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Via E-mail

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

Re: Shareholder Proposals Relating to the Election of Directors (File No. S7-17-07)
Shareholder Proposals (File No. S7-16-07)

Dear Ms. Morris:

I appreciate the chance to comment on the recent proposals concerning shareholder access to company proxy material for the purpose of proposing bylaws governing shareholder nominations of directors. In my comments I give reasons for supporting the rights of shareholders to make such proposals, as provided in SEC Release No. 34-56160 (the "Access Proposal"), and thus I favor the Access Proposal over the suggested rule changes in SEC Release No. 34-56161 (the "Non-Access Proposal"). I also argue that several provisions of the Access Proposal are overly restrictive or cumbersome. In particular, I oppose the 5% share ownership requirement for bylaw proponents, and I believe that at one or two points the disclosure requirements in the Access Proposal go too far. Indeed, although the Access Proposal is clearly better than the Non-Access Proposal, it is not clear that enacting the Access Proposal as is would be better than doing nothing at all.

I. Shareholder Access makes sense

The Access Proposal, at least as compared with the Non-Access Proposal, makes sense within the context of the American system of corporate governance as it has developed in recent decades. Large institutional investors have come to own a larger fraction of American public corporations, and some of them are gradually playing a more important role in the oversight of directors and officers. This market-based development fits well within the regulatory framework established by federal securities law and state corporate law.

In particular, I make the following points:

- allowing shareholder proxy access bylaws would boost the role of institutional investors as one of the important limits on boards;
- the role of shareholders in choosing directors is a central premise of the basic allocation of authority under state corporate law;
- the Access Proposal is an improvement on the Commission's 2003 proxy access proposal in that it allows for more experimentation and flexibility;
- the Access Proposal creates a pro-shareholder default rule which individual companies may avoid, if they choose, through certificate provisions specifying that shareholders may not make nominations using the company's proxy material; and
- the Access Proposal fits well within our system of federalism in setting the rules of corporate governance.

I elaborate on each of these points below.

Boosting the role of institutional investors

Our system of corporate governance contains a number of important limits on misbehavior by the directors of a public corporation, including managerial labor markets, performance-based compensation, the market for corporate control, product market competition, and reputation. However, each of these has serious limitations, and it is not at all clear that even collectively they provide adequate limits on incentives to make decisions that do not advance the interests of the corporation.

Institutional investors have become an increasingly important part of the stockholder base of most corporations, and in recent years they have started to play a more active role in monitoring director behavior. Traditionally, shareholder monitoring was not seen as an important part of the American corporate governance system because of the free riding problem that exists when shareholders are widely dispersed. However, the growth of institutional investors has created a class of shareholders that has some incentive to overcome the free riding problem. An increased use of Rule 14a-8 shareholder proposals focused on corporate governance, and increasingly high percentages of shareholder votes for many such proposals, are an important part of this change.

Some opponents of increased shareholder activism fear that the leading shareholder activists represent special interests, pointing to the role of union and public employee pension funds. That fear is misguided, for at least two reasons. First, insofar as the managers of such funds are to some extent influenced by the concerns of groups other than shareholders, they provide a way of airing the concerns of other corporate constituencies who have a real stake in corporate governance—not a bad thing. Second, the union and public employee pension funds can win a majority only if they induce other shareholders to vote with them. The fear mongering over special interest shareholders assumes that other shareholders cannot accurately determine and vote on their own interests. I see no reason to accept that assumption.

Shareholder franchise is a central part of the allocation of corporate authority

Opponents of the Access Proposal point to the central role of the board in corporate decision making under state law, and argue that the Proposal undermines that role. Indeed, the board is the central source of authority for most corporate decisions. However, the role of shareholders in choosing who will be on that board is also a central part of the allocation of corporate authority. The Delaware Chancery Court has said that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[1] The structure of corporate law codes supports this point, giving shareholders power to enact bylaws that regulate procedural matters and fundamental features of corporate governance. It seems clear that shareholder access proposals will be held as valid under state corporate law.[2]

An improvement upon the 2003 Proposal

The Access Proposal serves the same basic aims as the 2003 director nomination proposal. Both create a method by which shareholders may use the corporate proxy materials to nominate directors, if enough of the company's shareholders choose to be governed by such a system. However, the new Access Proposal is a definite improvement on the 2003 proposal. The 2003 proposal imposed a one-size-fits-all rule on all corporations which chose to be governed by the shareholder access rules. This rule specified how many shareholders were required to make a nomination and how many

[1] *Blasius Industries v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

[2] I make these points in greater detail in *Shareholder Bylaws, Shareholder Nominations, and Poison Pills,* 3 BERKELEY BUS. L. J. 205 (2005).

directors they could nominate. Perhaps the thresholds chosen made some sense. However, it is not clear that the levels chosen were the best possible as a general rule, or that they were best for all corporations.

The Access Proposal creates greater flexibility and room for experimentation. Shareholders in different corporations may choose to enact bylaws with different rules governing such questions as what percent of shares are required to make a nomination and how many directors the shareholders may nominate. If different corporations do adopt different rules, we will be able to watch and judge which rules work better. This experimentation should lead to improved rules over time. This flexibility also allows shareholders to adapt rules to the particular circumstances of their own corporations. Different companies have different shareholder ownership patterns, different managers, and different traditions and cultures. It may well make sense for their shareholder nomination rules to differ as well. The Access Proposal allows for that.

Corporations may opt out

For the reasons given above among others, I think that most corporations will benefit from being subject to the Access Proposal. However, I naturally admit that could turn out to be wrong as a general matter, or for a minority of corporations. In some cases, maybe the threat to board authority or the possibility of costly and disruptive elections does mean that corporations would be better off if shareholders could not submit proxy access proposals.

Where a board believes this to be so, they can choose to in effect opt out of this rule by foreclosing the possibility of shareholder bylaws that grant shareholders the power to use the corporate proxy material to make nominations. They can do so by enacting a provision in the certificate or articles of incorporation that specifies that the corporate proxy material may not be used for shareholder board nominations. Under the corporation laws of all states, the certificate or articles trump the bylaws. Once a corporation had such a provision in place, then any attempt to enact a shareholder access bylaw would be invalid under state law, and hence excludable under Rule 14a-8. Thus, while the Access Proposal creates a default rule making it easier for shareholders to give themselves access to the corporate proxy, corporations may opt out of this default. Given the greater ease of action by boards than shareholders to protect themselves, it makes sense to enact pro-shareholder defaults where the net benefits of different rules are uncertain.[3]

Of course, passage of such a certificate/article provision would require shareholder as well as board approval. However, if the arguments against shareholder proxy access are right and shareholders are truly harmed by the availability of such bylaws, then they should be willing to approve of such provisions. Indeed, if anything shareholders are prone to follow management too often in their voting. Those who oppose the Access Proposal must thus argue that shareholders are quite systematically unable to understand their own best interests on this matter.

Fits well in our federal system

A final point favoring the Access Proposal over the Non-Access Proposal looks to federalism. Under our federal system, states have always set the basic rules of corporate law. Federal securities law works best when it complements and supports state law. The Access Proposal does that.

[3] For an elaboration on this general point, *see* Lucian Arye Bebchuk and Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489 (2002).

I have already argued that the Access Proposal fits well with the state-law principle which legitimizes board authority through the shareholder franchise. Above and beyond that fundamental point, the Access Proposal will allow and encourage greater development of state law rules on the fundamental question of shareholder power over the board election system and shareholder bylaws more generally. The exact scope of the shareholder bylaw power has been rather mysterious for a long time. There has been much discussion of it over the last decade or so, yet the state law on this subject has not developed much. Why not?

The answer lies in the Commission's interpretation of Rule 14a-8. It has been too willing to allow corporations to exclude shareholder bylaw proposals of various sorts. Once this exclusion is allowed, most shareholders let the matter drop because of the cost of soliciting proxies. Thus, bylaw proposals that raise tough state law questions do not get enacted, and hence they are not litigated. The Commission and its staff would do better to force these bylaws to a vote, and then let state courts deal with the bylaws under state law. The Access Proposal does that, whereas the Non-Access Proposal will continue to limit the ability of shareholders to exercise what is probably their right under state corporate law.

II. The 5% shareholding requirement is too high

Although the Access Proposal is clearly better than the Non-Access Proposal, I have qualms about several specific elements. Most disturbing is the requirement, under proposed Rule 14a-8(i)(8)(ii)(A), that to propose a bylaw under the Rule, the shareholder proponents must hold at least 5% of the securities entitled to vote at the meeting. Especially for larger corporations, this is a fairly onerous requirement. Although most corporations do have shareholders who on their own hold that many shares, there are not a large number of such shareholders, and many large blockholders may be uninclined to challenge management with such a proposal.

Of course, dissident shareholders who do not hold the required 5% block may search for others who favor their proposal until they form a group that reaches 5%. However, the free rider problem kicks in pretty quickly here—the individual benefits to taking the lead in monitoring a troubled company are small enough that most shareholders are already disinclined to do much if anything. Any rule that increases the costs of action even mildly runs severe risk of discouraging almost all action. I fear the 5% requirement will have such an effect.

If the 5% rule is a limitation that turns out to be necessary to achieve passage of the Access Proposal, I would at least hope that the Commission closely monitors proposals under the new rule, and if there is little evidence of disruption, then I would hope that after not too much time the Commission would consider lowering the 5% requirement.

III. Excessive disclosure requirements

The Access Proposal imposes a variety of disclosure requirements on both the proponents of access bylaws and on the proponents of particular board nominees. For the most part, these disclosure requirements make sense. Shareholders presumably would like to know about the backgrounds of their fellow shareholders making such proposals or nominations, among other things so they can ascertain any possible agenda the proposers may have.

But, at one point at least I suspect the disclosure requirements go too far. Proposed Item 8C of Schedule 13G requires that shareholder proponents (including either those proposing an access bylaw or those nominating a director) who are not natural persons must disclose the natural person responsible for creating the proposal, the manner in which such persons were selected, whether such person has a fiduciary duty to the equity holders of the entity in forming the proposal, the qualifications of such persons, and any interests such persons have that could influence their decisions. This would seem to impose a heavy disclosure burden, and for little purpose. I suspect that all of Item 8C could be dropped at little or no cost. At most, the only part of Item 8C that seems at all close to being worth its cost is required disclosure concerning any interests the person drafting the proposal may have that are not shared generally by the other shareholders of the company.

IV. Doing nothing may be best of all

Although, as part I above argues, the Access Proposal is clearly better than the Non-Access Proposal, the problems identified in parts II and III, especially the 5% requirement, make it unclear whether enacting the Access Proposal would be as good as doing nothing at all.

The current state of the law is murky. Before *AFSCME v. AIG*,[4] the status quo allowed corporations to exclude proxy access bylaw proposals. For the reasons given in part I above, among others, the Access Proposal is clearly better than that old status quo. At least the Access Proposal forbids the exclusion of some proxy access bylaw proposals. However, after *AFSCME*, proxy access bylaw proposals whose proponents meet the relatively lenient general procedural requirements of Rule 14a-8 are able to get their

[4] 462 F.3d 121 (2d Cir. 2006).

proposal included, at least within the Second Circuit's jurisdiction. The law is left unsettled elsewhere. This uncertainty is obviously not good, and at least the Access Proposal would resolve that uncertainty. The Access Proposal also improves upon the current status quo even within the Second Circuit by imposing disclosure rules for shareholder proponents that mostly make sense, despite going too far in at least one area as argued above in part III.

However, as part II argues, the Access Proposal's 5% requirement makes it too hard for shareholder proponents to make it into the corporate proxy material. This worsens the status quo, at least insofar as the Second Circuit's approach holds sway. The costs of that flaw may outweigh the benefits of increased certainty and improved disclosure that the Access Proposal provides.

Thus, the best outcome would be to enact the Access Proposal without the 5% requirement. The worst outcome would be to enact the Non-Access Proposal. In between these two, it is hard to choose between the Access Proposal as it stands and the post-*AFSCME* status quo.

Conclusion

Shareholder proxy access bylaws are a natural step forward in our evolving federal system of corporate governance regulation. The Access Proposal is superior to the Non-Access Proposal for many reasons: it strengthens an increasingly important limit on corporate misbehavior, it is well-rooted in longstanding state law policy and structure, it leaves room for experimentation and flexibility, it can be sidestepped if individual corporations find it too costly, and it fits well within our federalist system of regulation.

Although the Access Proposal is better than the Non-Access Proposal, I would suggest change at several points. Most importantly, I would suggest reducing or eliminating the 5% shareholding requirement. Also, the excessive disclosure required in Item 8C should be reduced. With those changes, the Access Proposal would be a very useful step forward. If the 5% shareholder requirement is kept in place, it is a close call as to whether we would be better off if the Commission simply chose to do nothing at all.

Yours truly

/s/ Brett McDonnell