Shareholder Proposal Reform

The Need to Protect Investors and Promote the Long-Term Value of Public Companies

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Center for Capital Markets Competitiveness

U.S. CHAMBER OF COMMERCE

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CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Since its inception in 2007, the Center for Capital Markets Competitiveness has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. The CCMC is committed to working aggressively with the administration, Congress, and global leaders to implement reforms to strengthen the economy, restore investor confidence, and ensure well-functioning capital markets.

Shareholder Proposal Reform

The Need to Protect Investors and Promote the Long-Term Value of Public Companies

The U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) has long promoted effective communication between public companies and investors, which we believe to be a bedrock principle of our capital markets. By many measures, shareholders are increasingly able to engage with the companies in which they invest, and constructive dialogue with shareholders has often led to significant changes in corporate governance. However, the regulatory framework for shareholder proposals is badly out of date and needs to be reformed for the benefit of shareholders, public companies, and the capital markets.

The current rules governing shareholder proposals are administered by the Securities and Exchange Commission ("SEC" or "Commission") under Rule 14a-8 of the Securities Exchange Act. While it is not the only means an investor has to get the attention of management, Rule 14a-8 "is popular because it provides an opportunity for any shareholder owning a relatively small amount of the company's shares to have his or her own proposal placed alongside management's proposals in the company's proxy material. …"[1] Unless a company is able to use 1 of the 13 exemptions that exist under Rule 14a-8, it is generally required to include a shareholder's proposal with its proxy materials. The exemptions indicate that the SEC has never allowed unfettered access to a company's proxy statement.

> ***"The regulatory framework for shareholder proposals is badly out of date and needs to be reformed for the benefit of shareholders, public companies, and the capital markets."***

For decades, the fundamental purpose of the shareholder proposal system was to allow certain investors to put forth constructive ideas on how to improve a company's governance and performance. The SEC often took the position that proposals dealing with personal grievances, or those of a social or political nature, were not proper subjects for shareholders to vote on under Rule 14a-8, largely because such proposals sought to advance goals other than running the business more efficiently and profitably. This balanced approach helped prevent abuse of the system, while still affording shareholders a voice in the management of the companies they invested in.

The long-standing guardrails that were put in place to protect investors have steadily weakened, and the shareholder proposal system today has unnecessarily devolved into a mechanism that a minority of interests use to advance idiosyncratic agendas that come at the expense of other shareholders. As a result, proposals dealing with social or political issues and topics that the federal securities laws have long treated as not material are ending up in proxy statements with increasing frequency, even when the proposal's subject matter is wholly unrelated to a company's long-term performance. In fact, *half* of all proposals submitted to Fortune 250 companies during the 2016 proxy season dealt with some type of social or policy-related matter.[2]

Despite the prevalence of such proposals, shareholders have overwhelmingly rejected them when put to a vote. For example, from 2006 to 2016, Fortune 250 companies received 445 proposals dealing with corporate political

1 Proposed Rule: Amendments to Rules on Shareholder Proposals Release No. 34-39093. Sep. 19, 1997 ("SEC 1997 Proposal").

2 J. Copland and M. O'Keefe—An Annual Report on Corporate Governance and Shareholder Activism, September 2016.

> *"Half of all proposals submitted to Fortune 250 companies during the 2016 proxy season dealt with some type of social or policy-related matter…shareholders have overwhelmingly rejected them when put to a vote."*

disclosures—a perennial favorite topic of activists. Only 1 of these proposals during that time frame received majority backing, and in most years proponents failed to garner the support of more than 20% of voting shareholders.[3] Proposals dealing with social or other political matters have similarly, in general, received very low support when put to a vote.

Under current rules, a proponent is allowed to *resubmit* a proposal on multiple occasions even if the proposal was previously rejected by a vast majority of shareholders. In fact, in some cases, even if over 90% of shareholders have rejected a proposal more than once, a proponent is allowed to keep submitting it. These resubmissions make up a significant portion of all proposals. According to Proxy Monitor, 31% of the 3,392 proposals submitted to Fortune 250 companies from 2007 to 2016 had been submitted previously.[4]

Moreover, a very small subset of investors have come to dominate the shareholder proposal system, while the vast majority of investors—including those that routinely vote against social and political proposals—bear the costs. Fully one-third of all shareholder proposals in 2016 at Fortune 250 companies were sponsored by six individual investors, while 38% of proposals were sponsored by institutions with an explicit social, religious, or policy purpose.[5] Including a proposal on a proxy or seeking "no-action" relief from the SEC staff creates significant costs for all shareholders. Further, proposals dealing with social or political matters also serve as a serious distraction for boards, whose responsibility it is to focus on the long-term best interests of the company. Frivolous proposals can also obscure or lessen consideration of proposals that focus on how to improve a firm's performance that other shareholders have put forth.

The SEC has previously recognized that the current shareholder proposal system harms investors in key respects. For example, in 1997—under the leadership of Chairman Arthur Levitt—the SEC proposed raising the resubmission thresholds under Rule 14a-8 so that proposals would have to elicit meaningful support before being proposed again.[6] As the SEC stated then: "… we believe that a proposal that has not achieved these [proposed] levels of support has been fairly tested and stands no significant chance of obtaining the level of voting support required for approval."[7] While the SEC's rulemaking was never finalized, we believe that reform is needed even more today.

The broken Rule 14a-8 system is yet another burden on companies and their shareholders that only serves to make the public company model less attractive. As the Chamber has frequently pointed out, the U.S. has about half the number of public companies than existed two decades ago, and a recent report shows that we have

3 J. Copland and M. O'Keefe—Political Spending and Lobbying, June 2016.

4 Supra note 2.

5 *Id.*

6 The SEC's proposed rules would have increased the resubmission thresholds to 6% (if voted on once in previous five years), 15% (if voted on twice in last five years), and 30% (if voted on three or more times in last five years).

7 SEC 1997 Proposal.

fewer listed companies today than in 1976.[8] This occurred despite the fact that the U.S. is home to roughly 100 million more people than in 1976 and our economy is three times as large. While the 2012 Jumpstart Our Business Startups (JOBS) Act helped arrest some of this decline, too many businesses are unfortunately deciding that being public is not in the best interests of their shareholders and stakeholders.

The tragedy of this decline is that there is a body of evidence demonstrating the benefits that public companies bring in terms of job creation and economic growth. For example, a 2012 Kaufmann Foundation study found that from 1996 to 2010, the 2,766 companies that went public cumulatively increased their employment by over 2.2 million jobs and the annual sales increased by over $1 trillion.[9] During a period where our economy has struggled to achieve even 2% GDP growth, addressing the decline in public companies should be a top concern for policymakers.

Moreover, creating more burdens for public companies jeopardizes the ability of American households to build wealth or to effectively choose the companies or industries they wish to invest in. Because of the SEC's accredited investor rules that limit investment in private enterprises, most Americans have only limited options to invest outside of the public markets. Households therefore depend on robust public markets, and a system that imposes a substantial "tax" on public companies ultimately impacts the returns that investors receive on their retirement or other savings.

> ***"Frivolous proposals can…obscure or lessen consideration of proposals that focus on how to improve a firm's performance that other shareholders have put forth."***

To be sure, the decline in public companies is a multifaceted issue with no single solution. A number of factors contribute to this problem, including those outside the control of Congress or the SEC—such as the availability of private capital or market conditions that can make the public markets unattractive. But there are several issues squarely within the purview of the SEC that can and should be addressed to help bring our capital markets into the 21st century so that they can drive much-needed economic growth.

We believe that reform of the shareholder proposal process is an incremental but important step toward tilting the scales back in favor of the majority of public company investors. No company wants to go public only to find itself subject to endless politically driven campaigns intended to embarrass an enterprise that was built from scratch by its founders. And no small subset of activists should be able to commandeer long-standing SEC rules for their own parochial purposes. Rule 14a-8 reform is long overdue, and we look forward to working with policymakers to help make reform a reality.

8 The Incredible Shrinking Universe of Stocks. Credit Suisse, March 2017.

9 Post-IPO Employment and Revenue Growth For U.S. IPOs June 1996-2010. Kaufmann Foundation, May 2012.

Our recommendations are laid out in greater detail here.

Recommendation#1

Amend the SEC's Resubmission Rule to raise the thresholds for support that proposals must receive in order to be eligible for resubmission.

The current Resubmission Rule allows a company to exclude a shareholder proposal if it failed to receive the support of 3% of shareholders if voted on once in the last five years; 6%, twice in the last five years; and 10%, three or more times in the last five years. Thus, a proponent is allowed to resubmit a proposal even if nearly 90% of shareholders have rejected it on multiple occasions. Allowing for such recidivism of unpopular proposals does nothing to protect investors and only creates further distractions for companies trying to focus on the long term. Investors should be protected from having to repeatedly register their opposition to a proposal that has already been soundly rejected.

> *"A system that imposes a substantial tax on public companies impacts the returns that investors receive on their retirement or other savings."*

The SEC has previously recognized the problem that low resubmission thresholds pose, and in 1997 it proposed rules to raise the thresholds to more reasonable levels. The CCMC recommends that, at a minimum, the SEC revisit its 1997 rulemaking, which provided that a proposal could not be resubmitted if it received the following:

- Less than 6% support on the previous submission if voted on once within the previous five calendar years.
- Less than 15% support on the previous submission if voted on twice within the previous five calendar years.
- Less than 30% support on the previous submission if voted on three or more times within the previous five calendar years.

Recommendation #2

The SEC should withdraw *Staff Legal Bulletin 14H* (CF), issued in October 2015, in order to restore certainty under the Rule 14a-8(i)(9) exemption. 14a-8(i)(9) allows the exclusion of a proposal if it conflicts with one of the company's own proposals.

In the wake of the January 2015 decision by then-SEC Chair Mary Jo White to suddenly reverse a staff decision regarding a shareholder proposal at Whole Foods, SEC staff issued a legal bulletin that has limited the ability of companies to use an exemption under 14a-8(i)(9) that had been relied on for years. This legal bulletin was never considered or approved by the full Commission and has added a great deal of uncertainty to the no-action process.

Recommendation #3

Offer more transparency to investors by requiring proponents to provide sufficient disclosure regarding their economic interests and objectives.

There is currently a gap between the information a company must provide to investors in its proxy statement and the information—or lack of information—that is provided by many proponents of shareholder proposals. This is particularly pronounced when proposals are submitted via proxy in which the proponent nominally represents the true beneficial owner of the shares yet owns no shares of its own. To level this playing field and protect investors, proponents should—at a minimum—be required to disclose what follows:

- Personal information such as name and address.
- The number of shares that the proponent owns or has a right to acquire, as well as the purpose for why the proponent acquired the shares and the objectives they have with respect to the issuer.
- A description of any contracts or arrangements the proponent has with another person to provide any type of benefit in relation to submission of the proposal.
- Whether the person has submitted the same or a substantially similar proposal to another issuer and the identity of such issuer(s).
- If the person submitting a proposal is acting as a proxy or representative on behalf of someone else, the beneficial owner of the shares should be required to make similar disclosures.
- The SEC should define what it means to "own" shares in the context of eligibility for submitting a proposal; this would help ensure that a proponent actually has an economic interest in the company.

Recommendation #4

The Commission should reassert the "relevance rule" under 14a-8(i)(5) by allowing excludability of a proposal if the subject matter impacts less than 5% of a company's total assets and 5% of net earnings.

The relevance rule was intended to allow for exclusion of proposals that did not meet a certain financial materiality threshold, in this case the 5% noted earlier. In 1982, the Commission amended this exlusion to provide that matter failing the 5% tests would still have to be included in the company's proxy materials if it was "otherwise significantly related to the issuer's business." Over the years the SEC staff have eroded the viability of this exclusion by providing for an expansive interpretation of what is "significantly related to the issuer's business," notwithstanding the matter's financial insignificance to the business. This has helped open the door to social, political, and economically immaterial proposals—the very kind that shareholders have overwhelmingly rejected when voting.

- The Commission should reassert the original intent of the 14a-8(i)(5) exclusion by allowing proposals to be excluded that do not meet the 5% asset and net earnings threshold regardless of the underlying subject matter.

Recommendation #5

Prohibit the use of images, photos, or graphs as part of proposals, while maintaining the ability of proponents to include a hyperlink for a website they wish to include.

Recent developments have caused uncertainty over whether the SEC will grant no-action relief when a shareholder proposal includes some type of image, chart or photograph. Despite Rule 14a-8 limiting proposals (and supporting materials) to 500 words, SEC staff have in some cases allowed certain images to be included. Besides adding to issuer cost in preparing proxy materials, allowing such material is a slippery slope that could lead to proponents being allowed to include false or misleading imagery. Neither the SEC nor an issuer should be put into a position of having to determine the authenticity of an image or a photograph, or whether a chart or graph is labeled accurately.

- The SEC should prohibit the use of images, photographs, charts, or graphs with shareholder proposals to avoid situations where investors could be provided with false or misleading information. However, the SEC should maintain the ability of proposals to include hyperlinks to websites that the proponent wishes to include.

> *No company wants to go public only to find itself subject to endless politically driven campaigns intended to embarrass an enterprise that was built from scratch by its founders.*

Recommendation #6

The SEC should provide market participants with more certainty regarding its policing of 14a-8(i)(4), which deals with proposals that relate to a redress of a personal claim or grievance.

Because the shareholder proposal system is designed to facilitate deliberation over subject matter that impacts investors as a whole, the SEC adopted an exemption under 14a-8(i)(4) that allows the exclusion of proposals relating to the redress of a personal claim or grievance against the company. The SEC has in the past stated the need for this exclusion because it "has found that in a few cases security holders have abused this privilege by using the rule to achieve personal ends that are not necessarily in the common interests of the issuer's security holders generally."[10] *SEC Staff Legal Bulletin 14* and its amendments (which have never been approved by the Commission) provide some guidance on these issues but leave a number of critical questions unanswered. In any event, the Commission has not weighed in recently on these important questions.

- Further guidance detailing the SEC staff's no-action policies under Rule 14a-8(i)(4) should provide more certainty for issuers and proponents and lead to less confusion around the no-action process. Guidance also should facilitate the exclusion of personal claim or grievance proposals since such proposals impose unwarranted costs on a company's other shareholders.

Recommendation #7

The SEC must allow for the exclusion of proposals that include materially false or misleading statements.

Rule 14a-8(i)(3) states clearly that a proposal can be excluded "if the proposal or supporting statement is contrary to any of the Commission's proxy rules," including rules that prohibit false or misleading statements in proxy soliciting materials. In practice, however, SEC staff has eroded the viability of this exemption by placing the burden on issuers to prove that a statement made by a proponent is materially false or misleading. The staff has often erred on the side of proponents, even in cases where an issuer believes that it will result in false or misleading information being included in its proxy statement. Investors are not protected by such an outcome, and the SEC should provide a more reasonable course for issuers to exclude proposals that contain false or misleading information.

Looking Forward

The SEC has the opportunity to bring positive and lasting change to the shareholder proposal system. The modest recommendations included in this report would maintain the ability of shareholders to have their voices heard, but they would protect investors against those who abuse the system for their own purposes. The U.S. Chamber of Commerce looks forward to working closely with the SEC and other interested parties on this important issue.

10 SEC Release No. 34-20091 August 16, 1983.

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