November 14, 2003

Election Contests in the Company's Own Proxy Statement

Attached is our comment letter recommending, indeed urging, the SEC not to adopt the rule they proposed last month that would permit shareholders to use a company's proxy statement to run a director election contest.

Allowing shareholders to run an election contest through the company's proxy statement would be a serious mistake. Increasing the ease and frequency of election contests would have a negative impact on public companies and their boards, with no clear benefit. A number of issues are immediately apparent: the risk of an influx of special interest directors, the disruption and diversion of resources that would accompany annual election contests, the risk of balkanized and dysfunctional boards, the risk of deterring the most skilled men and women from serving on public company boards, the risk of deterring companies from taking business risks. In addition, there is serious doubt as to whether activist shareholders, public pension funds, labor unions and hedge and vulture funds — the parties most likely to want to include director nominees in a company's proxy statement — are well-suited to the role of nominating directors. Each has duties to its own constituencies, each has its own agenda, some have self-serving motives, but none has legal duties or obligations to the public company or other shareholders. Particularly in the context of the sweeping corporate governance reforms that have been adopted in the last year, and as we wait to assess the ultimate impact of these reforms, there is simply no compelling case for a new set of regulations designed to facilitate election contests.

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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

[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).

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.

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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.

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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