June 30, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
By email

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

Dear Mr. Katz:

I am writing regarding security holder director nominations.

My concern is with the best way of achieving the end of greater shareholder access.[1] Proposed Rule 14a-11 arose in the context of shareholder proposals that suggested or required various procedures for shareholder access. Proponents of those proposals asked the Commission's staff to reconsider its traditional interpretation of Rule 14a-8(i)(8), which provides that companies may exclude proposals that relate to board elections (the "Election Exclusion"). That traditional interpretation of the Election Exclusion allows companies to exclude shareholder-proxy-access proposals on the theory that they may lead to contested elections. Rather than re-interpret the Election Exclusion, the Commission instigated an investigation into how to handle the shareholder access question. The resulting Staff Report[2] listed reinterpreting the Election Exclusion as one possible response, but focused mainly on other possible responses. The Commission seems to have followed those other responses in proposing Rule 14a-11.

My concern is that reinterpreting the Election Exclusion may have gotten lost in the shuffle. In this letter I argue that the best path to achieving shareholder access lies in reinterpreting the Election Exclusion, either along with adopting Rule 14a-11 or, even better, instead of adopting that rule.

Reinterpreting the Election Exclusion has two main advantages over Rule 14a-11, tailoring and learning. The Staff Report recognizes the tailoring advantage. Public companies differ significantly, and different access rules might be better for different companies. Rule 14a-11 imposes a single regime on all companies that trigger the rule. Allowing shareholder-proxy-access proposals would allow shareholders to tailor procedures to the characteristics of each particular company.

---

[1] In this letter I presume that shareholder access to the company's proxy and proxy statement is a good idea. *See, e.g.*, the comment letter of Lucian Arye Bebchuk dated Dec. 22, 2003, or Bebchuk's article "The Case for Shareholder Access to the Ballot," attached to that letter.

[2] Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, July 15, 2003.

The second main advantage of reinterpreting the Election Exclusion is the potential for learning. As the debate over proposed Rule 14a-11 has made clear, there are many shades of opinion as to what an optimal shareholder access rule looks like. In my opinion the proposed rule is a pretty good guess, although it may make it rather too hard for shareholders to gain access-—the five percent shareholder rule, in particular, may be too high a threshold. One must answer many hard empirical questions in designing a rule. If, rather than promulgating Rule 14a-11, the Commission were to reinterpret the Election Exclusion, we would probably observe passage of a variety of different proposals at different corporations, and we would over time be able to observe how well or poorly the different proposals worked in practice.

In short, through tailoring and learning, reinterpreting the Election Exclusion would allow us to gain from the wisdom of a variety of shareholders acting in a variety of circumstances. Given these key advantages, are there any problems with reinterpreting the Election Exclusion that argue in favor of the proposed Rule 14a-11 either along with or instead of the Exclusion reinterpretation? The Staff Report raises several concerns that I would like to address.

The staff seems concerned about the potential for "an array of confusing company-specific rules."[3] Several considerations suggest this concern is not too worrying. First, the shareholder activists most likely to introduce successful proposals are typically sophisticated and well-informed, generally institutional investors with good legal counsel. Second, in many cases the shareholders seeking to use a nomination procedure will be those who introduced that procedure in the first place. Third, there are a fairly limited number of active shareholders likely to introduce successful proposals, and those shareholders will presumably introduce similar proposals, perhaps with a few variations, at many different companies. Finally, transactional lawyers almost never start writing with a blank page. Even lawyers who have not previously drafted a proposal will use the proposals of others as a model. The likely outcome is thus that there will be some real variety—variety, after all, is essential to the gains from tailoring and learning—but that variety is unlikely to be so great as to lead to a disabling degree of confusion. At most, this concern might weakly argue in favor of adopting Rule 14a-11 along with a reinterpretation of the Election Exclusion—insofar as a relatively large percentage of companies follow Rule 14a-11 rather than an individualized procedure, there will be a less confusing array of rules.

A second concern is whether boards would be able to ignore shareholder-proxy-access proposals under the reinterpreted Election Exclusion. Insofar as those proposals are merely precatory, boards would be free to ignore them, and in many cases would probably do so. However, shareholders could make proposals in the form of mandatory bylaws. It is an open question of state law as to whether such bylaws would be valid, but in my judgment they are likely to be upheld. I think that the distinctions suggested by John Coffee are likely to be at least close to the guidelines that courts will follow in reviewing shareholder bylaws,[4] and shareholder-proxy-access bylaws rather clearly fall on the allowable side of those distinctions. Shareholder

[3] Staff Report, p. 26.

[4] *See* John C. Coffee, Jr., "The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?," 51 U. Miami L. Rev. 605 (1997).

access bylaws are closely tied to matters that are clearly the subject of valid bylaws, such as setting quorums, times, and locations for shareholder meetings and specifying who can call special meetings.

Moreover, there are some recent indications from judges in Delaware that the courts there will be receptive to shareholder-proxy-access bylaws. In *Harrah's Entertainment, Inc. v. JCC Holding Co.*, Vice Chancellor Leo Strine wrote that:

> Because of the obvious importance of the nomination right in our system of corporate governance, Delaware courts have been reluctant to approve measures that impede the ability of stockholders to nominate candidates. Put simply, Delaware law recognizes that the "right of shareholders to participate in the voting process includes the right to nominate an opposing slate." And, "the unadorned right to cast a ballot in a contest for office. . . is meaningless without the right to participate in selecting the contestants. As the nominating process circumscribes the range of choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise."[5]

Also, in a recent meeting with institutional investors, Vice Chancellor Stephen Lamb told the investors that Delaware law is "very flexible", and that "stockholders should look at what the SEC is proposing and think creatively about what [they] think our law would permit [them] to do in terms of restructuring charters and bylaws of companies [they] invest in to permit greater access if [they] want it and [they're] willing to go a couple steps to try to get it."[6]

The current unsettled state of Delaware law actually points to another advantage of reinterpreting the Election Exclusion. The staff's current approach to this and related topics, such as the excludability of poison pill bylaws, tends to stunt the evolution of state law. Where there is serious uncertainty as to the permissibility of a proposal under state law, the staff generally appears inclined to allow the board to exclude that proposal. However, this approach effectively means that such proposals usually will not get passed, as mounting a separate proxy campaign is prohibitively expensive for most shareholders. If the proposals are not passed, they cannot be tested in state court. A better approach would be to give shareholders the benefit of the doubt in such cases. If a majority votes in favor of a proposal that raises a serious state law question, the board can then challenge the result in court, and the state courts will be able to decide those legal questions.

The Delaware courts in particular have great expertise and wisdom when it comes to corporate law. Thus, a further advantage of reinterpreting the Election Exclusion would be that it would draw state courts, especially Delaware, into the debate, along with a variety of shareholders, as I have already emphasized through the discussion of learning.

---

[5] 802 A.2d 294, 310-11 (Del. Ch. 2002).

[6] Alison Carpenter, Delaware Chancery Jurists Tell Investors To Be Creative, Do More if They Want Power, 2 Corp. Accountability Rep. 351 (2004)

I would like to address one more concern that the Staff Report raises. The Report says that "it is unclear whether companies could avoid implementing this type of proposal by amending their governing instruments to require board approval of shareholder nominees."[7] Since corporations have two main governing instruments, bylaws and certificates, this is actually two separate questions.

As to bylaws, there is a tricky question as to whether the board could itself amend or rescind a shareholder-passed bylaw which specifies that the board could not change it. In the large number of states that follow the Model Business Corporation Act, the answer is a clear no.[8] In Delaware, though, this is an unsettled question. There is dictum in at least one case suggesting that a shareholder bylaw can effectively specify that the board may not amend it.[9] However, there is a pretty strong argument on the other side, maintaining that a shareholder bylaw may not immunize itself from board amendments. Should Delaware courts ever resolve this issue, either result would not surprise me.

Even if Delaware courts were to hold that boards may amend shareholder bylaws, the practical effect would probably be limited. First, shareholder bylaws can probably specify procedures that will slow down a board's attempt to amend the bylaws.[10] Second, overturning a shareholder bylaw would usually lead to very bad publicity for a board, and I would be surprised to see many boards do it. Ignoring a precatory proposal is one thing; reversing a binding bylaw that has been approved by a majority of shareholders with a new board bylaw is a quite different, more serious snub of shareholders.

Certificate provisions limiting shareholder access raise a different set of issues. Legally, I see no doubt that the certificate can overrule any bylaw and limit shareholder access to the company proxy. The question is how likely it is that companies would adopt such provisions. As to already-public corporations, to my knowledge few if any currently have such provisions in place in their certificates. They would thus need to amend their certificates. This would require shareholder approval, which in the current climate seems unlikely for widely-held corporations without a controlling shareholder. For companies whose shareholders do choose to adopt such a provision, that would appear to constitute shareholder recognition that access is not desirable for those companies.

The dynamics will be different for companies that go public in the future. Managers of such companies may be tempted to put anti-shareholder-access provisions in their certificates before going public. How likely this is depends on one's judgment both about the desirability of such provisions and about how efficiently market mechanisms at the time of IPOs work. This is a highly-debated topic. This potential problem provides one reason for adopting Rule 14a-11 along with reinterpreting the Election Exclusion.

Thus, learning and tailoring provide two strong arguments in favor of reinterpreting the Election Exclusion, while many of the main concerns about such a change do not provide

---

[7] Staff Report, p. 26.
[8] *See* MBCA § 10.20.
[9] *See American Int'l Rent A Car, Inc. v. Cross*, 1984 WL 8204 *149 (Del Ch. 1984)
[10] *See* Coffee, *supra* note 4, at 617-18.

adequate reasons for maintaining the current approach to the Exclusion. I therefore strongly urge that the Commission reinterpret (or in the alternative, re-write) the Election Exclusion so that it does not allow corporations to exclude shareholder proposals that provide procedures for shareholder access to the company proxy.

The final issue I wish to address is whether it would be best to adopt Rule 14a-11 along with reinterpreting the Election Exclusion, or whether the reinterpretation alone is best. Above I have provided several reasons that favor introducing both changes—doing so may reduce possible confusion, and it would allow for shareholder access even if board-passed bylaws or certificate provisions were to block shareholder bylaws. However, these reasons are not particularly strong, and rather speculative. It might well make sense to reinterpret the Election Exclusion first, see how that goes, and hold off on adopting Rule 14a-11 until some of these speculative problems actually start to appear in fairly serious form.

There is a more positive reason favoring going forward with only the Election Exclusion reinterpretation at this point. The gains from tailoring and learning might well be threatened by adopting Rule 14a-11 at the same time. Given the well-publicized, easily available status of the Rule, shareholders might too often choose to follow it rather than experimenting with their own proposals. While individually rational, this could be socially sub-optimal. Each time a company experiments with a new proposal, it provides a social benefit in the form of learning, but shareholders may ignore that social benefit and hence engage in too little experimentation. As to tailoring, it may be that shareholders would be best off in a world where there are several widely-used and well-known proxy access procedures, but if just one system, such as Rule 14a-11, becomes dominant too quickly, too many shareholders might choose just to follow that rule because no competitors are nearly as well-known and explored.

Thus, I believe that the best approach would be to reinterpret the Election Exclusion and hold off on adoption of Rule 14a-11 for now, keeping the rule available for the future should some of the potential problems with shareholder bylaw proposals become actual and serious. But at any rate, even should the Commission choose to go forward with Rule 14a-11 at this point, I strongly urge it to consider also reinterpreting the Election Exclusion.

I hope that these comments are helpful.

Sincerely,

Brett McDonnell
Associate Professor
University of Minnesota Law School