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Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation

In Support of Comments by Business Roundtable

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CONTENTS

I. Introduction 1

II. Available measures effectively and affordably discipline weak management and boards 2
- A. The market provides multiple means of management discipline 2
- B. Managers associated with wrongdoing are ousted 3
- C. Contested director elections are often effective, but their low frequency suggests that they are rarely needed 4
- D. Contesting elections is not expensive and dissidents' costs can be mitigated without changing the election rules 5
  - 1. The SEC proposal would reduce the cost of contesting elections by only 5% 5
  - 2. Investors can further mitigate costs of proxy contests by collaborating 6
  - 3. Costs could also be reduced by increased reliance on electronic distribution of proxy materials 7

III. Efficiency Costs 7
- A. The Proposal would inefficiently allocate benefits and costs of proxy contests 7
  - 1. Reducing costs to minimal levels will lead to excessive nominations 8
  - 2. Requiring negotiation first is another superior alternative 8
- B. Shareholder nominees will impair quality of boards 9
  - 1. Companies with dissident board members substantially underperform compared to their peers. 9
  - 2. Board skill composition will be adversely affected 10
  - 3. Shareholders will nominate candidates to advance agendas at odds with shareholder value 11
    - a. Hedge Funds 12
    - b. Union and public employee benefit plans 12
  - 4. The Proposal's first-come, first-served rule will fail to select the best-qualified shareholder nominee 13
  - 5. Higher share ownership thresholds for nomination would mitigate incentive problems and negative effects on board quality 15
- C. The Proposal does not distinguish between the issues associated with expressing disapproval of an incumbent director and the issues associated with identifying, nominating, legitimating, and electing an outside insurgent director 15
- D. Companies will incur additional efficiency costs to evaluate shareholder-nominated candidates 17

IV. The Proposal will render U.S. equity markets less competitive with foreign markets 18
- A. U.S. equity market competitiveness has already been impaired by high regulatory costs. 18
- B. Private placement and private equity financing have grown at the expense of the public equity market 20

V. The Proposal will undermine competitiveness and capital formation at the company level 21

VI. The benefits predicted by the SEC will be at best small, and possibly prove to be costly rather than beneficial 22

VII. Conclusion 23

I. Introduction

In this Report, we address the substantial costs in terms of efficiency, competitiveness and capital formation that would result if the SEC's Proposed Election Contest Rules ("Proposal") were adopted. The SEC's Proposal would, at best, amount to modest savings for shareholders at a handful of companies, while imposing substantial costs on all public companies. If implemented, the Proposal would impose substantial efficiency costs on public companies, impair their competitiveness, and further undermine the attractiveness of U.S. equity markets.

Although Section 3(f) of the Securities Exchange Act of 1934 requires that the SEC consider the effect of certain proposed rules on efficiency, competition and capital formation and Section 23(a) of the statute prohibits any rulemaking that would unnecessarily or inappropriately burden competition, we find that the SEC has not considered or adequately recognized a number of costs associated with its proposal.[1] Key risks of the Proposal include the following:

§ Ensuing shareholder nominations will lead to less qualified boards of directors that do not achieve the experience and skill mix required to meet the challenges facing companies today.

§ Board members will be selected whose interests diverge from the goal of maximization of shareholder value.

§ The Proposal would impose an additional disincentive for U.S. companies to go public, further undermining the competitiveness of U.S. capital markets.

§ Deterring companies from public listing in the U.S. also increases the cost of capital for U.S. companies, thereby impeding capital formation and undermining those companies' competitiveness.

The Proposed Election Contest Rules would not only fail to achieve the predicted benefits, but would also impose a costly solution where there is little, if any, extant problem, at the risk of undermining shareholder wealth maximization. This report will discuss the available empirical and social science evidence on this topic. Our analysis of this evidence leads us to conclude that the proposed rules risk undermining, rather than improving, board quality and composition and are likely to undermine the ability of boards of directors to serve the interests of shareholders. Available measures and easily attainable alternatives effectively and affordably address the goal of disciplining weak management and revitalizing ineffective boards of directors. In sum, the Proposed Election Contest Rules fail to meet the standard that a new regulation should be introduced only if its benefits exceed its costs, and at minimum cost.[2]

[1] 15 U.S.C. Section 78c(f); 15 U.S.C. Section 78w(a)(2).

[2] This standard has been advocated in the recent reports of the Committee on Capital Markets, "The Global Financial Crisis: A Plan for Regulatory Reform" (p. ES-4) and Congressional Oversight Panel, "Special Report on Regulatory Reform," January 2009 (p. 3).

II. Available measures effectively and affordably discipline weak management and boards

Shareholders already possess means to address problems with management and boards of directors. In its obligation to determine whether the Proposal would unnecessarily burden competition, the Commission must make a convincing case that these measures are not adequate. In fact, however, shareholders' tools for addressing dissatisfaction with management and boards have proved powerful, and empirical evidence demonstrates that they are effective in disciplining managers.

A. The market provides multiple means of management discipline

There is a broad consensus that a robust market is the most effective mechanism for monitoring and disciplining corporate management and for providing incentives to officers and directors of public companies to maximize firm value.[3] Market participants reward or censure management by buying or selling shares, thereby increasing or reducing the share price and value of a company.

Investors can and do express dissatisfaction with boards by selling shares or taking short positions. The inherent nature of hedge funds is to take strategic positions. Other institutional investors keep, overall, the majority of their funds in actively managed strategies.[4] Such investors are likely to reduce their holdings in poorly performing companies through the actively managed portfolios that comprise the lion's share of stock holdings. Such decisions will be made for them by their active asset managers, who are generally evaluated on performance.

Empirical research bears out the theoretical insight that managers are replaced when a company's stock performance is poor. Numerous finance studies find that CEOs and other top managers of companies whose stock performance is weak measured relative to market returns are far more likely to be replaced than managers of companies with solid share performance.[5] Warner *et al.* (1988) find 50% higher turnover of top managers in the lowest decile of firms (ranked by stock returns), versus 8.6% in the highest decile of firms based on a random sample

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[3] Frank Easterbrook, "The Race for the Bottom in Corporate Governance" 95 *Virginia Law Review* 686 (2009); Jonathan Macey, *Corporate Governance, Promises Kept, Promises Broken*" (2008, Princeton University Press).

[4] In 2006, defined benefit, defined contribution and non-profits invested approximately two-thirds of their assets in actively-managed strategies (68.8, 64.3 and 71.3%, respectively), while public pension plans kept 47.3% in actively managed strategies. Kenneth R. French, "Presidential Address: The Cost of Active Investing," *Journal of Finance* (2008), vol. LXIII, no. 4, pp. 1537-1573.

[5] See, for example, Eugene P.H. Furtado and Vijay Karan, "Causes, Consequences, and Shareholder Wealth Effects of Management Turnover: A Review of the Empirical Evidence," *Financial Management*, Vol. 19, No. 2 (1990), pp. 60-75; Willard McIntosh, Ronald C. Rogers, C.F. Sirmans and Youguo Liang, "Stock Price and Management Changes: The Case of REITs," *Journal of American Real Estate and Urban Economics Association*, Vol. 22 (1994), pp. 515-526; Jerold B. Warner, Ross L. Watts and Karen H. Wruck, "Stock Prices and Top Management Changes," *Journal of Financial Economics* 20 (1988), pp. 461-492; George J. Benston, "The Self-Serving Management Hypothesis: Some Evidence," *Journal of Accounting and Economics* 7 (April 1985), pp. 67-84; Anne T. Coughlan and Ronald M. Schmidt, "Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation," *Journal of Accounting and Economics* 7 (April 1985), pp. 43-66.

of 269 firms listed on New York and American Stock Exchange from 1963 through 1978.[6] Similarly, Coughlan and Schmidt (1985) find top managers are 2.5 times more likely to turn over at firms in the lowest decile (ranked by stock returns) than in the highest decline, using a sample of 249 firms from 1978 through 1980.[7]

Takeovers also serve to change management.[8] Research by Davis and Stout (1992) finds that the probability that underperforming managers will be replaced is very high:

> Between 1980 and 1990, 144 members of the 1980 Fortune 500 (29 percent) were subject to at least one takeover or buyout attempt. While most of these attempts (77) were hostile—publicly resisted by management—the vast majority ultimately led to a change in control, including 59 of the hostile bids and 125 bids overall.[9]

In 10 years, mergers and takeovers resulted in management turnovers in roughly one-third of the largest industrial corporations in the U.S.[10]

B. Managers associated with wrongdoing are ousted

Advocates of more contested elections seem to overlook that the market is already disciplining managers. For example, Bebchuk (2007) has suggested that more contested elections would be desirable to rid companies of managers that have made accounting mistakes.[11] In fact, however, Karpoff, Lee and Martin (2008) find that 93% of all individuals associated with SEC and

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[6] Jerold B. Warner, Ross L. Watts and Karen H. Wruck, "Stock Prices and Top Management Changes," *Journal of Financial Economics* 20 (1988), pp. 461-492. Table 7.

[7] Anne T. Coughlan and Ronald M. Schmidt, "Executive Compensation, Management Turnover and Firm Performance: An Empirical Investigation," *Journal of Accounting and Economics* 7 (April 1985), pp. 43-66, Table 7.

[8] See, for example, Michael Jensen and Richard Ruback. "The Market for Corporate Control: The Scientific Evidence." *Journal of Financial Economics*, Vol. 1 pp. 5–50; Gregg A. Jarrell, James Brickley, and Jeffry Netter. "The Market for Corporate Control: The Empirical Evidence Since 1980." *Journal of Economic Perspectives* 2, no. 1 (Winter 1988): pp. 49–68; Roberta A. Romano, "Guide to Takeovers: Theory, Evidence, and Regulation." *Yale Journal on Regulation* 9 (1992): p. 119. ("the empirical evidence is most consistent with value-maximizing, efficiency-based explanations of takeovers"); Jonathan R. Macey. "Market for Corporate Control." *The Concise Encyclopedia of Economics*; David R. Henderson, ed. Liberty Fund, Inc. 2008. Library of Economics and Liberty [Online] available from http://www.econlib.org/library/Enc/MarketforCorporateControl.html; accessed 12 August 2009; Internet.

[9] Gerald F. Davis and Suzanne K. Stout, "Organization theory and the market for corporate control: a dynamic analysis of the characteristics of large takeover targets, 1980-1990," *Administrative Science Quarterly*, Vol. 37, 1992.

[10] *Id*.

[11] Lucian A. Bebchuk, "The Myth of the Shareholder Franchise," *Virginia Law Review* vol. 93, pp. 675 et seq. (2007).

Department of Justice enforcement actions relating to financial misrepresentation from 1978-2006 lost their jobs by the end of the enforcement period; 62% were fired.[12]

Boards also have the ability to discipline management, and board independence has steadily increased in recent years. Among companies in the S&P 1500, the overall proportion of independent directors increased from 69% in 2003 to 78% in 2008. In 2008, 85% of S&P 1500 companies had boards that were at least two thirds independent.[13] Section I.A.3. of Business Roundtable's Comment details numerous other improvements in corporate governance in recent years.

C. Contested director elections are often effective, but their low frequency suggests that they are rarely needed

The low frequency of proxy contests and activist campaigns, along with the frequent success of company/board slates against dissidents, suggest that shareholder dissatisfaction with outside directors is rare and that finding superior substitutes for incumbents is more difficult than generally is assumed. In 2008, there were a record 50 contested elections of outside directors.[14] However, this constitutes only 0.88% of all U.S. public companies.[15] Moreover, company/board director candidates won in 49.6% of contested elections during 2003-08, indicating that shareholders' actual dissatisfaction with management candidates—and preference for the available alternatives—is appreciably lower than the rate of proxy contests.[16]

Nonetheless, contesting director elections has proved to be an actively used and viable approach for shareholders to gain representation. Shareholders have contested an increasing number of director elections and gained either seats or concessions in an increasing percentage of those elections. As shown in Figure 1, the number of proxy contests over director seats has risen dramatically since 2005. Over 2003-08, of contests carried to completion or settlement, shareholders have won seats in 29.0% of contests and obtained settlements, presumably with concessions, in an additional 21.4% of contests.[17] In addition, many proxy contests—and many potential contests—are resolved without a vote through negotiations between dissatisfied shareholders and incumbent management.

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[12] Jonathan M. Karpoff, Scott D. Lee, and Gerard Martin, "The consequences to managers for financial misrepresentation," *Journal of Financial Economics*, vol. 88 (2008), pp, 193-215.

[13] RiskMetrics Group, "Board Practices: Trends in Board Structure at S&P 1,500 Companies," December 17, 2008, p. 2.

[14] Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46.

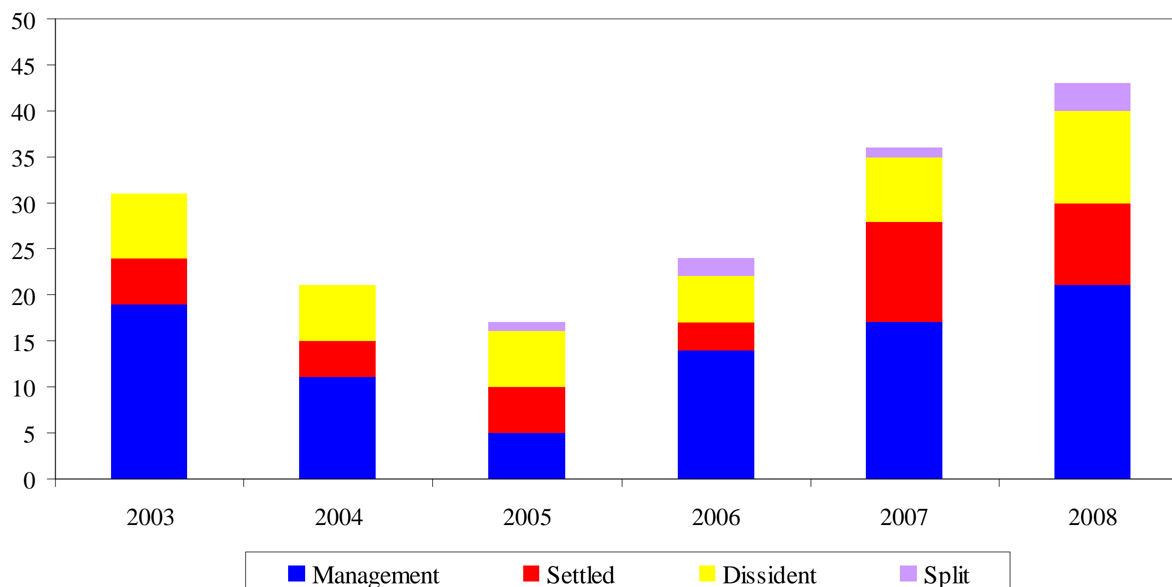
[15] FactSet Research Systems, Inc. reports a total of 5,707 U.S. companies traded on major U.S. exchanges in March 2009.

[16] Calculation using data from Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46. Includes only contests that carried to election or settlement; excludes contests categorized as Pending, None, Withdraw, No Result or Postponed.

[17] Calculation using data from Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46. Includes only contests that carried to election or settlement; excludes contests categorized as Pending, None, Withdraw, No Result or Postponed.

Figure 1

Outcome of Contested Proxy Solicitations
2003 - 2008



Source:
Georgeson Shareholder

D. Contesting elections is not expensive and dissidents' costs can be mitigated without changing the election rules

Although the primary goal of the Proposed Election Contest Rules seems to be to reduce the shareholder cost of putting forth outside director candidates, currently, proxy contests are relatively inexpensive to shareholders. Automatic Data Processing reported that, based on proxy statements filed by outsiders engaged in proxy solicitations during 2003–2005, the average cost of a contest was $368,000; based on their data, the median cost was $150,000 and 25% of contests cost $70,000 or less.[18]

1. The SEC proposal would reduce the cost of contesting elections by only 5%

Furthermore, the Commission itself estimates that savings due to being able to put a nominee on the company's ballot would only be the average $18,000 cost due to printing and postage, or 5% of the average cost.[19] This amount is truly trivial in relation to the value of the minimum stakes required to nominate a director candidate. On average, among firms with market capitalization

[18] See Letter from Richard Daly, Co-President, Brokerage Servs. Group, Automatic Data Processing, to Nancy M. Morris, Secretary, SEC (Apr. 20, 2006), available at http://www.sec.gov/rules/proposed/s71005/ccallan1565.pdf. The cost of proxy contests in ADP's sample ranges from $950 to $5,900,000. The lowest-cost contest appears to be a significant outlier, as the next most inexpensive contest is reported to cost $10,000.

[19] SEC Release No. 33-9046, pp. 183-184.

greater than $700 million, it is equivalent to 0.13% of the value of a 1% holding. Put another way, the holder of a 1% stake in this category of firms, on average, gains or loses $18,000 as a result of a $0.02 change in the stock's price; it gains or loses $368,000 as a result of a $0.41 change in share price.[20]

Although the SEC states that nominating shareholders may achieve additional savings by spending less, or nothing at all, on public relations, advertising or proxy solicitors, current rules do not force shareholders to incur these expenditures. The low cost of many contests indicates that many activist shareholders already expend little beyond printing and postage costs.[21]

2. Investors can further mitigate costs of proxy contests by collaborating

Proxy contest costs can be mitigated if shared by multiple institutional investors who jointly back the proxy contest, as has occurred in a number of past instances. According to the IRCC Institute, between 2005 and 2008, there were 23 proxy contests that resulted in hybrid boards in which multiple hedge funds were identified as dissidents in SEC filings.[22] This represents 17% of the 133 proxy contests in the same period.[23] Prominent examples of collaboration include the following:

A. A group including Carl Icahn and JANA Partners LLC threatened to launch a proxy fight to name directors to the board of Kerr-McGee Corp. The contest never took place, and the dissident group agreed to cease proxy solicitation activities after Kerr-McGee initiated a $4 billion stock buyback.[24]

B. Hedge funds the Children's Investment Fund (TCI) and 3G Capital Partners engaged CSX Corporation in a proxy contest in 2008, and successfully elected four dissident directors to the board, including Christopher Hohn, the managing partner of TCI.[25]

C. Three hedge funds and a mutual fund, organized by ZelnickMedia Corporation, effected a change in control of the board of directors of Take Two Interactive Software, Inc. at an annual meeting.[26]

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[20] Based on an analysis of all U.S. domiciled companies with market capitalization greater than $700 million traded publicly on major U.S. exchanges. Data are from FactSet Research Systems, Inc.

[21] SEC Release No. 33-9046, p. 185.

[22] IRRC Institute, "Effectiveness of Hybrid Boards," May 2009, p. 17, available at www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf.

[23] Georgeson Shareholder, "2008 Annual Corporate Governance Review," p. 46. The 133 proxy contests reported between 2005 and 2008 do not include contests that were not directly related to the election of directors.

[24] Stephen Taub, "Big Buyback Ends Kerr-McGee Proxy Fight," *CFO*, April 15, 2005.

[25] Chad Bray, "CSX to seat fund board members," *The Wall Street Journal*, September 17, 2008.

[26] Adam J. Kansler and Leila Zahedani, "Winning Without a Fight: Steps for Activist Shareholders to Change Management," *The Metropolitan Corporate Counsel*, June 2007, available at http://www.metrocorpcounsel.com/current.php?artType=view&artMonth=July&artYear=2009&EntryNo=6781.

3. Costs could also be reduced by increased reliance on electronic distribution of proxy materials

An alternative to the current proposal would be to reduce further the printing and postage costs of proxy contests through increased reliance on the Internet to distribute proxy materials. Under an SEC Rule effective January 1, 2008, issuers—as well as shareholders seeking to solicit proxies from other shareholders—may select the so-called "notice only" option for the delivery of proxy materials, in which proxy materials are posted on the internet, accompanied by a notice of the posting mailed to shareholders. Issuers must respond to shareholders' requests for paper copies of all materials, including permanent requests.

The Internet has already been used extensively and successfully by issuers as a complement to mail notices and vote solicitations: proxy materials that may be posted online include notices of shareholder meetings, proxy statements, consent solicitations, proxy cards, information statements, annual reports to security holders, additional soliciting materials and amendments to any of the foregoing. If any proxy materials are to be furnished online, then all soliciting materials must be furnished on the same website no later than the day such materials are first sent to shareholders or made available to the public.[27] The SEC estimated that issuers and others spent $962.4 million in printing and mailing fees to distribute proxy materials during the 2006 proxy season.[28] The SEC's Notice and Access model has been used in 1,965 distributions between July 2007 and May 2009 resulting in estimated savings of $377 million on printing and postage. Savings in the eleven month period from July 1, 2008 to May 31, 2009 alone were $234 million, equivalent to annual savings of $255 million.[29]

As to access, Internet penetration rates are currently high. As of April 2009, the Pew Internet and American Life Project reported that 79% of American adults use the internet and at least 94% of adults with household income greater than $50,000 use the Internet.[30] In addition, 63% of American adults have broadband access at home, and at least 80% of adults with household income greater than $50,000 have broadband access at home.[31]

III. Efficiency Costs

A. The Proposal would inefficiently allocate benefits and costs of proxy contests

The Proposal assumes that Rule 14a-11 will significantly reduce the costs of election contests, and that this will benefit shareholders. Both premises are mistaken. To be sure, the Proposal will facilitate a certain type of contest in which activist shareholders place nominees on the

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[27] SEC Release No. 34-56135, p. 11

[28] *Id.*, p. 38.

[29] Broadbridge, "Notice and Access: Statistical Overview of Use with Beneficial Shareholders as of May 31, 2009," http://www.broadridge.com/notice-and-access/, p. 11.

[30] Pew Internet & American Life Project, "Demographics of Internet Users," http://www.pewinternet.org/Static-Pages/Trend-Data/Whos-Online.aspx.

[31] Pew Internet & American Life Project, "Home Broadband Adoption 2009," June 2009, p. 14.

company proxy with no serious intent of campaigning for their election, but nonetheless impose significant costs on fellow shareholders. However, institutional investors that do have a serious intent to propose and elect alternate candidates will not realize significant cost savings from the Proposal. The Proposal will therefore impose unnecessary costs on fellow shareholders and will be less efficient than available alternatives.

1. Reducing costs to minimal levels will lead to excessive nominations

Under the Proposal, companies would be required to incur the cost of placing shareholder nominees in proxy materials. The proposed rule offers a benefit to the particular subgroup of shareholders who succeed in placing their chosen candidate on a company's board —a closely aligned board member and (presumably) improved information access—yet they will bear only a fraction of the costs. Effectively, companies will subsidize shareholders' costs of nominating directors. It is a well-known result in economic theory that when the marginal social cost of an activity exceeds its marginal private cost, as is the case with any subsidy, more of that activity will take place.[32] In the case of the proposed SEC rule, the marginal social cost of a shareholder nominating a director is higher than the marginal private cost because the costs of the contested election are borne in part by the issuer, rather than the nominating shareholder. This subsidy will inevitably increase the number of director nominations by shareholders.

As explained below, even if the company bears the costs of printing and postage under the Proposal, a pragmatic shareholder determined to get its candidate elected is likely to expend resources to improve its candidate's odds of being elected. (Those resources are far from prohibitive.) However, under the SEC's proposal, eligible shareholders would be able to nominate a candidate for a corporate board without campaigning for his election. The only cost would be that of identifying a candidate, and if the candidate is affiliated with the nominating shareholder, such as a partner of a hedge fund, these costs would be truly trivial. Any additional expenditures on advertising, public relations, legal fees or proxy solicitations would be optional. Although the likelihood of successful election will not be high in the absence of a concerted campaign, management and the incumbent board cannot assume the success of their chosen candidate and therefore will be compelled by their fiduciary responsibilities to expend great resources ensuring the candidate's defeat. (Ironically, precisely because such board candidates may be of the lowest quality, due to the proponent's low search efforts to identify a nominee, management and the incumbent board may feel compelled to devote extra efforts to assure the candidate's defeat.) Such low-cost candidacies—which involve low costs for the proponent but high costs for fellow shareholders—are particularly likely to be used by shareholders who wish to use the costs and risks to the company as leverage to obtain concessions on unrelated matters.

2. Requiring negotiation first is another superior alternative

The Proposed Election Contest Rules implicitly assume that a company and the shareholders seeking to nominate a director cannot reach a negotiated settlement. This is false: 76% of 2005

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[32] See, for example: Hal R. Varian, *Intermediate Microeconomics: A Modern Approach* (New York: W.W. Norton & Company, 1996), pp. 565-6; Edgar K. Browning and Jacquelene M. Browning, *Public Finance and the Price System* (Englewood Cliffs: Prentice Hall, 1994), pp. 40-41.

- 2008 proxy contests that produced hybrid boards did so through engagement.[33] Another less costly alternative would be to require activist investors who want to place people on corporate boards to recommend candidates to the company's nominating committee. Many companies already have a process in place for shareholders to do this. This would mean that only if a candidate is rejected inappropriately would there be the necessity and expense of having an election.

B. Shareholder nominees will impair quality of boards

The Commission's Proposal rests on the premise that facilitating the election of dissident directors is largely an unadulterated good. For multiple reasons, that premise is mistaken.

1. Companies with dissident board members substantially underperform compared to their peers.

Several empirical studies establish that when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest. These findings are highly relevant to any cost-benefit analysis of the SEC Proposal because this data strongly suggests that directors who win seats pursuant to the new rule will in fact weaken, rather than strengthen, share prices in U.S. public companies. Thus, implementation of the rule likely will hurt U.S. shareholders and undermine the ability of U.S. companies to raise capital. Ikenberry and Lakonishok (1993) find a negative and statistically significant cumulative abnormal return (CAR) of -18.3%, relative to all companies of similar size trading on the NYSE and AMEX, in the 24 months following proxy contests at 97 firms from 1968 to 1987. This negative return, relative to a company's peers, is driven by cases where dissidents gain control of board seats: when dissidents gain at least one board seat, the 24-month CAR is -32.6%, and when dissidents gain the majority of a board's seats, this figure is -40.8%. Negative and statistically significant CARs are also found for 12- and 36-month periods for companies when at least one dissident joins the board.[34] In cases where dissidents do not gain any board seats, the CAR is small (-1.7%) and statistically insignificant.[35] Borstadt and Zwirlein (1992) study proxy contests from July 1962 to January 1978; when dissidents win, they find a negative and statistically significant CAR of -22.8% for the 24 months following the resolution of the contest.[36] Looking at 185 threatened proxy contests at NYSE- and AMEX-listed firms between 1977 and 1988, Fleming (1995) similarly finds negative and statistically significant returns of -19.4% in the 24 months

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[33] IRRC Institute, "Effectiveness of Hybrid Boards," May 2009, p. 13.

[34] Where dissidents gain one or more board seat, the returns are -17.2% in the 12 months post-announcement and -36.2% for the 36 months post-announcement, both statistically significant at the 5% level. Where dissidents gain control, the 12 and 36 month returns are -22.0% and -40.9%, respectively.

[35] David Ikenberry and Josef Lakonishok, "Corporate Governance through the Proxy Contest. Evidence and Implications," *Journal of Business*, Vol. 66, No. 3, 1993, p. 420. See p. 410 for details on the methodology used to calculate CAR.

[36] CARs for proxy contests when dissidents win and there is no subsequent takeover. Returns are also negative over 12 and 36 month periods, but are statistically insignificant. Lisa Borstadt and Thomas Zwirlein, "The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance," *Financial Management*, Autumn 1992, p. 28.

following the announcement of a contested election for the 27 firms where dissidents win board seats.[37,38]

The Commission will have to come to terms with this substantial literature when determining the Proposal's effects on efficiency, competition and capital formation.

2. Board skill composition will be adversely affected

One of the most significant risks presented by the Proposal is that shareholder nominees will impede companies from achieving the skill and experience balances they need for their boards to function effectively. Unlike activist shareholders, whose interest is gaining board seats for like-minded people, in this age of specialization, boards of directors are required to determine the unique attributes and strengths of a company's existing management team and incumbent board members. Boards take these characteristics into consideration when nominating board candidates in order to insure a balanced and effective board that can respond to all of the challenges that the company might face after the election. Examples of critical expertise needs would be the minimum three independent board members with financial literacy required to staff the audit committees of NYSE-listed companies,[39] risk management expertise to serve on the risk management committee of a financial firm, marketing expertise, experience in international trade, or mergers and acquisitions or technology to serve on the boards of technology and non-technology companies. Whereas companies consider the entire board composition in selecting board nominees, shareholders often will lack the knowledge or the capacity to do this. Moreover, unlike boards of directors, activist shareholders, who owe no duties to anybody but themselves, may select nominees with vastly different objectives and agendas than other shareholders. In particular, activists will recruit nominees likely to support the nominating activist shareholder's particular, issue-specific agenda. This is likely to lead to numerous acute problems as a practical matter. For example, if a company's financially-literate nominee lost to a shareholder nominee, the company might be unable to staff its audit committee. If a nominee with a particular skill set were replaced by an activist's nominee, the company might not be as successful in achieving its objectives as it might otherwise have been.

Ultimately it will fall to voting shareholders to select the candidates with the experience needed to fill out the board. Yet, academic studies have recognized that shareholders have little incentive to carefully weigh their proxy contest choices and, as a result, inferior candidates may win. Shareholders who only own a small stake in the company will experience little wealth effect

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[37] Michael Fleming, "New Evidence on the Effectiveness of the Proxy Mechanism," Federal Reserve Bank of New York Research Paper No. 9503, March 1995, p. 17 and Table 1.

[38] Although other studies have found positive relative returns in companies with hybrid boards, those findings have not been statistically significant. See J. Harold Mulherin and Annette B. Poulsen, "Proxy contests and corporate change: implications for shareholder wealth," *Journal of Financial Economics* 47 (1998), pp. 279-313; IRRC Institute, "Effectiveness of Hybrid Boards," May 2009.

[39] NYSE Listed Company Manual, Section 303A.07.

even if the outcome of the contest affects shareholder value and will consider it unlikely that their few votes will affect the outcome of the contest.[40]

For these reasons, it is unrealistic to expect that voting shareholders will effectively assesses and weigh the skill and experience mix of the current board and the skills of proposed board candidates, the skills needed on the board (including technical requirements such as audit committee membership, technology or industry expertise), and incorporate that understanding into their voting.

3. Shareholders will nominate candidates to advance agendas at odds with shareholder value

An underlying, and unrealistic, assumption of the SEC's proposal is that shareholders will nominate qualified board candidates who will work collegially (or at least effectively) and contribute positively to management and shareholder value. In fact, institutional shareholders' incentives to put forth their own director candidate are not necessarily aligned with improving corporate governance, management or shareholder value. As such, they may not be aligned with the incentives of individual shareholders, nor with other types of institutional shareholders. The shareholders most likely to nominate director candidates are those who are most commonly activist: hedge funds, union benefit plans and public pension plans, all of which have a history of using proxy fights to pursue agendas other than shareholder value. If nominating a candidate has minimal cost, it is likely that they will put forth candidates at every election.[41]

Most companies with market capitalization of $75 million or more have multiple union and hedge fund shareholders. Approximately 36% of companies with market capitalization of $700 million or more have at least one hedge fund shareholder with a qualifying stake. Approximately 8% of such companies have at least one qualifying union-related or public pension fund shareholder, although this is likely an understatement as union holdings may be filed under their hired asset managers and may hold the same stock through multiple managers.[42]

Whatever the defects of the current system, current boards of directors are obligated to nominate directors who they believe will act in the best interests of the company and its shareholders to maximize long-term value creation. Investors, however, will not be obligated to do so—and may have incentives to do otherwise based on their particular agenda.

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[40] Lucien Arye Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests," *California Law Review* (1990), Vol. 78, p. 1080.

[41] Mutual fund and other asset managers frequently follow proxy advisory services, such as the RiskMetrics Group and Glass Lewis & Co., to satisfy their legal obligation to vote on behalf of their investors in an informed manner. Leo E. Strine, Jr., "Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America," 119 Harvard Law Review (2006), p. 1765. If the Proposed Election Contest Rules are put in place, such proxy advisory services will have enhanced power. It is at least possible that they would expand their services to recommending director candidates for qualifying shareholders to nominate, either individually or jointly.

[42] For companies with market capitalization of at least $700 million, a shareholder with a qualifying stake must have held at least a 1% stake at every quarter-end over the year from March 31, 2008 to March 31, 2009.

a. Hedge Funds

Hedge funds have possible perverse incentives as they may have a qualifying stake in the company yet have other positions, including derivative positions, which could cause them to profit if the company stock falls in value. In the case of *CSX Corporation v. Children's Investment Fund Management (UK) LLP*, the Children's Investment Fund was long up to 8.8% of CSX stock via total return swaps.[43] However, a hedge fund could equally well establish a qualifying long position in common stock, yet be net short the company via a larger position in total return swaps. For example, a hedge fund could have a qualifying 1% stake in a company with market capitalization of $700 million or more yet a short position equivalent to 2% via total return swaps for a net short exposure of 1% of market capitalization. Such a fund would have an incentive to put forth director candidates who would disrupt the board and pressure the company to take measures that would undermine shareholder value. The Commission's proposal includes no incentives or enforcement mechanism to prevent hedge funds from nominating directors intended to undermine share value such that they may profit via net short positions, nor even any means to determine the total position of shareholders with qualifying common equity stakes.

b. Union and public employee benefit plans

Union benefit plans have used elections to advance labor agendas, sponsoring, for example, withhold votes for board chairs to punish them for not granting concessions in ongoing collective bargaining. Agrawal (2008) finds that "AFL-CIO affiliated shareholders vote against directors partly to support union worker interests rather than increase shareholder value alone."[44] Examining the split of the AFL-CIO in 2005, Agrawal found that AFL-CIO funds were statistically significantly more likely to support director nominees at a corporation after the AFL-CIO ceased to represent that company's workers. Furthermore, AFL-CIO funds are statistically more significantly likely to vote against directors at firms with greater frequencies of conflict between labor and management.[45]

Public employee benefit plans have exhibited similar activism, sometimes joining forces, as in the 2004 challenge to Safeway management. In March 2004, five California public employee pension funds collaborated to launch a "vote no" campaign against three Safeway directors including Chairman/CEO Stephen Burd. The effort was concurrent with a major strike by Safeway employees in Southern California. In May, prior to board elections taking place, Safeway agreed to replace three directors, but retained Mr. Burd.[46]

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[43] *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.*, 562 F.Supp.2d 511, p. 15.

[44] Ashwini Agrawal, "Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting," Working Paper, September 2008, p. 1.

[45] *Id.*

[46] Joan Lublin and Janet Adamy, "Safeway CEO is Challenged by Dissident Holders," *The Wall Street Journal*, March 25, 2005; Janet Adamy, "Safeway to Replace Three Directors --- Pension Funds' Criticism is Driving Force for Move; Lead Director to be Named," *The Wall Street Journal*, May 3, 2004.

4. The Proposal's first-come, first-served rule will fail to select the best-qualified shareholder nominee

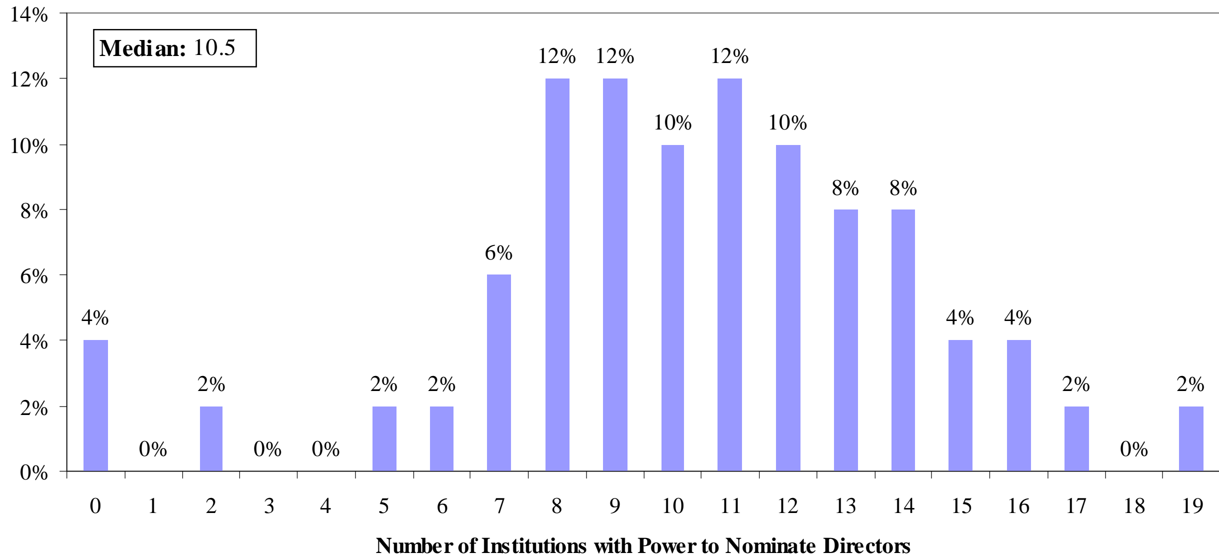
The SEC's proposed requirement that companies use a first-come, first-served process to place director candidates on the ballot, if multiple eligible shareholders submit director nominees, could place the least qualified of numerous shareholder nominees on the ballot and, ultimately, on the board. Whereas the SEC has focused on the percentage of companies with at least one eligible shareholder, or with a pair of shareholders who would be jointly eligible, it is important to recognize that many companies have five, ten or more eligible shareholders. This sets up a potential competition (or race) among shareholders to name their own nominee. If there is little cost to naming one's own candidate, it will be rational for eligible shareholders to nominate a candidate or candidates who are best aligned with their own, possibly narrow interests.

There is every reason to expect a race for eligible shareholders to get their nominees in, especially for larger companies. As of March 31, 2009, we find that companies with market capitalization of $700 million or more have a median of 10.5 shareholders eligible to nominate directors, based on a 50 company sample using the dual criteria of a 1% minimum stake held for at least one year.[47] Figure 2 shows the distribution of the number of eligible shareholders based on a 50-firm sample. Considering the possibility of smaller shareholders cooperating to put forth nominations based on their aggregate holdings, the number of potential nominations rises even higher. Companies with market capitalization of $700 million or more have a median of seven shareholders with stakes of at least 0.5% but less than 1%, based on the same 50 firm sample.

[47] 50 firms were randomly sampled from the set of all U.S. domiciled companies with market capitalization greater than $700 million traded publicly on major U.S. exchanges, obtained from FactSet Research Systems, Inc.

Figure 2

Institutional Investors with a 1%+ Stake Held for at Least One Year
Companies with Market Cap Greater than $700MM, 50 Firm Sample
March 31, 2009



Notes and Sources

Institutional holdings from Factset Research Systems Inc. and SEC filings where unavailable.
Shares Outstanding data are from Bloomberg, LP.

If the first-come, first-served rule takes the form of a company opening nominations at a fixed time, it will be little different than attempting to be the first caller to a radio station to win a prize. Effectively, it would be random or at least not substantive: the first email to arrive at 9 a.m. on a particular date or the first of messengers sent to queue at company offices in the wee hours of the date in question.

The number of shareholder nominees would be limited to no more than one or the number that represents 25% of the company's board of directors, whichever is greater.[48] Allowing the first-in shareholder to nominate up to the maximum nominees, where that exceeds one, would only exacerbate the problem.

While eligible shareholders could in principle resolve the race to nominate by coordinating to select a single candidate, it is not apparent that different types of institutional shareholders with different objectives would be able to agree on a candidate. As noted, institutional shareholders fall into diverse categories including hedge funds and union and public pension funds. Past examples of cooperation have generally involved similar shareholders, although there have been

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[48] It is not clear how the SEC would propose to resolve a situation where 25% of the board exceeds the number of independent directors up for election. Consider, for example, a 20 person board with 40% independent directors (8) and half of those elected each year (4 directors) or 20%.

instances of collaboration by different types of shareholders such as the case of Take-Two Interactive Software, Inc., in which a mutual fund collaborated with three hedge funds.[49]

5. Higher share ownership thresholds for nomination would mitigate incentive problems and negative effects on board quality

The SEC could better align the incentives of qualifying shareholders with other shareholders by setting higher ownership thresholds. By allowing nominations only by larger stakeholders, it would reduce the odds that shareholders would make nominations to advance agendas contrary to shareholder wealth maximization, as any negative impact on share price would be more costly to the nominating shareholder. This would be effective with shareholders with long positions, including union benefit and public pension plans. It would also make it more costly for any hedge fund to establish a qualifying stake and a net short position, then use the qualifying stake to try to bring about a fall in the company's stock price.

Large companies have a number of shareholders that can meet higher thresholds. Of the top 50 companies by market capitalization, on average, the top five shareholders jointly have an 18.4% stake (average of 3.68% each) and the top 10 jointly a 26.7% stake (average of 2.67% each). (See Appendix Exhibit 1.)

C. The Proposal does not distinguish between the issues associated with expressing disapproval of an incumbent director and the issues associated with identifying, nominating, legitimating, and electing an outside insurgent director

It is important to recognize the vast difference between the relatively straightforward issues involved when shareholders simply express their disapproval of existing directors and the vastly more complex issues involved in identifying, recruiting, nominating, legitimating, and electing a new director or slate of directors. Voting against or withholding votes from, or otherwise expressing disapproval of, an incumbent director presents few analytical problems.[50] Replacing directors involves the extremely challenging problem of identifying and recruiting replacement directors whom the majority of shareholders will be familiar with, much less trust. It may be the case that commentators such as Bebchuk are correct when they assert that directors should be voted out of office more often than they are. A default rule requiring some form of majority voting, would accomplish this result.

But the SEC's proposal goes well beyond simply enhancing the ability of shareholders to express their dissatisfaction with one or more incumbent directors. The SEC's proposal envisions contested elections, which will require not merely the expression of dissatisfaction with an incumbent, but the identification, recruitment, legitimization, nomination and election of entirely

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[49] Adam J. Kansler and Leila Zahedani, "Winning Without a Fight: Steps for Activist Shareholders to Change Management," *The Metropolitan Corporate Counsel*, June 2007.

[50] For example, in March 2004, Michael Eisner was stripped of his post as chairman of Disney Corporation when forty-three percent of Disney shareholders withheld their votes from the embattled Disney chair, resulting in a decision by the Disney board to split the posts of board chair and CEO. See Michael McCarthy, Disney Strips Chairmanship from Eisner, USA Today, Mar. 4, 2004, at B1.

new candidate-directors. The SEC ignores two problems with the process of nominating and electing new directors, rather than merely expressing dissatisfaction with incumbent board members. First, the SEC provides no explanation for how outside challengers to incumbent boards are to be identified and recruited. Second, even if such directors can be identified and recruited, the SEC provides no guidance on the crucial question of how outside challengers for board positions will be able to send a credible signal to shareholders and other corporate constituencies that they will be faithful corporate stewards, much less that they will be able to outperform a company's incumbent directors.

As for the recruitment problem, it is not easy to find able, experienced, and competent people who are eager to become directors of public companies. In the political context, democracies have a highly developed system in which two or more political parties recruit, screen, and legitimize potential nominees for political office. There is no analogous process for corporate elections, and it is not obvious how one could be created. Rival board candidates compete along vectors such as competence, experience, and integrity, as well as along vectors such as ideology, interest-group identification, and loyalty. As such, it is far from clear what, if any, signaling function might be played by rival parties who nominate candidates in corporate elections.

The role of corporate director is both more time consuming and more risky than ever before. Presumably adoption of the SEC's proposal would not change this trend. We further presume that the SEC would not wish for directors to be less accountable, either to regulators and shareholders, than they currently are. Even at present, a significant number, perhaps as many as half of all prospects, decline offers to serve on boards, even when such offers are made by the companies, not by insurgents.[51] The SEC's proposal appears to assume away the acute problems of identifying, recruiting, and performing due diligence for potential challengers to incumbent directors.

Moreover, even to the extent that outside shareholder activists are able to locate challengers for board incumbents, it is far from clear how to make such challengers credible candidates for office. Corporate elections are plagued by a variety of collective action and signaling problems. Challengers in proxy contests have a difficult time signaling credibly to shareholders that they are seeking to displace the incumbent directors because they are better managers, rather than for more nefarious reasons.

Bebchuk (2007) generally recognizes the existence of these sorts of problems when he writes that:

> [S]hareholders cannot infer from a rival team's mounting a challenge that the rival directors would perform better. To begin with, even a rival team that believes it will perform better may be acting out of hubris. Furthermore, and very important, a rival's decision to mount a challenge does not even imply that the rival itself

[51] See Key Considerations for Serving on a Board of Directors, 2 Advantage (RSM McGladrey, Minneapolis, Minn.), Jan. 2006, http://advantage.hanleywood.com/default.aspx?page=article236.

believes it will perform better. After all, a challenge could be motivated instead by a desire to obtain the private benefits associated with control.[52]

The SEC's Proposal will exacerbate, not mitigate, the credibility problems facing challengers. Rational shareholders will understand that if the SEC's reimbursement proposal is implemented, challengers will internalize an even smaller share of the costs of mounting a proxy contest for control, but will internalize the same benefits. This, in turn, will provide less-qualified, lower-probability candidates with greater incentives to run, particularly since those candidates with the lowest opportunity costs to their time and effort will benefit most by the prospect of having the company bear part of their election expenses.

D. Companies will incur additional efficiency costs to evaluate shareholder-nominated candidates

If shareholder nominees are included on the ballot in many elections, which we believe to be a likely outcome, companies will incur the costs now associated with a proxy contest far more frequently than they do now, when less than 1% of elections involve proxy battles.[53] The Commission's assertion that companies will be able to vet outside candidates in only 20 hours is unrealistic.[54] A survey of Business Roundtable companies estimates that the inclusion of a shareholder nominee will cost a company approximately $1,160,000 for the services of outside professionals, as well as approximately 300 hours of company personnel and director time.[55]

As mentioned above, shareholders will not have the same obligation as current directors to nominate directors who will maximize shareholder value, and may have incentives to nominate directors who will pursue agendas contrary to shareholder value. This risk imposes an obligation on companies to do thorough due diligence on shareholder nominees and, in the exercise of their fiduciary responsibilities, to vigorously oppose candidates whom they consider less qualified than the board nominee. The SEC's proposal not only fails to adequately account for the cost resulting from vetting and opposing candidates, but it also fails to account for the costs associated with litigation against new directors for acting in ways contrary to the company's interests.

In addition to the disruption to management and boards of contested elections and the associated costs to the company, additional disruptions may come from qualifying shareholders' ability to use the threat of nomination to extract concessions or private benefits from management. Indeed, this likely will be among the most frequent uses of the power: A meeting with management or board representatives in which the institutional investor communicates that if certain things are not done (e.g., a labor dispute resolved, or a contract with a union company

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[52] Lucian A. Bebchuk, "The Myth of the Shareholder Franchise," 93 Va. L. Rev. 675, 106 (2007).

[53] See III.B.4 for calculation of less than 1%.

[54] SEC Release No. 33-9046, p. 97.

[55] Business Roundtable, "Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rules of the U.S. Securities and Exchange Commission," August 17, 2009, p. 110.

signed), then they will run an alternative candidate (at shareholder expense). Management will have to consider the relative cost of fulfilling the shareholder demand versus the costs of opposing the alternative candidate. Because qualifying shareholders can nominate board candidates at very little cost, any qualifying shareholder will be able to make a credible threat of nominating.

IV. The Proposal will render U.S. equity markets less competitive with foreign markets

Although the SEC states that the Proposed Election Contest Rules will improve the competitiveness of U.S. companies by improving corporate governance practices relative to other leading markets, it ignores detrimental effects on the competitiveness of U.S. capital markets. As has been widely discussed since the passage of the Sarbanes-Oxley Act in 2002, the market share and competitiveness of U.S. capital markets have deteriorated markedly since the 1980s.

Holding constant the current merits of listing in the U.S. and overseas, the Proposed Election Contest Rules would be an added negative for U.S. markets. Even if other countries currently have similar rules for director nominations, this is an incremental cost to listing in the U.S. To the extent that it slows growth of U.S. equity markets relative to foreign markets, it will reduce the relative liquidity of U.S. markets, making them yet less competitive. Ironically, because the Proposal would apply only to companies subject to the proxy rules, it would be a greater deterrent to listing in the U.S. for American companies than for foreign companies.

A. U.S. equity market competitiveness has already been impaired by high regulatory costs.

By any measure, the U.S. share of equity listings has declined substantially in recent years. The 2006 report of the Interim Committee on Capital Markets stated, "[T]he United States is losing its leading competitive position compared to stock markets and financial markets abroad. … [C]ertainly one important factor contributing to this trend is the growth of U.S. regulatory compliance costs and liability risks compared to other developed and respected market centers." [56] U.S. share of IPOs done outside a firm's home country (measured by value of IPOs) decreased from 50% in 2000 to 5% in 2005; measured by number of IPOs, the U.S. share fell from 37% in 2000 to 10% in 2005.[57] In a 2009 update, Committee Chairman Hal S. Scott stated,

> While the latest results must be cautiously interpreted in light of the global recession, the competitiveness of U.S. public equity markets appears to continue to decline. [58]

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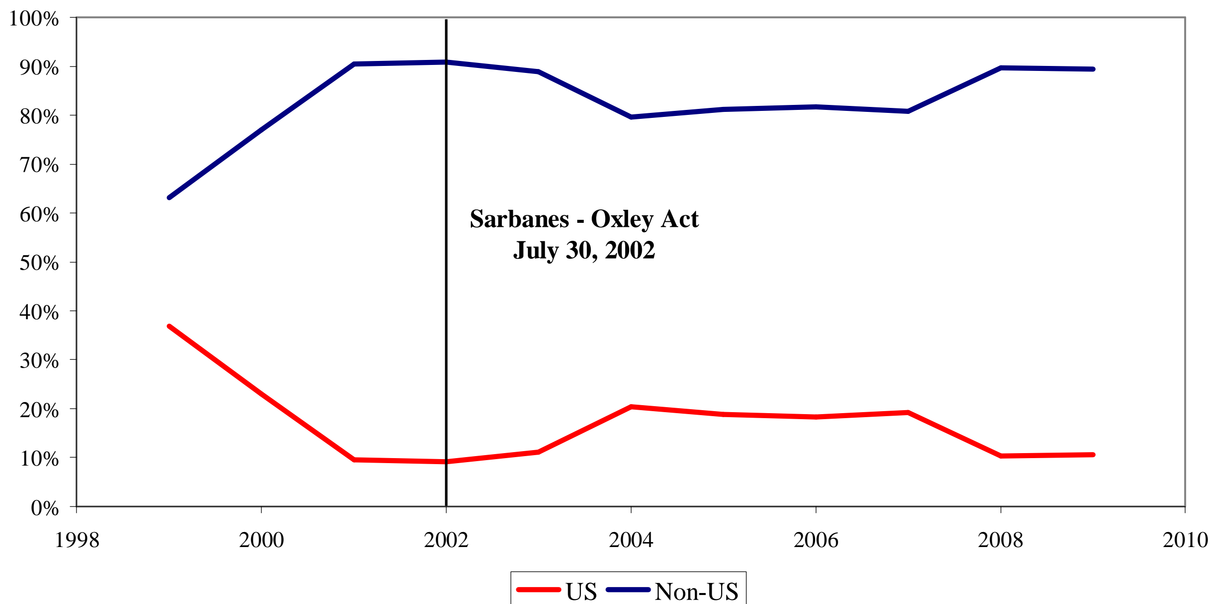
[56] "Interim Report of the Committee on Capital Markets Regulation," November 30, 2006, Introduction p. ix.

[57] "Interim Report of the Committee on Capital Markets Regulation," November 30, 2006, p. 2.

[58] Committee on Capital Markets Regulation, "First Quarter Measures Reveal Continued Decline in Competitiveness of U.S. Public Equity Markets," July 22, 2009, p. 1.

In dollar terms, the U.S. share of global IPOs fell from a 1996-2006 average of 28.7% to 6.9% in 2007 and 1.9% in 2008.[59] As shown in Figure 4 below, the U.S. share of IPOs (in number) declined from 36.9% in 1999 to 10.7% in 2008.

Figure 3



Notes and Sources:
Data obtained from Bloomberg, L.P.

Other measures point to a similar, if not more severe, loss of market share:

§ In 2006, nine of the 10 largest IPOs were done outside the U.S.; in 2005, the proportion is a more striking 24 of the top 25.[60] In both 2007 and 2008, none of the top 20 IPOs worldwide were done in the U.S.[61]

§ A recent study of companies cross-listed in the U.S. and their home market found that the proportion of volume has reversed; whereas in the 1980s the majority of volume was traded in the U.S., by the 1990s, the preponderance of the volume had shifted to the home markets as the liquidity advantage of U.S. markets declined.[62]

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[59] *Id.*

[60] *Id.*

[61] Committee on Capital Markets Regulation, "First Quarter Measures Reveal Continued Decline in Competitiveness of U.S. Public Equity Markets," July 22, 2009, p. 2.

[62] "Interim Report of the Committee on Capital Markets Regulation," November 30, 2006, p. 3.

B. Private placement and private equity financing have grown at the expense of the public equity market

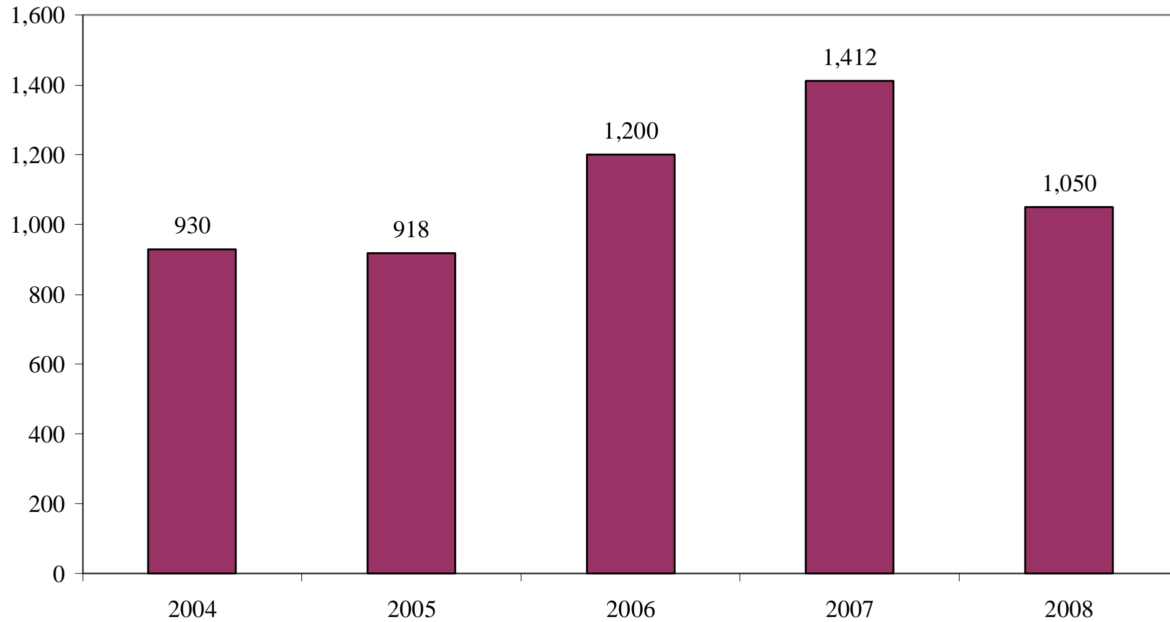
U.S. and foreign firms are increasingly relying on alternative markets to raise capital in the U.S., another sign that the balance between the public equity market and its alternatives is shifting in favor of the latter. One factor may be that companies find the increased regulatory burden of public ownership in the U.S. already outweighs any financing cost or liquidity advantage of public listing. The Proposal will add yet another cost to this equation. On balance, a shift from public to private equity markets deprives individual investors of the opportunity to invest.

Private placements have grown to account for approximately 90% of the volume of capital raised in the U.S. by foreign companies in 2005, versus 50% in 1995. This signals foreign companies' preference to avoid the regulatory requirements associated with public listing. Rule 144A private placements allow foreign companies to raise funds from large institutional investors without subjecting themselves to most aspects of U.S. securities regulation, including avoiding all disclosure requirements, Sarbanes-Oxley Act Section 404 requirements, and liability provisions of the Securities Act of 1933.[63]

An increasing number of publicly-traded U.S. firms have opted to leave the equity markets and revert to private ownership, as shown in Figure 5. Despite the decline in 2008 associated with the credit crisis, the 2008 level remains higher than the number in 2004 or 2005.

[63] *Id.*, p.5

Figure 4



Notes and Sources

Data are from Capital IQ's Monthly Market Observations, January 2009, p. 47. Figure is based on transaction announce dates and includes both closed and pending transactions as well as those without transaction values.

V. The Proposal will undermine competitiveness and capital formation at the company level

The Proposed Election Contest Rules will undermine the competitiveness of U.S. companies by burdening publicly-traded companies with the efficiency costs discussed above and, in doing so, effectively raise the cost of capital for U.S. companies. First and foremost, as discussed above, companies with dissident directors underperform their peers by 19 to 40% in the two years after the contested election. By facilitating contested elections, the Proposal is bound to result in more dissidents winning board seats.

Moreover, because the Proposal would make it more expensive to operate as a public company, public equity issuance would become relatively less attractive as a form of financing. To the extent that yet-unlisted companies choose to instead raise capital via debt or private placements, this may raise their cost of capital and impair their competitiveness. By the same token, the Proposal would make it more attractive, at the margin, to take public companies private.

In addition to the added costs of going public, the Proposal will introduce non-financial deterrents to going public that may cause company founders to prefer to keep their companies privately held. Company founders who wish to maintain their executive positions will factor in an increased risk of loss of control via shareholder-nominated directors, who may run for the

board in order to change management. By the same token, founders who wish to continue to focus on their company's business will face the increased distraction of public ownership not only from increased regulatory burdens, but potential management and board distraction from dealing with contested director elections. An even greater fear will be that dissident directors will be more easily able to gain seats, be detrimental to boardroom dynamics, cause management and board efficiency losses and harm the company's returns.

By discouraging companies from participating in public equity markets, the Proposal will also discourage capital formation. Because an illiquidity premium is built into the price of debt and private equity placements, companies cannot raise as much money issuing these securities as publicly-traded stock. Public equity markets are widely considered to be the most efficient markets, in terms of stock prices reflecting all available information. Debt markets are less liquid, with transactions in corporate debt securities often infrequent; they are less likely to be efficient in that, without transactions, prices cannot immediately react to news. Markets for 144A securities are yet less liquid, with no public information on prices. The Proposal will nonetheless drive firms away from the public equity markets toward the more costly debt and private placement markets.

VI. The benefits predicted by the SEC will be at best small, and possibly prove to be costly rather than beneficial

For the Proposed Election Contest Rules to overcome the many costs laid out above, the benefits would need to be substantial. Yet the three benefits predicted by the SEC range from small to simply implausible:

(1) The SEC predicts a reduction in the cost to shareholders of soliciting votes in support of a nominated candidate for election to the board of directors. However, the SEC itself estimates that savings at only $18,000, or 2% of the estimated $1,160,000 in costs that a company would incur due to having a shareholder nominee on the ballot.[64, 65]

(2) The SEC cites improved disclosure of shareholder-nominated candidates as enhancing transparency and facilitating better informed voting decisions.[66] While transparency is always a positive, we note that even the SEC does not attempt to quantify this benefit.

(3) The SEC conjectures that board performance may be improved, either by incumbent directors working harder to retain their seats or because shareholder nominees may improve board or corporate performance. However, this report has presented substantial evidence that the Proposal is likely to impair board and company performance. Contested elections will distract boards from other company business. Insurgent victories may result

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[64] SEC Release No. 33-9046, pp. 183-184.

[65] Business Roundtable, "Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rules of the U.S. Securities and Exchange Commission," August 17, 2009, p. 110.

[66] SEC Release No. 33-9046, pp. 185-186.

in boards without the right skill and experience mix. Indeed, as discussed above, a number of studies show that dissident board representation has a negative impact on company returns.

VII. Conclusion

Our accounting of the costs of the Proposed Election Contest Rules in terms of effects on efficiency, competitiveness and capital formation reveals that the costs of this Rule, if adopted, will be substantially higher than acknowledged by the SEC. These costs overwhelm the few benefits posited by the SEC, some of which will be small and others of which are simply not credible.

In order to obtain modest savings for large, activist shareholders at the less than 1% of companies that face proxy fights or negotiations over board representation in any given year, the SEC would increase dramatically the frequency of contested elections. The SEC restricted its analysis to the number of companies with one or more shareholders eligible to nominate a director candidate. We note, however, that companies with market capitalization of $700 million or more have a median of 10 eligible shareholders. Moreover, more than one-third of these shareholders fall into the traditionally activist categories of hedge funds, union benefit or public pension funds. These companies will face frequent shareholder director nominations, as well as the specter of inefficient “races” among shareholders in order to win a place on the ballot, because only the shareholder who is first to make a nomination will gain a ballot spot.

Efficiency costs ignored by the SEC include the excessive nominations that would result from a subsidized option, significant negative effects on board quality, and the substantial costs that companies and shareholders will incur in dealing with the nomination and election of board candidates with special interest agendas and goals inconsistent with the traditional goal of maximizing shareholder value. We also believe that the SEC underestimates the costs that companies will face in vetting shareholder-nominated candidates because they do not appreciate the cardinal importance to companies of properly and thoroughly vetting board nominees.

The SEC also ignores the detrimental effects of the Proposal on the competitiveness of U.S. capital markets, by ignoring the fact that subsidized proxy contests add yet another negative factor to U.S. companies' decisions about whether to go public and to foreign companies' decisions about whether to list in the U.S. or overseas.

Finally, the Proposal risks undermining the competitiveness of U.S. companies. To the extent that U.S. companies are even further discouraged from going public than they are at present, and public companies are incentivized to go private, the Rule will raise their cost of capital, render them less competitive in global markets, and discourage capital formation.

APPENDIX TABLE 1

Top 50 Companies by Market Capitalization:
Percentage of Shares Outstanding Held by Top 5 and 10 Institutions
March 31, 2009

Rank	Company	% Of Shares Outstanding Held by Institutional Investors	
		Top 5	Top 10
(1)	(2)	(3)	(4)
		--------------%--------------	
1	Exxon Mobil Corp.	14.1	19.2
2	Wal-Mart Stores Inc.	9.1	12.8
3	Microsoft Corp.	15.7	21.8
4	AT&T Inc.	17.2	24.4
5	Johnson & Johnson	15.9	21.7
6	Procter & Gamble Co.	17.0	22.0
7	Chevron Corp.	17.6	24.2
8	Berkshire Hathaway Inc.	7.6	9.9
9	International Business Machines Corp.	15.8	21.7
10	Google Inc.	17.3	25.8
11	General Electric Co.	13.7	18.7
12	Coca-Cola Co.	22.0	30.8
13	JPMorgan Chase & Co.	18.3	26.1
14	Apple Inc.	17.9	27.6
15	Pfizer Inc.	16.1	23.4
16	Cisco Systems Inc.	17.6	24.9
17	PepsiCo Inc.	14.9	21.1
18	Intel Corp.	15.9	22.2
19	Verizon Communications Inc.	19.7	26.7
20	Hewlett-Packard Co.	18.8	28.5
21	Oracle Corp.	17.1	24.7
22	Abbott Laboratories	15.4	23.1
23	Philip Morris International Inc.	21.1	29.4
24	QUALCOMM Inc.	17.8	27.3
25	Wells Fargo & Co.	23.7	34.5
26	McDonald's Corp.	22.3	31.0
27	ConocoPhillips	18.9	28.0
28	Wyeth	18.0	28.9
29	Merck & Co. Inc.	21.7	33.4
30	Visa Inc.	10.4	14.7
31	Goldman Sachs Group Inc.	20.1	31.1
32	Amgen Inc.	19.0	29.7
33	United Parcel Service Inc.	17.8	24.2
34	Schlumberger Ltd.	19.6	33.6
35	Occidental Petroleum Corp.	19.2	32.1
36	Bank of America Corp.	16.3	21.4
37	Bristol-Myers Squibb Co.	18.4	29.0
38	Gilead Sciences Inc.	23.2	38.0
39	Monsanto Co.	18.6	29.2
40	United Technologies Corp.	27.7	37.3

APPENDIX TABLE 1

Top 50 Companies by Market Capitalization: Percentage of Shares Outstanding Held by Top 5 and 10 Institutions March 31, 2009

Rank	Company	% Of Shares Outstanding Held by Institutional Investors	
		Top 5	Top 10
(1)	(2)	(3)	(4)
		--------------%	--------------
41	CVS Caremark Corp.	17.6	27.5
42	Comcast Corp.	17.7	24.6
43	Kraft Foods Inc.	22.2	27.8
44	Eli Lilly & Co.	33.5	44.6
45	Schering-Plough Corp.	25.4	36.9
46	Home Depot Inc.	17.9	27.6
47	Medtronic Inc.	21.4	33.1
48	3M Co.	19.3	25.8
49	Walt Disney Co.	18.3	27.7
50	Altria Group Inc.	16.5	24.8
	Average	18.4	26.7

Notes and Sources:

Institutional holdings data from Factset Research Systems, Inc. Shares outstanding data from Bloomberg, L.P. and SEC filings where unavailable.

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