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September 19, 2007

VIA E-MAIL

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 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:

We are pleased to submit the following comments with respect to the Securities and Exchange Commission's (the "SEC") proposed changes to Rule 14a-8 of the Securities Exchange Act of 1934. The changes outlined in the SEC's Release No. 34-56161 would codify the SEC's existing position that shareholder proposals on proxy statement access for board nominations are categorically excludable under Rule 14a-8(i)(8). In contrast, the proposal in SEC Release No. 34-56160 (the "Access Proposal") would allow shareholders owning 5% or more of a company's voting shares to include in the company's proxy materials a proposal for an amendment to the

company's bylaws mandating procedures to allow shareholders to include director nominations in the company's proxy materials. We write in support of the proposal in Release No. 34-56161 and in opposition to the Access Proposal in Release No. 34-56160.

As we stated in our comment letters with respect to the SEC's proposals on proxy access in 2003, we believe that allowing shareholders to use a company's proxy statement for director nominations would be a serious mistake with far-reaching consequences. We refer you to our comment letters of June 11, 2003 and November 14, 2003. Activists' efforts over the last several years to facilitate election contests are part of their broader and ongoing campaign to undo the director-centric model of corporate governance established by state corporate law, a model that has served our public corporations and economy well throughout our country's history. These activists seek to substitute this model with a shareholder-centric model under which the delegation of authority granted to directors in public corporations would be constrained and undermined by the constant threat of dissident and other efforts to replace directors who do not hew to the activists' short-term agenda. We have long believed that the replacement of the director-centric model with a shareholder-centric one would risk severe harm and should be vigorously resisted.

The proponents of shareholder access proposals have failed to demonstrate any need for encouraging election contests or any benefit that facilitating more election contests would confer. While the ability to run an election contest may serve a purpose as a last resort in extreme circumstances, election contests are tremendously disruptive and divert the time and attention of a company's board and management from running the business. When successful, they also can create a dysfunctional and balkanized board. And the proliferation of proxy contests, together with the more general attacks witnessed over the last several years on corporate boards, threaten to deter the most qualified people from agreeing to serve as directors in the first place.

In this letter, we will first comment on the context in which the proposals to facilitate election contests arises, *i.e.*, the ongoing campaign to undermine the director-centric model of corporate governance. We will then summarize some of the costs and risks of proposed

amendments that seek to facilitate proxy access shareholder proposals. Finally, we will comment on the lack of any demonstrated need for enhanced proxy access.

I. The Attack on Director-Centric Corporate Governance

In considering the debate over proxy access, and the broader debate over corporate governance generally, it is important to keep in mind the end goals of the public corporation: wealth creation, job creation and long-term investment to produce economic and social prosperity. These goals have been implemented in the United States through a legal framework that delegates initiative and decision-making power to a corporation's board of directors and management. Under this director-centric model of corporate governance, the board moderates and balances the interests of management, employees, creditors, shareholders and others to optimize the long-term success of the corporation. This structure has created the most successful economy the world has ever seen, unequalled in its ability to reward investors, employees and all the corporation's other constituencies by raising overall standards of living through the mobilization of large pools of capital over a long-range time horizon.

For the past twenty years, the activist governance lobby, primarily made up of ISS-type advisors, short-term hedge fund "activists" and academics, and emboldened since 2002 by the Enron-WorldCom scandals and the legislative and regulatory aftermath, has been seeking to destroy the director-centric model of corporate governance. This lobby seeks to replace the director-centric model with a simplistic rule that the shareholders at any given moment own everything and therefore have the power to decide everything in their own interests. The governance lobby uses the "shareholder as owner" refrain as an unspoken axiom to present shareholder power as an intrinsic right. The flaws in this approach are many, as we have previously described in the context of the SEC's 2003 proxy access proposal and in other contexts before that.[1]

[1] *See* Martin Lipton & Steven A. Rosenblum, "Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come," 59 Bus. Law. 67 (2003); Martin Lipton & Steven A. Rosenblum, "A New System of Corporate Governance: The Quinquennial Election of Directors," 58 U. Chi. L. Rev. 187 (1991).

In the shareholder-centric model, the interests of non-shareholder groups are accorded no legitimacy at all. Indeed, the governance lobby and its allies argue that corporate boards have a positive duty to ignore – even damage – the economic interests of employees, managers, creditors and others, if doing so maximizes (short-term) shareholder value. Thus, we see these groups devise campaigns to cause companies to incur debt to pay large special dividends, to divert capital expenditure to equity buy-backs, to engage in transactions that reduce high-rated corporate debt to junk status, and to divest businesses, close facilities and cut employment.

The key elements of the existing corporate governance order have been: (1) centralized professional management; (2) supervision of management by a knowledgeable, largely independent group of directors who help set long-term policy and deal with extraordinary events; (3) a federal regulatory system largely limited to disclosure and punishment for outright fraud; (4) a body of state law that recognizes the critical importance of the business judgment rule and therefore limits judicial intervention to egregious cases; and (5) a role for shareholders that is generally restricted to the periodic election of directors and voting on selected events such as mergers.

In attacking this model, the corporate governance lobby has pursued a double-barreled strategy. First, it has created a long list of "best practices" which constitute micromanagement of board-level issues, which it attempts to impose by holding directors hostage to "withhold" vote campaigns. Second, it has supported a growing number of bylaw amendments which even more directly supplant directorial discretion and judgment by purporting to require the board to do or not do certain things within the board's legal prerogatives (such as to adopt poison pills). The current effort to persuade the SEC to permit shareholder proposals for proxy access bylaws is simply another element in this strategy.

Despite the demonstrated success of the existing director-centric framework, it has been under sustained attack for more than two decades. The reasons for the current demands for change can be traced to the confluence of two trends, long in the building. First is the decades-long obsession of academic observers of corporate law with solving a single problem, namely the "agency" problem, whereby managements' personal interests are assumed to diverge in some

persistently material and harmful way from the interests of shareholders. Second is the growth of a large group of corporate governance professionals – individuals who earn their living devising, implementing and monitoring "best practices" that supposedly address the agency problem that the academics have endowed with transcendent importance.

The moving forces behind these attacks – for-profit corporate governance advisors and tenured academics – have no direct stake in the success or failure of American business or American capital markets. These two groups have the least real-world experience of anyone involved with corporate governance, and are the least accountable players in the corporate governance arena. Paradoxically, they have made a prominent place for themselves by calling attention to the supposed lack of accountability of directors and CEO's – persons who are subject to market discipline, government regulation, judicial oversight and press scrutiny.

These activist groups are driven by their own rational self-interest. If you are in the business of selling advisory services to passive investment vehicles, it makes sense that you would create a perceived demand for your product by emphasizing the supposed ills that your advice can cure. If you are a tenured academic (or an academic seeking tenure) who desires professional recognition, leading the charge for "reform" is more likely to draw recognition than analyzing the strengths of the current system. The motivation of these groups is easily understood, and there is no good reason to accept their positions at face value. No real-world crisis has shown that the current system needs radical revision. Five years after Enron and WorldCom, the capital markets are well into a cycle of unprecedented vigor, and no one seriously argues that shareholder activism, governance grandstanding or the Sarbanes-Oxley Act deserves the credit.

Yet the academics and corporate governance professionals would have us believe that the state of American corporate governance is grave if not desperate. In their hyper-critical view, American capital markets are at risk from a laundry list of supposedly poor governance practices, ranging from executive pay practices to poison pills to audit firm relationships. The remedies the corporate governance lobby proposes for these deviations from their own self-proclaimed corporate governance orthodoxy are sweeping: wholesale restructuring of the relationship between

shareholders and boards. This is a classic case of proposing radical surgery for a patient without a serious illness, and it happens because the "doctor" needs work.

The constant talk of "best practices" and emphasis on incremental changes, always accompanied with appeals to mom-and-apple-pie concepts like "access," "openness," "dialogue" and "accountability," have been a key component of the governance lobby's success. These words conceal the corporate activists' real agenda. If the principle that shareholder plebiscites can tie the hands of directors on seemingly innocuous issues is established, then it will be only a matter of time before directors find themselves powerless – or, more accurately, with the power of mere agents – while retaining the liability of principals. And the corporate governance debate is not, at bottom, about apparently harmless access, dialogue and openness or even about accountability. It is all about power – is all power in the hands of shareholders because they are the "owners" of the corporation, or is power to run the company to be entrusted to boards of directors, subject to legal and real-world constraints? The corporate governance lobby frames the debate as one in which the corporation is a kind of political democracy in which the ability of the shareholder-voters to decisively and immediately implement their desires is the sole benchmark of success. But what is really being made is a claim to exclusive ownership and control. The appeal to "democracy" is a diversion. The debate is fundamentally about the claim of the shareholder-centric camp that shareholders and only shareholders are entitled to the fruits of corporate success. The shareholder-centrics are thus consistent when they ignore demands to supply concrete evidence that proxy contests, shareholder-imposed "discipline" on boards and management, and corporate governance "best practices," correlate with economic success, because to them, shareholder "ownership" confers absolute control on shareholders without any need for proof of utility.

The best way to understand the error of the shareholder-centric position is to go behind the rhetoric and explore its underpinnings. The shareholder-centric assault on the director-centric model rests on three main propositions: first, that directors have no independent right to do anything but implement the general will of shareholders, based on the axiomatic assertion that

shareholders are "owners" and directors are mere "agents"; second, that there is no social or shareholder wealth maximizing purpose to be served by recognizing any directorial power beyond that of an agent; and, third, that directors are prone to abuse any independent power they are accorded by lining their own pockets or those of corporate managers. Each of these propositions is simply false.

Owners vs. agents. A primary purpose of the corporate form is to make clear that shareholders are not active owners; that their share ownership gives them no right to claim or exercise control over a *pro rata* share of the corporation's assets or profits. Shareholders have no right to compel or prohibit the declaration of dividends, to commit corporate assets to investment, or to sell or spin-off corporate investments. Instead, shareholders are entitled to cash payments in the event that the directors decide to liquidate or sell the corporation for cash, *i.e.*, if corporate existence is to be terminated, or determine to pay dividends. The "shareholder as owner" axiom that is fundamental to the shareholder-centric position simply describes inaccurately the legal and economic reality.

Moreover, the existing statutory framework recognizes that power and responsibility are two sides of the same coin. Directors have power, and thus potential liability, while shareholders lack power but are insulated from liability to creditors, employees and other shareholders. This is a fundamental bargain society has authorized, through its legislation, for investors. If you want direct decision-making power as a director (or as a partner or trustee), you cannot avoid liability; you can avoid liability only by ceding power to others. In short, there is a reason that judges, lawyers and legislators describe directors as "fiduciaries" and describe their duties as fiduciary in nature; they are not agents, and they do not owe a legal duty of obedience to principals.

Wealth maximization. Stimulated by the challenge of the shareholder-centric forces, economists have recently developed a persuasive explanation of why – even assuming that maximizing the wealth of shareholders is the major or even sole goal of corporation law – a system that gives independent status and decision-making power to directors is superior to a model

in which all power resides with shareholders. Briefly, this economic approach recognizes that large corporations make long-term investments in specialized capital goods, human capital and intellectual property that have value only if the project is brought to fruition. Constituencies other than shareholders, including lenders, employees, management, communities or governments, need some assurance that ultimate decision-making lies not solely in the hands of an ever-changing group that may at any given time have an economically rational incentive to expropriate these investments of non-shareholder stakeholders by, for example, paying large special dividends or cutting off capital investment or laying off key personnel. In other words, other contributors to corporate success must be persuaded that their investment in the corporation cannot be destroyed without compensation by the shareholder "owners." The traditional, director-centric corporation provides such a method. A switch to a shareholder-centric model puts the achievement of the modern corporation – the ability to harness equity, debt and human resources to invest in large projects with long-term profit horizons – in serious danger. Without empowered directors possessing independent powers recognized by law, an optimal form of business organization would become unavailable.[2]

This recognition of the need to protect non-shareholder contributors to the corporation from expropriation by "owners" is built into the statutes that authorize the limited-liability corporate form. These statutes confer independent power on directors and emphatically give directors a status different from "agents" of shareholder "principals." The typical statute, like § 141(a) of the Delaware General Corporation Law, gives directors the "power to control the business and affairs of the corporation," and allows shareholders only limited pro-active rights. And no corporation statute in any U.S. jurisdiction requires that a corporation be organized for the purpose of maximizing shareholder value.

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[2] Two examples of recent scholarship that recognize the value of the director-centric model are: Margaret M. Blair & Lynn A. Stout, "Specific Investment: Explaining Anomalies in Corporate Law," 31 J. Corp. Law 719 (2006); and Stephen M. Bainbridge, "Director Primacy and Shareholder Disempowerment," 119 Harv. L. Rev. 1735 (2006). *See also* Martin Lipton & William Savitt, "The Many Myths of Lucian Bebchuk," 93 Va. L. Rev. 733 (2007); Jonathan R. Macey, "Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's *Seraglio*," 93 Va. L. Rev. 759 (2007).

Untrustworthy directors. An entirely different sort of argument is also used to support the attack on directorial power – the allegation that directors are, as a group, faithless fiduciaries. To this, there are two equally good and sufficient answers. First, as an empirical matter, very few independent directors are ever found, after judicial inquiry, to be derelict in either their duty of care or of loyalty. Second, if there were a social consensus that this is a problem, the legal rules for review of the exercise of directorial power could be adjusted without limiting the scope of power itself. In no other arena would we give credence to an argument that because of a few bad (or negligent) apples, we should chop down all the apple trees.

It is worth noting, also, how out of touch the agenda advanced by the corporate governance lobby is with the genuine problems facing American business. Imbalances caused by globalization, where American companies suffer externality costs that are not imposed on competitors in developing nations, are a much more serious issue than the litany of corporate governance items on which management and directors are more and more forced to spend their time. The academics and corporate governance professionals have not contributed anything to what should be a vigorous debate about how American corporations can remain competitive in the world's rapidly-changing economic landscape, especially when the American regulatory regime is becoming increasingly burdensome and Byzantine, while the rest of the world is streamlining their regulations.

Especially in light of the fundamental error at the heart of the shareholder-centric position, the question remains why the shareholder-governance lobby has been as successful as it has been. Prominent corporations have conceded the notion that it is a good governance practice to meet periodically with self-appointed shareholder representatives, and the custodians of large sections of the investment management universe have outsourced their voting decisions to ISS and its clones. The corporate governance lobby's greatest real-world success has been diversion of attention from two key flaws – lack of support for its key claim that "good governance" improves performance, and the internal conflicts of interest of the governance industry itself.

II. The Costs and Risks of Access Proposals

With this background, the governance lobby's campaign to allow activists to place dissident board nominees in a corporation's proxy statement can be understood as part of the broader campaign to usurp the traditional and legal prerogatives of directors and create more leverage for the activists to impose their will on public companies. It was the governance lobby's campaign that gave rise to the SEC's access proposal in 2003. When that was rightly rejected, the lobby pursued the effort through the courts, and now again through the current Access Proposal, to accomplish the same purpose in the form of shareholder proposed bylaws. The goal of these various forms of access proposals is not only to increase the number and likely success of election contests, but also to increase the ability of activists to push directors to take steps such as leveraged share buybacks or divestitures or putting the company up for sale, with the threat of a proxy contest if the directors do not comply. The Access Proposal, like the access proposals that preceded it, is intended as a tool in the campaign to undermine the director-centric model of corporate governance and replace it with a shareholder-centric model. For the same reasons that this broader campaign is dangerous and should be rejected, as we reviewed in the prior section of this letter, the Access Proposal should similarly be rejected.

Because the governance lobby uses the "shareholder as owner" axiom to posit that increasing shareholder power is an intrinsic good, the proponents of proxy access proposals typically do not try to justify their support of the proposals with evidence that would suggest that increasing the frequency and success of proxy contests would improve the performance of public corporations or otherwise result in any economic or social good. Nor do they take seriously the costs and risks of increasing and facilitating dissident election contests. Instead, they simply repeat the tautological mantra that increasing shareholder power is good, so giving shareholders a greater ability to nominate dissident board nominees must also be good.

From a pragmatic perspective, however, it is clear there are significant costs and risks to the Access Proposal and the prior proposals designed to permit shareholders to include their director nominees in a company's proxy materials. We have reviewed these costs and risks in our

prior comment letters and articles, and we summarize them below:

Distraction of management and diversion of corporate resources. Given that director elections go to the heart of corporate governance and can have far-reaching consequences, a public company facing an election contest will typically devote a substantial amount of management time and resources to the contest. As a result, election contests – even for a minority of the board seats – are extremely disruptive and divert considerable resources away from operating the business. Even assuming that the number of election contests resulting from the Access Proposal would be far less than the number of Rule 14a-8 proposals, any real increase in the number of election contests will have an impact. To the extent the SEC's proposed rule changes will shift the costs and responsibility of preparing and disseminating information about shareholders and their nominees to companies in proxy contest situations, these burdens will be exacerbated.

Promotion of special interest agendas. Giving shareholders access to company proxy materials for director nominations will facilitate the election of dissident and special interest directors. Special interest groups would very likely be at the forefront of those proposing and seeking to implement access regimes, and then using access mechanisms to nominate director candidates. It is no coincidence that the most vocal supporters of proxy access proposals tend to be political or union shareholder activists, or hedge funds seeking short-term profits at the expense of long-term interests of a corporation. Directors nominated by these special interest groups will be beholden to such groups, due in part to their personal connections with and allegiance to such groups outside of the boardroom as well as the philosophical and political persuasions for which they were chosen as nominees.

Balkanization of the Board. The general view among directors and others with first-hand experience of board operations is that candid boardroom deliberations, a level of mutual respect and trust among directors, and an ethic of teamwork and cooperation all tend to produce more effective boards. In such an environment, directors feel comfortable discussing and debating the merits and risks of business decisions, opportunities and corporate policy and work together to craft an informed consensus. To the extent the Access Proposal would facilitate the

nomination and election of dissident or special interest directors, it will promote balkanization, factions and politicization of boards. This will lead to a breakdown in communications among directors and between management and the board, as individuals become more defensive, more partisan and less open. While politicking, sidebars and efforts to outmaneuver opposing factions may be the operating model we have accepted for certain elected governmental bodies, it is generally not the paradigm that is embraced by business managers for work environments, nor should it be.

Creation of adversarial relationships between companies and their shareholders. Following the wave of hostile takeovers in the 1980s and the adoption of SEC shareholder communication rules in 1992, in many instances shareholders and managers have sought to develop more cooperative relationships. Avenues have opened for shareholders who wish to make their views known to company management and directors, and many companies have become increasingly attuned to the concerns of large shareholders and actively solicit their views. Election contests undermine these efforts to develop cooperative relationships. Even the most tame proxy contest is an adversarial exercise that is fundamentally incompatible with cooperation. And many election contests devolve into personal attacks, creating bitterness and a sense of division that is difficult if not impossible to overcome. Thus, an increase in the frequency of election contests would likely chill efforts towards cooperative communication and reintroduce the adversarial atmosphere and general wariness that was prevalent in the hostile takeover era.

Impact on director recruiting and risk aversion. An increase in the incidence of election contests will likely exacerbate the difficulties companies currently face in recruiting and retaining high quality directors for their boards. A number of hurdles have already surfaced in recent years – including public criticism and skepticism of directors in the wake of Enron, WorldCom and other scandals; the various procedural requirements imposed on boards by recent regulatory developments; and certain court decisions which have created at least the perception that directors may face increased personal liability. The prospect of more frequent proxy contests, with the divisiveness and personal attacks they often entail, would be yet another reason for po-

tential directors to decline nominations or, if they do serve, to be unduly risk averse.

These are among the readily identifiable costs and risks of promoting shareholder access to company proxy statements for director nominations. In contrast, we have seen no evidence to demonstrate that facilitating dissident nominations or increasing the frequency of proxy contests will produce healthier companies, a stronger economy, long-term value or growth, or any other benefits to society or shareholders in general. We continue to believe that if adopted, the Access Proposal and other proposals like it would do far more harm than good.

III. The Lack of a Need for Proxy Access

A further irony of the governance lobby's campaign for proxy access is that shareholders today have more avenues than ever for communicating with boards and management, providing input into the nomination process, and even running their own proxy contests without use of the company's proxy statement. The frequency of proxy contests, particularly short-slate proxy contests of the type that access proposals seek to facilitate, has been steadily climbing. And recent proxy reforms will only make these contests easier. Given that we believe the increase in proxy contests is already having ill effects, we also believe that the last thing a policy maker should want to do is to adopt yet more regulations to facilitate or encourage proxy contests. At a minimum, the fact that it is already easier than ever to run a proxy contest, as evidenced by the increasing frequency of such contests, demonstrates the lack of any need for adoption of the Access Proposal.

Board nomination process. At virtually all public companies today, shareholders who wish to nominate director candidates are encouraged to submit their suggestions to the company's nominating committee. A nominating committee is well positioned to evaluate potential nominees from the vantage point of the best interests of the company and its shareholders as a whole. In 2003, the SEC adopted rules enhancing the required proxy statement disclosure with respect to a company's nominating committee and the procedures followed by the committee in nominating directors. Thus, the nominating process is more transparent to shareholders than in

the past, and companies have developed procedures for nominating committee consideration of director candidates proposed by shareholders.

Running a direct proxy contest. Shareholders have long been able to run a proxy contest by filing their own proxy materials and using their separate proxy statement and proxy card to solicit votes for their nominees. While there are some costs to shareholders who wish to pursue this option, the cost of running a short-slate contest has decreased and the frequency of short-slate contests has increased in recent years. In addition, as the SEC has recognized, requiring the dissident to post its own proxy materials enhances clarity and avoids shareholder confusion. In any event, imposing some level of cost on a dissident proxy contest is appropriate. Requiring shareholders to file and take responsibility for separate proxy materials promotes a level of scrutiny, disclosure and accountability that an insert into a company's proxy statement will likely not provide. In addition, imposing some level of cost helps ensure that shareholders will view a proxy contest as more of a last resort rather than business as usual. We also note that the SEC's new rules permitting electronic dissemination of proxy materials are expected to significantly reduce the costs of distributing proxy materials, thus easing the way for shareholders to pursue a standalone proxy contest. While we view this by-product of the rules for electronic dissemination of proxy materials with some concern, it further undercuts the notion that the SEC should take yet more steps to facilitate and encourage proxy contests.

Other corporate governance reforms. In the wake of the Enron, WorldCom and other scandals, there have already been a plethora of other regulatory changes in the past few years focused on increasing the openness and independence of board processes and the ability of shareholders to provide meaningful input. The Sarbanes-Oxley Act and stock exchange rules have strengthened the standards of independence for directors, require a majority of a board to consist of independent directors, and require key committees to consist entirely of independent directors. They also obligate companies to adopt and publicly disclose committee charters, corporate governance guidelines, and codes of conduct and ethics governing directors and employees. Independent directors are required to hold executive sessions on a regular basis, and New

York Stock Exchange rules require listed companies to disclose means by which their shareholders may communicate with their independent directors. Majority voting standards have also gained traction and have now been adopted by a growing number of public corporations. While we believe some of these reforms have been useful, as a general matter we believe the regulatory response to the Enron and WorldCom scandals, in hindsight, has been excessive, creating a risk aversion that has not been healthy for the operation of public companies generally. Again, in any event, the massive regulatory response that has already been implemented further undercuts the argument that yet more reforms are necessary.

Non-regulatory developments. Apart from regulatory changes, developments in the shareholder activist landscape and mobilization of special interest groups have already been facilitating contested elections. Hedge funds and other activist investors have become particularly prominent in recent years and have waged several successful short-slate election campaigns or successfully procured board seats by merely threatening to wage such campaigns.[3] The increasing influence of ISS and other proxy advisory services has also enhanced the ability of shareholders to garner support for their proposals and consolidate their influence. Notably, the rate at which such advisory groups recommend voting "for" rather than "against" shareholder-nominated directors in election contests suggests, to a startling degree, that these groups have an institutional bias towards supporting shareholder nominations irrespective of the qualifications and suitability of individual nominees. In addition, the institutional ownership of public companies has become increasingly concentrated and the influence of these large shareholders has grown, particularly as a result of the recent elimination of broker discretion to vote in uncontested elections where brokers do not receive direction from their clients. Again, we view these developments with concern over the negative impact they have had and may have in the future on the healthy operation of public companies. Furthermore, we believe these developments provide further evidence of why additional regulation, such as the Access Proposal, is not warranted.

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[3] For example, Nelson Peltz captured two board seats at H.J. Heinz Co., Carl Icahn and allies won board seats at ImClone Systems Inc. and Blockbuster Inc., and Third Point LLC captured two board seats at Massey Energy Co.

IV. Conclusion

Proposals to allow shareholders to include director nominations in a company's proxy statement are hardly new. On numerous occasions dating as far back as 1942, the SEC and Congress have considered such proposals and, in each case, rejected them after careful review. As recently as 2003, the SEC again considered and rejected proxy rule reforms which would have facilitated shareholder access to company proxy statements for director nominations.

In contrast, the express carve-out in Rule 14a-8(i)(8) to permit companies to exclude shareholder proposals relating to director elections was enacted in 1947, and the SEC has a long-standing policy of construing this carve-out to cover not only director nominations by shareholders but also proposals for procedures which may result in contested board elections.

We believe the tests of time and experience have firmly established the wisdom not only of the Rule 14a-8(i)(8) exclusion, but also of the director-centric model of corporate governance and the value of an impartial board positioned to balance competing interests to promote long-term shareholder value. Accordingly, we believe the SEC should reject the Access Proposal and instead amend Rule 14a-8(i)(8) to codify its well-established position that a company may exclude shareholder nominations of directors and related bylaw amendment proposals from its proxy statement.

Very truly yours,

Wachtell, Lipton, Rosen & Katz

Comment Letters of Wachtell, Lipton, Rosen & Katz
Regarding Shareholder Access Proposals of 2003

(attached)

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, New York 10019-6150

June 11, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. S7-10-03
Solicitation of Public Views Regarding Possible Changes to the Proxy Rules

Dear Mr. Katz:

On May 1, 2003, the SEC issued a notice soliciting comments with respect to possible changes in the proxy rules and regulations. We are pleased to submit the following comments with respect to one possible change that the SEC has indicated it may consider, namely allowing activist shareholders to use a company's proxy statement to run a director election contest.

Allowing shareholders to use the company's proxy statement for director nominations would be a mistake. This is not a question of whether shareholders should have the right to nominate candidates for the board. They should have that right and state laws give them that right. Nor is it a question of whether companies should be receptive to shareholder input in selecting board nominees. Most well run companies provide a mechanism for shareholders to make suggestions to the nominating committee, a committee that under the new stock exchange rules must be comprised entirely of independent directors. Rather, this is a question of whether the SEC should require, and whether it has the legal authority to require, a company to include in its proxy statement nominees for its board who are selected outside the company's nominating process and are running against the board's own nominees.

On a number of occasions in the past, the SEC and Congress have considered and rejected proposals to allow shareholders to run an election contest through the company's proxy statement. The SEC considered such a proposal as far back as 1942, but abandoned it in the face of unfavorable public comment and strong Congressional criticism. By 1947, the SEC added the express provision of Rule 14a-8 under the proxy rules that permits companies to omit

shareholder proposals that relate to elections of directors. In 1977, the SEC again considered the issue of allowing shareholders to put their nominees in the company's proxy statement and again rejected it. In the early 1990's, a number of shareholder activists once more sought rule changes that would give them the ability to wage an election contest through the company's proxy statement. While the SEC adopted sweeping reforms to the proxy rules in 1992, including rules that made it easier for shareholders to run an election contest, it did not give the activists access to the company's proxy statement for those contests. Again last year, similar proposals were introduced amidst the turmoil that gave rise to passage of the Sarbanes-Oxley Act. Despite significant support for corporate governance reform, and rapid approval of the Sarbanes-Oxley Act and new stock exchange rules, none of these proposals was adopted.

There are a number of sound reasons why the latest round of election contest proposals should again be rejected. First, the election of directors is a fundamentally different exercise than a vote on a management or shareholder proposal. Board elections go to the very heart of corporate governance, of who will be responsible for running the company. In contrast, a vote on a single proposal involves only one isolated decision. The threshold for running an election contest is and should be significantly higher than for a shareholder proposal.

Second, an election contest is a tremendously disruptive event for a company. Because of the supreme importance of board elections in corporate governance, when a company faces a contested election, the company typically devotes a significant amount of resources and time to explaining why the board-nominated slate should be elected. This kind of disruption would be very unhealthy for our nation's companies if it became the rule rather than the exception. The number of Rule 14a-8 shareholder proposals submitted in recent years has been growing steadily. Already in 2003, almost 900 shareholder proposals have been presented at annual meetings. If shareholders had the ability to run election contests through the company's proxy materials as well, the resulting disruption and diversion of resources would be significant and destructive. The possibility of hundreds of election contests each year, with all that entails, would simply be disastrous for companies and their shareholders.

Third, giving shareholders access to the corporate proxy machinery to run an election contest would facilitate the nomination and election of special interest directors. While diversity and fresh viewpoints are good for a company and its board, the election of special interest directors is not. Electing directors who view themselves as representing the shareholder activists, unions, social

activists or some other subset of the shareholder population would balkanize boards and render them dysfunctional. A company's board works best when it works as a unified whole, without camps or factions and without internal divisions. In our experience, when a board is balkanized and partisan, there is less open discussion and a greater reluctance to dissent than when a board acts a cohesive group of intelligent parties seeking to forge an honest, informed consensus.

Fourth, requiring someone who wants to conduct an election contest to file separate proxy materials assures a level of disclosure and accountability that is both important and healthy. This requirement also avoids the logistical difficulties and confusion that would result from having more nominees on a single proxy card than there are seats and from having nominees opposing the company's slate listed in the company's own proxy statement and card. The SEC has long recognized the importance of disclosure and accountability in the context of an election contest, and the proxy rules contain special provisions and require enhanced disclosure for such contests. The rules recognize that the election of directors goes to the core of the company's governance, and that shareholders need full and detailed disclosure about director candidates as well as the parties that are proposing and soliciting proxies for those candidates. These rules are not anti-democratic, nor do they preclude shareholders from nominating and soliciting proxies for director candidates of their choosing. Rather, they simply require added disclosure for election contests, clear identification of soliciting parties and pre-filing of proxy materials in contested elections. These rules work well, avoiding confusion and furthering the shareholder protection and disclosure objectives of the securities law. In order to allow shareholders to run an election contest through the company's proxy statement, the SEC would have to engage in a wholesale reworking of these rules, a difficult effort that would create more problems rather than solving them.

Fifth, there already exist constructive avenues for shareholders to have meaningful input into the nominating and election process. When the SEC rejected similar election contest proposals in 1977, it suggested studying ways to improve the nominating process instead. When it decided not to adopt the proposals to permit election contests through the company's proxy statement in the early 1990's, it did adopt sweeping proxy reforms to improve shareholder communications and allow shareholders to run a "short slate" election contest (*i.e.*, to nominate less than a full slate of directors for election) through their own proxy statement. The most recent corporate governance reforms ensure that public company nominating committees will be comprised entirely of independent directors, and further tighten the definition of independence. The recent reforms also require nominating committees to

adopt and publicly disclose their charters. All of these reforms have improved the nominating process and given shareholders the ability to provide more meaningful input into that process.

Particularly given the contentiousness and divisiveness of election contests, and the difficulty and confusion that would be involved in reworking the proxy rules to permit shareholders to run an election contest through the company's proxy statement, proponents of such election contest proposals simply cannot show the need for this far-reaching change. Instead, the best way to continue to improve the quality and responsiveness of public company boards is to remain focused on the company's existing nominating process. In determining the nominees for election to the board, as in other actions taken by directors of a public company, the members of a public company's nominating committee and board are subject to fiduciary duties to act in good faith in what they believe to be the company's best interest. Shareholders are not subject to the same duties in proposing director nominees, nor is there a mechanism to ensure that shareholders nominate well qualified candidates. The best route for shareholders to influence the nominating process is to propose nominees to the company's nominating committee, which should take bona fide nominee proposals from shareholders seriously. The nominating committee can then consider these proposed nominees from the vantage point of the best interests of the company as a whole. Acting within the framework of its fiduciary duties and the new stock exchange rules, the nominating committee is in the best position to ensure that strong candidates with fresh views and diverse backgrounds may be added to the board.

Sixth, under the existing rules, running an election contest through separate proxy materials is already a viable alternative and a viable threat. Running an election contest is obviously not as easy under the existing rules as bringing a Rule 14a-8 shareholder proposal, nor should it be. But shareholders do run election contests on a regular basis under the existing rules. Last year, there were 40 election contests. As noted above, the SEC's 1992 proxy rule reforms have made contests easier by permitting shareholders to run a short slate proxy contest. In recent years, the majority of election contests have been short slate contests, and a majority of those contests have resulted in either the successful election of the shareholder nominee(s) or a negotiated settlement with the company. In addition, the mere threat of a proxy contest has often been enough to push companies to negotiate with shareholders and agree on one or more mutually acceptable board nominees. Successful contests have been run not only by institutional investors, but by individuals as well, undercutting any argument that there are insurmountable obstacles to an election contest. To the extent the threat of a proxy contest is necessary to keep a company's nominating committee and board "honest", that threat is very real today. Given

the policy reasons why an election contest should be a last resort, rather than a first, one could argue that the SEC should make it harder to run such a contest, not easier.

Seventh, it is far from clear that the SEC has the authority under the federal securities laws to require companies to allow shareholders to run an election contest through the company's proxy statement. Under state law, the board of directors has the authority and responsibility to manage the business and affairs of the company. One of the most basic and fundamental tasks performed by a board is to direct the process of electing new directors. Requiring the board to expend corporate funds and grant use of the corporate proxy machinery for director candidates nominated outside the board's nominating process would infringe on this function.

In *Business Roundtable v. SEC*, the 1990 case invalidating the SEC's one-share, one-vote rule, the D.C. Circuit court held that the SEC's authority under the Securities Exchange Act does not extend to regulation of an issue that is "far beyond matters of disclosure" and is "concededly a part of corporate governance traditionally left to the states." While the proponents of allowing shareholders to run an election contest through the corporate proxy machinery may portray such a proposal as a "procedural" proxy rule, there is no question that such a rule would fundamentally and substantively change the nature of director elections, a matter at the core of corporate governance. These election contest proposals would create a substantive requirement under which a company, in effect, must solicit proxies for nominees opposed to the company's own slate. This goes far beyond the central purpose of the proxy rules, namely to ensure a fully informed and orderly vote on matters coming before the shareholders. Like the one-share, one-vote rule invalidated in the *Business Roundtable* case, the election contest proposals would extend "far beyond matters of disclosure" and would create substantive requirements in the arena of "corporate governance traditionally left to the states."

Fundamentally, the question of how to treat shareholder nominees and election contests must be considered within the overall context of our entire corporate governance system, not just the context of the SEC's proxy rules. Requiring shareholders who wish to conduct an election contest to do so through their own proxy materials is part of an overall corporate governance balance, one that has been reexamined and reaffirmed on several occasions. In its current review of the proxy rules, the SEC should again reach the same conclusion that it and Congress have reached in the past. Whatever decisions the SEC may reach regarding whether other proxy rule reforms are necessary or desirable at this time, the SEC should again reject the proposals that would give shareholders the ability to run an election contest using the company's

own proxy statement.

Very truly yours,

Wachtell, Lipton, Rosen & Katz

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, New York 10019-6150

November 14, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: File No. S7-19-03
Security Holder Director Nominations

Dear Mr. Katz:

On October 14, 2003, the SEC proposed new proxy rules that would, under specified circumstances, allow shareholders to use a public company's proxy statement to run a director election contest. For all the reasons set forth in our comment letter of June 11, 2003, submitted in response to the SEC's previous solicitation of comments on this subject, we believe that allowing shareholders to use a company's proxy statement for director nominations would be a serious mistake. It will have such an adverse impact on public companies as to threaten serious harm to the nation's economic well-being. This letter summarizes the concerns we expressed in our prior letter, and comments on some of the specific questions posed by the SEC in the October 14 release.

The advocates of the proposed election contest rules have not demonstrated any benefit that would result from increasing the frequency of election contests or the frequency with which dissident directors are elected to public company boards. Instead they rely on conclusory statements that generally fall into one of two categories: (1) the shareholders "own" the company and, therefore, anything that gives shareholders more voice or more control is good, and (2) the threat of more election contests, and the fear of destabilization that this threat generates, will motivate and discipline directors and managers, making them work harder and perform better.

Neither of these arguments holds water. As Martin Lipton and Steven Rosenblum of our firm explain in a forthcoming article in the November 2003 issue of *The Business Lawyer*,[1] the relationship of shareholders to a public company is far more complex than the relationship between an individual and a piece of personal property such as a car or a building. The governance of a

public company is a balance, developed over time, that is designed to contribute to the successful business operation and economic performance of the company. This goal benefits all the company's constituencies, including the shareholders. Shareholders make an important investment in the company, but so do many other corporate constituencies. The notion of shareholder "ownership" does not form a solid basis for the argument that shareholders have an "intrinsic" right to control all aspects of a company's operation or to use a company's proxy statement to nominate director candidates.

The second category of arguments, revolving around the use of threats and fear of destabilization to discipline and motivate directors and managers, is equally unfounded. These arguments, at least, focus on the right goal, namely the business performance of the company. But there is no evidence to suggest that increased threats and fear of destabilization will have any positive effect on director or manager performance. To the contrary, there is already concern that the cumulative effect of the governance reforms adopted in the last two years, together with increasing fear of exposure to lawsuits and legal liability, is causing directors to become too risk-averse and deterring good director candidates from serving. Increasing the frequency of election contests and the election of dissident directors will only exacerbate these problems.

In contrast, the potential harm from the proposed new rules is both real and significant. These costs, which we discuss in more detail in our June 11 comment letter, include:

- *Significant disruption from annual election contests*: because the election of directors goes to the heart of corporate governance, a public company facing an election contest typically devotes a substantial amount of management time and resources to the contest. This makes an election contest extremely disruptive. Even assuming that the number of election contests under the proposed rules would be far less than the number of Rule 14a-8 proposals (over 900 this year alone), any real increase in the number of election contests will result in substantial disruption and diversion of resources.

- *Election contests by special interests*: the institutional shareholders most likely to take advantage of the proposed election contest rules are the politically active institutions, such as labor unions and public pension funds, that have interests and agendas beyond the economic performance of the company. These shareholders may use election contests strategically to serve other goals. Moreover, there is a substantial risk that any director candidates nominated by such shareholders, even though not affiliated with the nominating shareholders, would be special-

interest candidates.

- *Balkanization of the board*: experience indicates that the election of dissident directors results in a balkanized board. The directors split into camps, politicizing the board, destroying collegiality, inhibiting open discussion and give and take, and impeding the board's proper functioning.

- *Creation of adversarial relationships*: following the takeover decade of the 1980s and the adoption of the SEC's shareholder communications rules in 1992, shareholders and managers have generally tried to develop a more cooperative relationship, with many avenues now existing for shareholders to make their views known to executives and the board. Indeed, the new stock exchange rules approved by the SEC on November 4, 2003 require executive sessions of outside directors and a means for shareholders to communicate directly with the outside directors. Increasing the frequency of director election contests, in contrast, threatens to recreate the more adversarial relationships that existed during the takeover decade.

- *Adverse impact on director recruiting and increased aversion to risk*: As noted above, the cumulative impact of wide-ranging corporate governance reforms and increased fear of exposure to liability is already making it harder to recruit top director candidates and is leading to concerns about excessive risk aversion in corporate decision-making. Increasing the number of election contests would make these problems worse.

- *Confusion and disclosure issues*: The SEC's policy of requiring shareholders who wish to conduct an election contest to file their own proxy materials furthers the fundamental purpose of the federal securities laws by promoting full and clear disclosure. Including shareholder nominees in the company's proxy statement risks confusion and less complete disclosure.

It is particularly inappropriate to be considering the adoption of election contest rules now, given the adoption over the last two years of the most sweeping corporate governance reforms since the federal securities laws were enacted in 1933 and 1934. Although it is too early to assess the full impact of these governance reforms, it is clear that many will have a significant effect on the relationship between shareholders and directors. The new reforms will create additional avenues for shareholders to have meaningful input into the management and direction of the companies in which they invest, over and above the many constructive avenues that already exist. For the reasons

summarized above, we believe that the proposed election contest rules have no clear benefit and threaten significant harm. But even were this less clear, it would be extraordinarily unwise to adopt a radical new set of rules before assessing the impact of the sweeping corporate governance reforms already just adopted.

* * *

In addition to asking the general question of whether the proposed election contest rules are a good idea, to which we answer no, the SEC's proposing release also seeks comments on a number of specific aspects of the proposed rules. The remainder of this letter responds to some of the specific questions posed by the SEC's release.

Nomination Procedure Triggering Events

Question C.3. As proposed, the nomination procedure could be triggered by withholding votes for one or more directors of more than 35% of the votes cast. Is 35% the correct percentage?

No, a threshold of 35% of the votes cast is far too low. Activist institutions now regularly wage withhold authority campaigns for any number of reasons, including political and policy reasons that have little to do with the company's business and economic performance. Given the highly concentrated institutional ownership in most major public companies today, these campaigns can reach the threshold of 35% of the votes cast on one or more directors even in companies where performance is strong. The 35% threshold would also mean that the shareholder nomination procedure could be triggered despite the fact that 65% of those voting support the entire board-nominated slate. It could also trigger the procedure in a case where the vast majority of the board's candidates enjoy overwhelming support and only one director is targeted for a withhold authority campaign. In light of the disruption and cost of triggering the shareholder nomination procedure, one could easily argue that this trigger should require a supermajority vote to withhold authority with respect to a majority of the board candidates. At a minimum, the threshold should be no less than the vote of a majority of the outstanding shares to withhold authority with respect to at least a third of the candidates up for election.

Question C.4. Should the nomination procedure triggering event related to direct access security holder proposals trigger the procedure only where a more than 1% holder or group submits the proposal? . . . Should the required holding period for the securities used to calculate the security holder's ownership be longer than one year?

A shareholder's or group's ownership of 1% of a company's stock for one year does not signify long-term share ownership, nor does it demonstrate any significant commitment by the shareholder or group to the long-term business performance of the company. These thresholds would give a wide variety of activists, hedge funds, vulture funds and other relatively short-term institutional holders the ability to threaten to bring a nominations procedure resolution in order to gain leverage and push for short-term concessions that would not benefit the company and its shareholders as a whole. A qualifying ownership threshold for bringing such a resolution of two years and 5% would reduce this risk, although even that threshold would not eliminate the concern.

Question C.6. As proposed, a direct access security holder proposal could result in a nomination procedure triggering event if it receives more than 50% of the votes cast with regard to that proposal. Is this the proper standard? Should the standard be higher?

In light of the significant risks and costs of the election contest procedure, the procedure should not be triggered (if it is ever to be triggered) without evidence of overwhelming shareholder support. For this reason, a threshold of 50% of the votes cast is too low. At a minimum, the threshold should be no less than a majority of the outstanding shares.

Question C.11. We have discussed our consideration of and requested public comment on the appropriateness of a triggering event premised upon the company's non-implementation of a security holder proposal that receives more than 50% of the votes cast on that proposal. Should such a triggering event be included in the nomination procedure?

No, such a trigger could have disastrous consequences, eventually leading to governance by shareholder plebiscite. Including this triggering event would confer increased power on Rule 14a-8 proponents and encourage an increased number of Rule 14a-8 resolutions. Currently, a board will consider seriously and carefully the views of shareholders as expressed in a majority vote on a Rule 14a-8 resolution, but it is still the board's responsibility to determine what the board believes in good faith to be the company's best interests. The board has a fiduciary obligation to make its own determination as opposed to complying automatically with the results of the shareholder vote. If this trigger is adopted, however, directors will feel enormous pressure to do as the shareholder resolution instructs, regardless of their independent determination as to the company's best interests.

We should note that this risk exists indirectly even assuming the SEC does not adopt the non-implementation trigger. Shareholder activists can threaten to bring an access procedure proposal, or to wage a withhold authority campaign,

if the board does not comply with a Rule 14a-8 resolution. Indeed, many activists have already begun to link withhold authority campaigns to the failure of a board to implement a Rule 14a-8 resolution, and some proxy voting advisory services, such as Institutional Shareholder Services, may support a withhold authority campaign in these circumstances. If the consequence of determining not to implement a Rule 14a-8 resolution is to trigger a successful withhold authority campaign, and the consequence of a successful withhold authority campaign is to trigger the shareholder nomination procedure, then the pressure on directors to do as the Rule 14a-8 resolution instructs will be almost as great as if the failure to implement the resolution directly triggered the nomination procedure.

The best way to address this problem is not to adopt the election contest rules in the first place. In the event these new rules are adopted, however, the SEC should concurrently scale back on the scope of Rule 14a-8. At a minimum, for example, Rule 14a-8 resolutions on corporate governance matters should be eliminated. If the shareholders have a path to run an election contest in the company's proxy statement, this should be their recourse if they are not happy with the company's governance. If the election contest rules are adopted, there is no reason that companies should also be peppered with the panoply of Rule 14a-8 governance resolutions that they now regularly face.

Proposed Eligibility Standards

Questions E.2. and E.3. Is it appropriate to include a restriction on security holder eligibility that is based on percentage of securities owned? If so, is the more than 5% standard that we have proposed appropriate? . . . Should there be a restriction on security holder eligibility that is based on the length of time securities have been held? If so, is two years the proper standard?

There should clearly be both an ownership percentage threshold and an ownership duration threshold in order to establish eligibility for any shareholder nomination procedure that the SEC may determine to adopt. As noted above, there are many distinctions between share ownership and the ownership of a car, building or similar personal property, undercutting the argument that shareholders have an "intrinsic" right to control the company. One of these distinctions is the fact that owners of shares may trade in and out of a company with some regularity. Having thresholds tied to significant ownership percentage and duration at least provides a minimal screen to prevent the worst potential abuses by short-term holders, hedge funds, vulture funds and the like. (We note, however, that these thresholds cannot address a number of other concerns, including the use of the nomination procedure by political entities such as public pension funds and labor unions to pursue

separate agendas notwithstanding that they are long-term holders of substantial amounts of stock.)

The minimum ownership percentage threshold should be no less than 10%. Even that threshold is too low, but in an era of concentrated institutional ownership and increased activism, assembling a group holding 5% of a public company's stock is truly a minimal hurdle. The SEC's proposed ownership duration requirement of two years may be an adequate "look back" requirement to provide some protection against the separate interests of relatively short-term holders. Equally important, however, is the "look forward" requirement, addressed in response to Question E.4. below.

Question E.4. As proposed, a nominating security holder would be required to represent its intent to hold the securities until the date of the election of directors. Is it appropriate to include such a requirement? Would it be appropriate to require the security holder to intend to hold the securities beyond the election of directors?

It is hard to see how a shareholder or group could make a colorable claim to a valid interest in nominating a director if the shareholder or group plans to sell their shares before or shortly after the election. With respect to this issue, one may make an analogy to a shareholders' agreement under which a major shareholder is given the contractual right to nominate one or more directors to a company's board. Without exception, such rights are granted only for so long as the major shareholder maintains a minimum shareholding. Typically, any director nominated by the major shareholder must step down when the shareholder's percentage ownership falls below the minimum. Similarly, a nominating shareholder or group should represent their intent to hold their shares until the election, and thereafter for the duration of the nominee's term as a director should the nominee be elected. In the event the nominee is elected and the nominating shareholder or group falls below the ownership percentage eligibility threshold (*e.g.*, 10%), the director should step down from the board.

Question E.5. Is it appropriate to permit the filing [by a shareholder or group intending to use the nominating procedure to nominate a director candidate] to be on Exchange Act Schedule 13G rather than Exchange Act Schedule 13D? If not, why not?

Such a filing should be on Schedule 13D and should provide the full level of disclosure required by Schedule 13D. A 5% or greater shareholder or group that seeks to nominate a director has always been required to file on Schedule 13D since the 5% ownership filing requirement was first implemented. This is consistent with the disclosure purposes of the federal securities laws. If a

major shareholder or group is going to run an election contest, an act obviously designed to influence the management and control of the company, other shareholders are entitled to full disclosure as to the identity of the shareholder or group (including their controlling persons), the source of their funding, the purposes of their actions, agreements or understandings they have with others with respect to their shareholdings, *etc*. To allow such a shareholder or group to make only the minimal disclosures required by Schedule 13G runs contrary to the central disclosure purposes of the federal securities laws. It is hard to see any justification for curtailing these requirements of full disclosure, a purpose at the heart of the securities laws, while at the same time creating substantive rights to facilitate more election contests, a purpose beyond the scope of the authority granted by those laws.

To Which Companies Would the Proposed Rule Apply

Question B.1. As proposed, the security holder nomination procedure in Exchange Act Rule 14a-11 would apply to all companies subject to the proxy rules. Would this broad application have a disproportionate impact on smaller operating companies? Would it be more appropriate to apply the procedure only to "accelerated filers" and funds as an initial step? . . . Would other limitations be more appropriate . . .?

For the reasons summarized in the first part of this letter and set forth in our prior comment letter, we believe the proposed election contest rules are a serious mistake. This leads, of course, to our conclusion that they should not be adopted at all. If they are adopted, however, a narrow application would allow time to gain experience with the rules and assess whether they should be broadened to apply more broadly in the future or, alternatively, rescinded altogether. A limited experiment with, for example, the largest 500 or 1,000 companies would be less dangerous than applying the rule immediately to all publicly traded companies.

B.3. Would adoption of this procedure conflict with any state law, federal law, or rule of a national securities exchange or national securities association?

As set forth in our June 11 comment letter, we continue to believe that the SEC does not have authority under the federal securities laws to adopt these proposed rules. Under state law, the board of directors has the authority and responsibility to manage the business and affairs of the company. One of the most basic and fundamental tasks performed by a board is to direct the process of electing new directors. The SEC's proposed election contest rules would infringe on this function. Like the one-share, one-vote rule invalidated in *Business Roundtable v. SEC*, the proposed election contest rules extend to regulation of an issue that is "far beyond matters of disclosure" and is, instead,

"a part of corporate governance traditionally left to the states."

The SEC's effort to address this issue in its proposal only makes clearer how substantive the proposed election contest rules are. The proposed rules would apply only to companies incorporated in those states where state law allows shareholders to nominate directors. The SEC thus implicitly concedes that it does not have the authority to grant shareholders the right to run an election contest where state law does not give them that right. But the proposed rules do grant substantive rights as to how a shareholder may run an election contest. Unlike the disclosure and process-oriented proxy rules that apply uniformly, these proposed rules would supplement substantive rights in some states and have no effect in others, serving only to highlight the substantive nature of the proposal. Moreover, the proposed rules effectively would create different classes of shareholders within a single class of shares, with different rights regarding nominating directors, use of company resources and running election contests. This raises further issues under state law provisions that require shares of the same class to carry the same rights.

* * *

Both as a matter of policy and as a matter of legal authority, we believe that the SEC should reach the same conclusion today as it has reached many times in the past. We believe that the SEC should reject the proposed election contest rules, allowing shareholders who wish to conduct an election contest to continue to do so through their own proxy materials, not through those of the company.

Very truly yours,

Wachtell, Lipton, Rosen & Katz

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1 Martin Lipton and Steven A. Rosenblum, Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come, 59 Bus.Law __ (2003). A similar explanation may be found in Martin Lipton and Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U.Chi.L.Rev. 187 (1991).