership is large enough to authorize a shareholder to unilaterally impose costs on the rest of the shareholder base? One percent is an awfully low ownership level to enable a shareholder to impose the tangible and intangible costs of a proxy fight on a company, since there is no reason to think that 1% of the shareholder base represents the views of the other 99%. In light of the Commission's willingness to allow shareholders to aggregate their holdings, we believe it is fair to ask shareholders to demonstrate more meaningful levels of support for their contention that board change is needed, say in the range of 5 to 10% of the company's stock, before being permitted to impose costs on the company that all other shareholders will have to bear. If a serious and dedicated proponent cannot find 5 to 10% like-minded shareholders, it is hard to see why the company and more than 90% of its shareholders should be required to finance the proponent's campaign.

3. If there are competing rule 14a-11 nominations, that of the largest shareholder or group should prevail.

Rule 14a-11 as proposed sets up the potential for a midnight rush to the fax machine by competing proponents, leaving the company in the position of determining whose nomination arrived first. It's difficult to see why first-in is a sensible way to break a tie. We support the approach reflected in the Commission's 2003 proposal of letting the shareholder or group that owns the most shares prevail if there are more nominations than there are available rule 14a-11 slots.

4. Directors nominated pursuant to agreements with shareholders, and incumbents nominated in the past three years under rule 14a-11, should count towards the 25% limitation of proposed rule 14a-11.

Proposed rule 14a-11 would perhaps unwittingly discourage the consensual resolution of board representation concerns between companies and major shareholders. Since directors nominated pursuant to agreements with shareholders would not count against the 25% limitation, boards will be loath to enter into such agreements, fearing that they might be inadvertently ceding control of the company. It seems to us, though, that agreements of this sort are precisely what the Commission ought to be facilitating.

In a similar vein, it appears that the Commission has not thought through the consequences of "success": if a rule 14a-11 nominee is in fact elected, what happens the following year? It will often take more than a year for a new director to come up the curve, to make a full contribution to the workings of the board, and to earn the unqualified support of fellow directors. Yet the proposed rule would make boards disinclined to renominate such directors, since by so doing the board could be faced with a new set of rule 14a-11 nominees. We think that the rule should encourage the integration into the board fabric of directors elected pursuant to rule 14a-11. Unless such directors are counted, at least for a few years, against the rule's limitations, board continuity and cohesiveness will suffer.

5. The rule should not apply during contested elections.

During a contested election, shareholders are already being offered a choice between a management slate and a slate opposed by management. Why not allow even more choice? Two reasons:

- First, the opportunities for shareholder confusion multiply, and not only because there would be at least two proxy cards with potentially more than twice the number of director nominees than slots available. Even though the rule 14a-11 nominating shareholder will have certified that it does not have a control motive, other shareholders are likely to presume an alliance between the rule 14a-11 slate and the slate opposed to management; indeed, they are allied at least in the sense that both seek to change the composition of the board. This presumption – that a broad group of shareholders is opposed to the current board – is likely to make it much more difficult for management to communicate its case to the shareholders, all to the very real benefit of the shareholder who plainly possesses a control motive.

- Second, even though the rule 14a-11 nominating shareholder will have certified its lack of a control purpose and will have fielded a slate of no more than 25% of the board, it's easy to imagine that in some contested elections a rule 14a-11 nominee would be the swing vote, tipping the majority of the board and thus control of the company. Since the Commission does not intend the rule to be available to any shareholder seeking to change the control of the company, it should follow that the rule not be available when the shareholder's nominee would or could change the control of the company.

The Commission stated in the proposing release that:

> "We do not believe that an election contest conducted by a shareholder to change the control of the issuer or to gain more than a limited number of seats should be funded out of corporate assets. Further, extensive changes in board membership, or the possibility of such changes as a result of additional nominees being included in the proxy statement, have the potential to be disruptive to the board, while also potentially being confusing to shareholders." (Proposing release at p. 75.)

Since each of the Commission's concerns expressed above – the use of corporate assets to fund changes of control, undue disruption to the board and shareholder confusion – would exist if rule 14a-11 operated in tandem with a traditional election contest, we believe that a company should not be required to include a rule 14a-11 shareholder nominee on the proxy card if it is already subject to an election contest.

6. The rule should not apply to IPO companies or controlled companies.

We suggest that any adopted rule exclude companies for at least three proxy seasons from the conclusion of their initial public offering. Rule 10A-3 permits an IPO company to stagger the effectiveness of the requirement to have all members of the audit committee meet required independence standards. As a result, it is not unusual for an IPO company to add several new independent directors over time to its board, rather than immediately at the IPO. In addition, of course, given its newly public status, an IPO company is also less likely to have displayed the alleged corporate governance failures that may justify granting shareholders access to the proxy. IPO company boards should have a meaningful opportunity to work together and establish an effective governance structure, without the disruption that shareholder nominations would entail.

We also suggest that the Commission exempt controlled companies from the scope of the rule. Since a shareholder nominee would have no chance of being elected to the board against the wishes of a majority shareholder, there is no reason to impose the incremental expense of a rule 14a-11 nominee on controlled companies, particularly since minority shareholders have other avenues of communicating with the company, including rule 14a-8.

Efficiency, Competition and Capital Formation Considerations

As the Commission noted in the proposing release, Section 23(a)(2) of the Securities Exchange Act of 1934 requires the Commission, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Section 3(f) of the Exchange Act and Section 2(c) of the Investment Company Act of 1940 provide that when the Commission engages in rulemaking that requires it to consider whether an action is necessary or appropriate in the public interest, the Commission must consider whether the action will promote efficiency, competition and capital formation.

In the proposing release, the Commission offered no empirical data or other factual support to show that the proxy access proposal would not burden competition, or that adoption of proxy access will promote efficiency, competition and capital formation. Instead, the Commission posited a number of conclusory assumptions about the impact of the proposal, including the following:

> "We expect the proposed rules to promote the efficiency of the exercise of shareholders' rights to nominate and elect directors. We expect proposed Rule 14a-11 would increase efficiency because a shareholder will not have to engage in a formal proxy contest if the shareholder only wants to nominate a small number of directors and is not seeking control of a company's board." (Proposing release at pp. 200-201.)

While it may be more “efficient” for the individual shareholder to be able to include its nominee on the company’s proxy card, it is not at all clear how this efficiency translates into efficiencies for our capital markets in general. The Commission’s analysis of the competitive impact of the proposal takes a similar tack:

> “If a company is required to include shareholder nominees in its proxy materials, competition for board seats could increase, which might encourage or discourage qualified candidates from running.” (Proposing release at p. 201.)

While competition for board seats will certainly increase if the rule is adopted, we doubt that this is the kind of competition Congress was trying to encourage and protect when it enacted Sections 3(f) and 23(a)(2) of the Exchange Act and Section 2(c) of the Investment Company Act. Instead, Congress was focused on competition in the markets and the competitiveness of US companies generally. See *Am. Equity Inv. Life Ins. Co.* v. *SEC*, No. 09-1021 (D.C. Cir. 2009) (interpreting the analogous Section 2(b) of the Securities Act of 1933 and noting that the Commission “did not make any finding on the existing level of competition in the marketplace”). We think the statute requires the Commission to perform a serious analysis tying increased competition for board seats to marketplace competition. The proposing release suggests that this analysis has yet to occur (and instead asks commenters to provide empirical data to support <u>their</u> views).

Although the Commission acknowledged that “one possible adverse impact on efficiency, competition, and capital formation is that boards may devote less time to fulfilling their other responsibilities” as a result of “the board devoting additional time to considering shareholder concerns,” the Commission dismissed this concern, stating:

> “[W]e believe that investors may be able to evaluate a company’s board of directors more effectively and make more informed investment decisions as a result of the proposed rules.” (Proposing release at p. 201.)

It is not clear how the proposals would increase a shareholder’s ability to evaluate the company’s board, and it is also not clear how granting shareholders access to the proxy would enable investors to make “more informed investment decisions.” The entire purpose of the Commission’s proxy disclosure rules is to help an investor evaluate the company’s board and thereby make informed voting and investment decisions. If there is a shortcoming in the Commission’s proxy disclosure requirements, it is very difficult to see how that will be cured by requiring the company to include someone else’s nominee on the proxy card. In fact, the Commission’s recent proposal, *Proxy Disclosure and Solicitation Enhancements* (Release Nos. 33-9052; 34-60280; IC-28817) (July 10, 2009), recognizes the need to supplement existing proxy statement disclosure and proposes to require an explanation of individual directors’ experiences, skills and qualifications. We think enhancing proxy disclosure is far more likely than facilitating proxy fights to further the Commission’s goal of helping investors make more informed investment decisions.

Finally, the Commission observed that:

> “We also believe that these developments may have some positive impact on the efficiency of markets and capital formation because it may help to increase investor confidence during this time of uncertainty in our markets.” (Proposing release at p. 201.)

This statement seems as though it could be empirically validated, and we urge the Commission to do so before adopting a rule that many believe could have extremely adverse consequences for the workings of the nation’s publicly traded companies.

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Thank you for the opportunity to comment on the Commission's proposals. If you would like to discuss our comments, please contact any of the undersigned at (212) 450-4000.

Very truly yours,

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