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Dear Ms. Morris:

We at The Race to the Bottom,¹ a faculty-student law blog addressing issues of corporate governance,² appreciate the opportunity to comment on the recent proposal by the Securities and Exchange Commission to limit shareholder access to the company proxy statement in connection with proposals related to the election and nomination of directors. In this letter, we limit our comments to Exchange Act Release No. 56161 (July 27, 2007), the so-called “short” or “non-access” proposal.

I. Overview

The proposal would amend Rule 14a-8 to allow companies to exclude proposals that relate “to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election”. The language, therefore, substantially broadens the existing exclusion by adding any proposal that relates to nominations and any proposal that involves procedures for nominations and elections. For the reasons stated below, we oppose this proposal.

First, the proposal would effectively result in the use of federal rulemaking to deny shareholders a right that exists under state law.

Second, the language is imprecise and will result in challenges to an increased number of proposals made by shareholders. This will include challenges to proposals in subject areas already considered resolved by the staff of the Commission. The language will, therefore, tax Commission resources and impose substantial additional burdens on shareholders.

Third, the language of the proposal will result in unintended consequences. The language can be easily circumvented. It will push shareholders to make proposals permissible under Rule 14a-8 that if adopted would be more intrusive than the access proposal at issue in this Release and would result in a higher number of election contests.

¹ www.theracetothbottom.org

² For a short history of the blog, go here: <http://www.theracetothbottom.org/teaching-materials/so-you-say-you-want-a-revolution-the-development-of-theracet.html>

Fourth, the affirmative reasons given by the Commission are not adequate to support the proposal. The reasoning at best would support amendments to the proxy rules to ensure adequate disclosure whenever shareholders included a nominee in the company's proxy statement. Moreover, given that some companies will voluntarily include these provisions (two have already done so) or some shareholders will pay the costs to have these provisions adopted, the adoption of this proposal will leave the problem of inadequate disclosure unaddressed.

II. State Law

The proposed language would deny shareholders access to the proxy statement for proposals that they are authorized to make under state law. State law gives shareholders broad authority to propose bylaws. The bylaws may include any subject related to the "rights or powers" of shareholders, see Del. C. § 109(b), including bylaws that would affect the size and composition of the board, see *Richman v. De Val Aerodynamics, Inc.*, 183 A.2d 569 (Del. Ch. 1962)(upholding bylaw that would allow shareholders to determine size of board and permit shareholders to fill vacancies), the qualifications of directors, see 8 Del. C. § 141(b)("The certificate of incorporation or bylaws may prescribe other qualifications for directors."), or the process used by the board. See *Hollinger Int'l v. Black*, 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005)("there is a general consensus that bylaws that regulate the process by which the board acts are statutorily authorized.")³ This broad authority encompasses the process for electing directors, including bylaws that would require the company to insert shareholder nominees into the company's proxy statement.

By imposing substantial regulatory burdens and costs on these types of bylaws, the Commission's approach will effectively deny shareholders their state law right to make the proposals.

Under state law, shareholders generally have the right to propose bylaws at the meeting (although advance notice bylaws may limit this authority). The proxy rules, however, have mostly transformed this into an empty right. Shareholders do not generally vote at the meeting but through the proxy process. See Exchange Act Release No. 56160 (July 27, 2007)(most shareholders "vote through the grant of a proxy before the meeting"). Moreover, Rule 14a-4(c) allows those soliciting proxies to obtain discretionary authority to vote on matters that unexpectedly arise at the meeting. 17 CFR 240.14a-4(c). Matters raised at the meeting and not supported by management will, therefore, invariably lose.

For shareholders to have any hope of success on a proposal, they must participate in the proxy process. But participation can be an expensive. Shareholders will need to incur the costs of drafting and distributing proxy materials. These costs and burdens in most instances make a solicitation practically impossible.

³ In some states, the matter is a non-issue. They permit bylaw proposals even if they would affect the management of the company. See A.C.A. § 4-26-809(a)(3)(2007)("The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation.").

The Commission has mitigated this effect through the adoption of Rule 14a-8. 17 CFR 240.14a-8. Thus, 14a-8 is not an example of bureaucratic benevolence but a necessary component of a regulatory scheme that otherwise would deny shareholders their state-law rights. In fact, the Commission has noted that the proxy process operates as a substitute for the shareholder meeting. *See* Exchange Act Release No. 56160 (July 27, 2007)(proxy process designed "so that it functions, as nearly as possible, as a replacement for an actual, in-person gathering of security holders").

The non-access proposal is inconsistent with this approach. Denying shareholders access to the company's proxy statement would render the proposals all but impossible to make. It would amount to federal preemption of a state law right and would not result in the proxy process functioning as a replacement for the meeting.

III. Imprecise and Broad Language

The proposal uses imprecise language that will invite excessive uncertainty and be susceptible to varying interpretations. Moreover, the breadth of the language will result in challenges to proposals in areas previously deemed resolved by the staff.

The Second Circuit has described the language in Rule 14a-8 ("proposal relates to an election for membership on the company's board of directors") as "not particularly helpful." *AFSCME v. AIG*, 462 F.3d 121, 125 (2nd Cir. 2006). In other words, the language is imprecise and not susceptible to clear interpretation.

The non-access proposal retains this unhelpful language and seeks to make changes that further deprive the provision of clarity. In addition to retaining the phrase "relates" to an election of directors, the Commission has proposed to extend the language to any proposal that "relates" to a nomination or "relates" to "procedures" for such nomination or election. On its face, therefore, the language would allow for the exclusion of proposals that would impose minimum qualifications for nominees or proposals that seek the adoption of election procedures such as majority or cumulative voting, areas where the Commission has permitted proposals in the past.

The Commission has acknowledged the problem posed by the imprecise language but has simply promised that the staff will "not adopt an inappropriately broad reading" of the language in order to exclude "all proposals regarding the qualifications of directors, the composition of the board, shareholder voting procedures, and board nomination procedures." This commitment does little to mitigate the unnecessarily broad language. First, a promise to avoid an "inappropriately broad reading" is no real limitation. It contains no objective content, is susceptible to multiple interpretations, and will likely have shifting meanings over time, something that can occur as illustrated by the facts in *AFSCME*.

Take for example advance notice bylaws.⁴ These bylaws require shareholders to notify management of any nominee for the board some time prior to the meeting. A lingering issue

⁴ We have discussed these on The Race to the Bottom here: <http://www.theracetothetbottom.org/preemption-of-delaware-law/advance-notice-bylaws.html>

with these bylaws is the amount of advance notice that must be given. Excessively long periods can effectively disenfranchise shareholders.

Shareholders may want to make proposals that would, for example, shorten the time periods contained in the advance notice bylaw.⁵ Under the existing version of Rule 14a-8(i)(8), the proposal would almost certainly not be subject to exclusion because it would not relate to the election of directors. Under the Commission's proposed language, however, the proposal would almost certainly fall within the exclusion since it relates both to nominations and to procedures for nominations. Only the vague promise to avoid an "inappropriately broad reading" of the language would potentially save the proposal from exclusion.

Second, the Commission merely promised not to exclude "all proposals" relating to director qualifications, board composition and voting/nominating procedures. In other words, this was tantamount to an acknowledgement that some will be excluded. The result will likely be increased challenges to shareholder proposals that relate to these areas.

Third, the language is broad enough to allow for the exclusion of proposals that the staff has previously found cannot be excluded. Thus, the short release discloses in footnote 41 that the Commission staff had previously found that "voting procedures," including proposals on cumulative and majority voting, were not subject to exclusion. The Release, however, studiously avoided reaffirming these positions (the footnote is merely descriptive) and did not explain how they could survive the proposed changes to Rule 14a-8(i)(8), particularly the addition of language that would allow for the exclusion of proposals that relate to procedures for the election of directors.

The imprecise nature of the language (and the likelihood that it will impact future shareholder efforts in areas other than those at issue in *AFSCME*) is particularly noticeable when compared with the language used by the Commission in the long proposal. There, the Commission proposed to give shareholders access. Rather than put in broad, vague language potentially allowing shareholders to argue that other types of proposals ought to be included, the Commission used very narrow, very precise language designed to make sure that the exclusion applied only to one type of proposal.⁶ Yet in the non-access context, the Commission used broad and vague language that would provide additional opportunities to argue for the exclusion of proposals that go well beyond access for shareholder nominees.

If this language is adopted, the Commission staff will find itself having to make fine distinctions on proposals that relate to critical areas of shareholder governance, including nominations and election procedures, limited only by vague admonitions against inappropriately broad readings. The language will result in uncertainty, something that will add cost to the shareholder proposal process, a cost that will be felt most severely by shareholders. Moreover, each type of proposal excluded under this provision will amount to an effective denial of a shareholder's state law rights. Finally, the changes will reopen areas already deemed resolved by the staff of the

⁵ See *Vicinity Corporation* (Nov. 3, 2002)(proposals among other things seeking to shorten advance notice from 120 days to 60 days).

⁶ The proposal would allow shareholders to include proposals "to establish a procedure by which shareholder nominees for election of director would be included in the company's proxy materials . . ." Exchange Act Release No. 56610 (July 27, 2007).

Commission, with shareholders forced to incur the expenses associated in defending these positions.

IV. Unintended Consequences

Adoption of this proposal will not abate pressure by shareholders to find cost effective mechanisms for improving the process of electing directors and using Rule 14a-8 to submit them to shareholders. As a result, this proposal will likely generate unintended consequences. It will push shareholders in other directions, away from access for nominees, to far more intrusive methods to accomplish the same goal. Moreover, these alternatives will likely result in a higher number of contests than the access proposal at issue in *AFSCME*.

Thus, for example, the staff of the Commission has taken the position that proposals may not be excluded if they relate to the “reimbursement of shareholder expenses in contested elections.” Exchange Act Release No. 56161 n. 41 (July 27, 2007). As a result, shareholders prohibited from having access under this proposal may simply use Rule 14a-8 to obtain passage of a bylaw that would require reimbursement of their own proxy costs. This far more intrusive proposal would likely result in far more contests than the current access proposal.

This is not an academic hypothetical. In *Citigroup Inc.* (March 2, 2006), AFSCME submitted a proposal that “urge[d]” the board to amend the bylaws to “provide procedures for the reimbursement of the reasonable expenses . . . in a contested election of directors”. Reimbursement only applied to a “short slate” (less than a majority of contested directors) and the amount reimbursed depended upon the number of votes received by the shareholder nominees.

Citicorp sought to omit the proposal, arguing that it “would directly encourage parties to engage in proxy contests.” As the financial institution logically argued:

“The Proposal is nothing more than an attempt by the Proponent to elude the Staff’s consistent position that it will not recommend enforcement action if companies exclude stockholder proposals seeking adoption of a bylaw requiring the inclusion of stockholder nominees in a company’s proxy statement. . . The mandatory reimbursement scheme described in the Proposal would similarly establish a repayment procedure for proxy solicitation expenses that may result in contested elections. Indeed, the Proponent endorses the Proposal precisely because, as suggested in the Supporting Statement to the Proposal, contested elections will create a ‘meaningful threat of director replacement.’ It makes absolutely no difference that the Company funds used to finance proxy contests would be presented in the form of direct reimbursements rather than only providing access to the Company proxy materials.”

Moreover, Citicorp took the position that it would be more likely to cause proxy contests than shareholder access proposals.

“Permitting use of company funds for the full panoply of ‘legal, advertising, solicitation, printing and mailing costs’ of a solicitation is far more likely to lead to a contested

election than the so-called stockholder access proposals, which employ company funds only insofar as a stockholder nominee would appear in a company's proxy statement. If adopted, the Proposal could drastically increase the frequency of contested elections by offering multiple insurgents the possibility of simultaneous company subsidies for their efforts, and guaranteeing reimbursement if a stockholder successfully elects a director to the Board or comes close."

Despite the arguments, the Commission, however, declined to allow Citicorp to omit the proposal. *See also American Express* (Feb. 28, 2006).

Nor is the approach in *Citicorp* the only possible avenue. In other instances, shareholders have sought approval of a plan that would require management to nominate more than one candidate for each position on the board. The Commission has allowed these proposals to go forward. *See Micron Technology, Inc.* (Sept. 10, 2001)(seeking to have the board nominate at least two candidates for each board position). *See also Peregrine Pharmaceuticals Inc.* (August 15, 2007).

If shareholders are denied access, as the Commission proposes in this release, the law of unintended consequences will come into play. Shareholders will seek other avenues for improving the director election process. Some of these will be far more intrusive than the type at issue in this release and result in more contests.

V. Analysis of Stated Reasons for the Position

The only real basis given for denying shareholder access in the proposal is that it will "prevent the circumvention of other proxy rules that are carefully crafted to ensure that investors receive adequate disclosure and an opportunity to make informed voting decisions in election contests." Exchange Act Release No. 56161 (July 27, 2007).

This reasoning fails for two reasons. First, the justification could easily be fixed by amending the other rules to take away any issue of inadequate disclosure. This would be a far more appropriate approach than denying shareholders their rights under state law. The long proposal shows that this can be done.⁷

Second, the approach leaves in place a structural flaw in the proxy rules. Even if the short proposal is adopted, shareholders may still gain access to the company's proxy statement for their own nominations. The board may adopt such a bylaw voluntarily (as was the case with *Comverse and Apria Healthcare*)⁸ or one may be adopted as a result of a solicitation conducted outside of Rule 14a-8. In these circumstances, the problem of inadequate disclosure identified by the Commission will remain in place. Thus, the Commission's solution in this case does nothing to fix the problem of inadequate disclosure, something that is likely to surface with increased frequency.

⁷ See proposed Rule 14a-17, Exchange Act Release No. 56161 (July 27, 2007).

⁸ For a post on this subject, see <http://www.theracetothetbottom.org/home/shareholder-non-access-corporate-governance-and-the-sec-the--1.html> Apria Healthcare has had its provision in place since 2003 and has never been used.

VI. Conclusion

The non-access proposal will not accomplish its stated purpose. It will deny shareholders existing rights, create enormous uncertainty, tax Commission resources, and force the Agency to make fine distinctions about shareholder proposals.⁹ Moreover, shareholders will find ways to circumvent the restriction and do so in ways that are even more likely to result in election contests. Finally, it sets an uncertain precedent, putting the Commission in the center of the corporate governance debate but on the side of denying shareholders rights that exist under state law.

As noted in the essay, “Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure”¹⁰, the Commission has become increasingly involved in the corporate governance process. A hallmark of the involvement should, at a minimum, be to do no harm, that is to avoid using federal regulation to reduce existing governance rights. That is exactly what this proposal would do.

Yours truly,

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⁹ As the long release noted, the staff last year handled 360 no action requests. *See* Exchange Act Release No. 56160 n. 24 (July 27, 2007). The number will likely increase if this proposal is adopted.

¹⁰ The paper is available at <http://ssrn.com/abstract=982444>.