RESPONSIBLE SHAREHOLDER ENGAGEMENT AND LONG-TERM VALUE CREATION

Modernizing the Shareholder Proposal Process

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Modernizing the Shareholder Proposal Process

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I. Introduction

Effective communication with shareholders is a critical element of the operation of today's public company. While the current shareholder proposal submission process under Rule 14a-8 remains a key component of the interaction between companies and investors, the process — which requires companies to include qualified shareholder proposals in their proxy statements unless one of the 13 delineated exclusions applies — is outdated and needs modernization.

Effective communication with shareholders is a critical element of the operation of today's public company.

II. Why Modernization Is Needed

When creating the shareholder proposal process, the Securities and Exchange Commission (SEC) originally intended to replicate attendance and participation by shareholders at corporate annual meetings. However, the current shareholder proposal process is dominated by a limited number of individuals who file common proposals across a wide range of companies but own only a nominal amount of shares in the companies they target. These investors are pursuing special interests — many of which have no rational relationship to the creation of shareholder value and conflict with what an investor may view as material to making an investment decision. As a result, the current process is often used to promote the self-interest of a minority of shareholders, frequently at a significant cost to the company.

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This transformation in the shareholder proposal process has occurred for two primary reasons:

First, the threshold for submitting a proposal is too low. Set decades ago, the threshold has fallen out of step with the reality of stock prices in the current market. To be qualified to submit a proposal, a shareholder must own only $2,000 in market value or 1 percent — whichever is less — of a company's outstanding stock for at least one year. The $2,000 threshold, in particular, falls well short of any reasonable material ownership standard for public companies. Case in point, at current market prices, a shareholder would need to purchase only three shares of Google stock to meet this requirement.

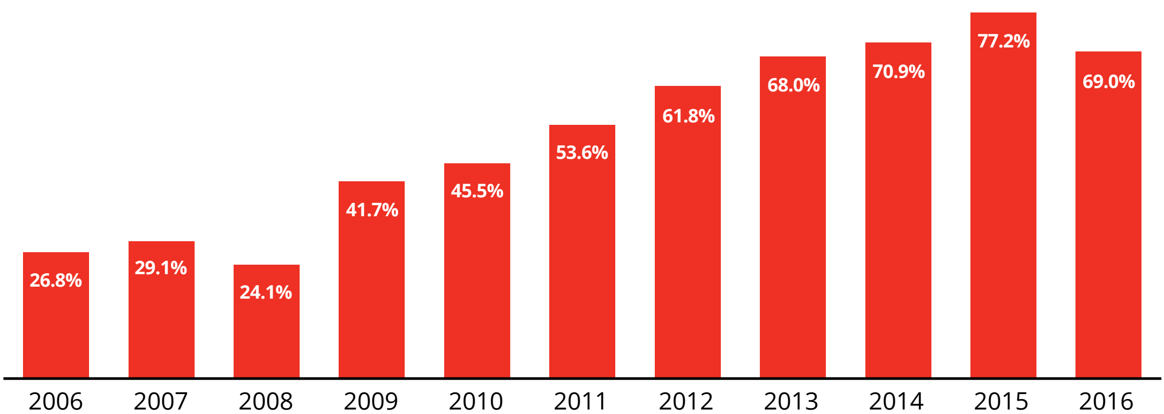
Further, a number of shareholders take advantage of this holding threshold, described as "absurdly low" by former SEC Commissioner Daniel Gallagher, to submit proposals to a broad spectrum of companies to further their personal agendas, rather than to create shareholder value or address concerns material to the company. This practice is evidenced by the fact that while Fortune 250 companies, on average, faced more proposals in 2015 and 2016 than any year since 2010, the number of shareholders actually participating in the shareholder proposal process remains low.

Only three shareholders and their families were responsible for nearly 22 percent of all nonmanagement shareholder proposals submitted to Fortune 250 companies in 2016. To illustrate the tiny stake some submitting shareholders have in the companies they are trying to influence, take a look at the case of one of the three shareholders referenced above. The shareholder's holdings in companies at which he submitted shareholder proposals, as disclosed in public filings during the 2014 proxy season, ranged from a low of $2,172 to a high of $16,433 in dollar amount ownership and from a low of 0.000003 percent to a high of 0.00008 percent in percentage ownership.

These proponents are able to submit such a large number of proposals in part because they have been able to pursue their agendas even at companies where they have no relationship and own no shares by acting as a "proxy" for a shareholder of the company. The individual who actually is a shareholder of the company frequently has shown little or no interest in the proposal in question. Further, the relationship between the individuals making the proposals and the shareholders granting the proxy is often murky at best, leaving the company and other shareholders little direct communication with the actual shareholder of the company or transparency regarding the proponent's true motivations.

Share of Proposals Brought by Cheveddens, Steiners and McRitchie/Young

Percentage of All Proposals Brought by Individuals, Fortune 250 Firms



Source: Proxymonitor.org

Second, excluding proposals relating to general social issues is difficult for companies. For several decades, the SEC permitted corporate managers to exclude proposals submitted "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." In 1970, however, the D.C. Circuit Court of Appeals ruled against the SEC and found that shareholder proposals are not excludable when they raise issues of corporate social responsibility or question the "political and moral predilections" of management. In response, the SEC narrowed the "general economic, political, racial, religious, social or similar causes" exclusion to proposals that are "not significantly related to the business of the issuer nor within its control."

This court-driven change in SEC policy has facilitated a continuous influx of proposals on social issues. Last year, activist shareholders filed 479 social, environmental and political proposals, and this stream of proposals remains steady with more than 400 such proposals submitted for 2016 meetings.

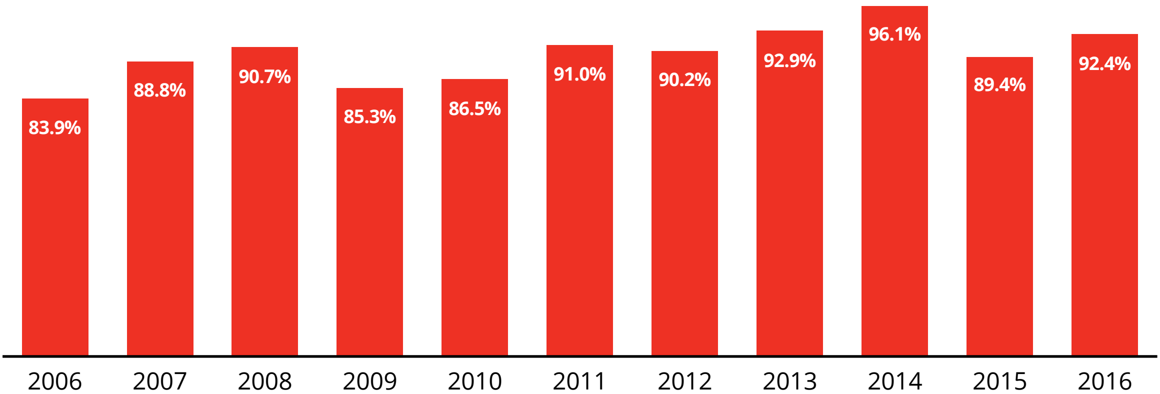
A fraction of small-stakes shareholders motivated by concerns unrelated to enhancing shareholder value and immaterial to the company can override the expressed will of a majority of shareholders indefinitely — a situation frequently dubbed "tyranny of the minority."

Most social, environmental and political proposals, such as those related to corporate political spending, climate change and human rights, have only an attenuated connection to shareholder value and are generally not issues material to a company's business. In addition, these proposals rarely garner meaningful shareholder support, with support for such proposals hovering around 20 percent of shares cast in both 2015 and 2016. Since the beginning of 2015, only nine such proposals have obtained the requisite support of a majority of votes cast, one of which was a proposal commending Kellogg Co. for switching to cage-free eggs in its supply chain.

In 2016, average support for shareholder proposals is the lowest it has been in the past four years, based on proposals voted on through June 1, 2016. However, even if the vast majority of a company's shareholders vote against a shareholder proposal, under the current resubmission rules, it is nearly impossible for the company to exclude the proposal. Under the current rules, proposals getting a mere 3 percent of the votes cast qualify for resubmission at least once, and for as long as the proposal obtains 10 percent of the votes cast, it may be submitted indefinitely. As a result, a fraction of small-stakes shareholders

Share of Nonmanagement Proposals Failing To Win Majority Support

Percentage of Fortune 250 Firms



Source: Proxymonitor.org

motivated by concerns unrelated to enhancing shareholder value and immaterial to the company can override the expressed will of a majority of shareholders indefinitely — a situation frequently dubbed "tyranny of the minority."

The current shareholder proposal process is no longer consistently serving the purpose for which it was established. It is also costing companies tens of millions of dollars and countless hours of management time through the cost of negotiating with proponents, seeking SEC no-action relief to exclude proposals from proxy statements, preparing opposition statements and other activities that are diverting from creating long-term shareholder value. The unintended consequences of these activities can cause shareholders to lose sight of matters of true economic significance to the corporation if simultaneously presented with numerous immaterial proposals to consider, and companies will incur the costs of implementing successful proposals, even if they are immaterial to the operation of the company, wasting shareholder resources.

III. Options for Modernizing the Shareholder Proposal Process

Full-scale modernization of the shareholder proposal submission process may not happen any time soon given the backlog of Dodd-Frank Act rulemaking initiatives and the need for a rigorous cost-benefit analysis supporting a new rulemaking construct. To address the greatest concerns with the current shareholder proposal process, the following reforms should be considered to tighten eligibility and enable more exclusions of proposals and repeat submissions:

The current holding period encourages a focus on short-term goals at the cost of long-term investing.

Replace the $2,000 holding requirement. The $2,000 monetary holding requirement was implemented in 1983 and last updated in 1998 to adjust for inflation. It is no longer a reasonable standard for ownership. Rather than providing for a threshold based on a dollar amount that will periodically need to be adjusted for inflation and has a disparate effect based on the size and stock price of the company, the SEC should instead employ a holding requirement based solely on the percentage of stock owned by a proposal proponent. This requirement would be similar to the general practice that has been established in creating proxy access rights for shareholder-nominated director candidates. For proposals related to topics other than director elections, a truly reasonable standard could be to use a sliding scale based on the market capitalization of the company, with a required ownership percentage of 0.15 percent for proposals submitted to the largest companies and up to 1 percent for proposals submitted to smaller companies. Additionally, if a proposal were submitted by a group or by a proponent acting by proxy, the ownership percentage sliding scale could be increased to up to 3 percent.

Increase the length of the holding requirement. The current holding period encourages a focus on short-term goals at the cost of long-term investing. Proponents holding the stock for as little as one year are able to highjack the proxy as a means to promote their short-term social and political agendas without regard to the effect on long-term shareholder value. Requiring a longer holding period would better align the interests of the shareholders making the proposals with the long-term success of the company. As with the ownership requirement, a better standard for the holding requirement could be to mirror the three-year holding period that has become the standard established for proxy access.

Enhance proponent disclosure requirements. The current shareholder proposal rules require a company to include in the proxy either the proponent's name, address and number of voting securities or an undertaking to provide the same upon request. Proponents, on the other hand, are not required to state their economic ownership in the company or the period of time during which they have had an investment in the company. As a result, shareholder proponents — and even more concerning, proponents by proxy — are currently allowed an opportunity to influence the management and strategy of the company without being transparent about who they are and their true motivations and priorities. Amending the rules to require proponents owning less than 5 percent of the company and proponents by proxy to disclose their motivations, goals, economic interests and holding in the company's securities and any similar proposals they have submitted at other companies (as well as the results of those proposals) would allow other shareholders to make a fully informed decision regarding the interests of the proponent of the proposal. Then other shareholders would be able to better evaluate the materiality and long-term value of the proposal to the company.

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Prohibit or set reasonable limitations on the use of images. Despite the fact that Rule 14a-8(d) states that a supporting statement "may not exceed 500 words," proposal proponents at times submit supporting statements containing images. General Electric Company alone received four such proposals for its 2016 annual meeting, with images ranging from emojis and graphs to a picture of a burning building. Most of these proposals were revised to remove the images when the company notified the proponents that their proposals did not comply with Rule 14a-8; however, when the company sought no-action relief to exclude a proposal containing a graph without labeled axes, the SEC staff denied the request. As a result, what types of images, if any, the staff will allow companies to exclude currently remains unclear. In future guidance and no-action requests, the staff should set reasonable limitations and parameters on image use and allow companies to exclude proposals including images that are, among other things, false or misleading, offensive, protected by copyright, oversized, or otherwise aimed at circumventing the parameters with respect to supporting statements set forth in Rule 14a-8(d).

Increase requirements for proposals by proxy. At times, a proponent has no material ownership of the company but rather receives permission to act on behalf of a shareholder that meets the shareholder proposal eligibility threshold. As such, the true proponent of the proposal may have no significant economic ownership in, or material relationship to, the company. Further, when the proponent does not own any shares of the company, the resulting situation is at odds with a set of rules designed to promote and ensure shareholder communication and instead fosters an environment in which individuals can influence aspects of the company's management without any accountability to the company or its shareholders. To help address this issue, the rules should be revised so that when a proponent is relying on a proxy to submit a proposal, the shareholder giving the proxy must meet a higher eligibility threshold as set forth above.

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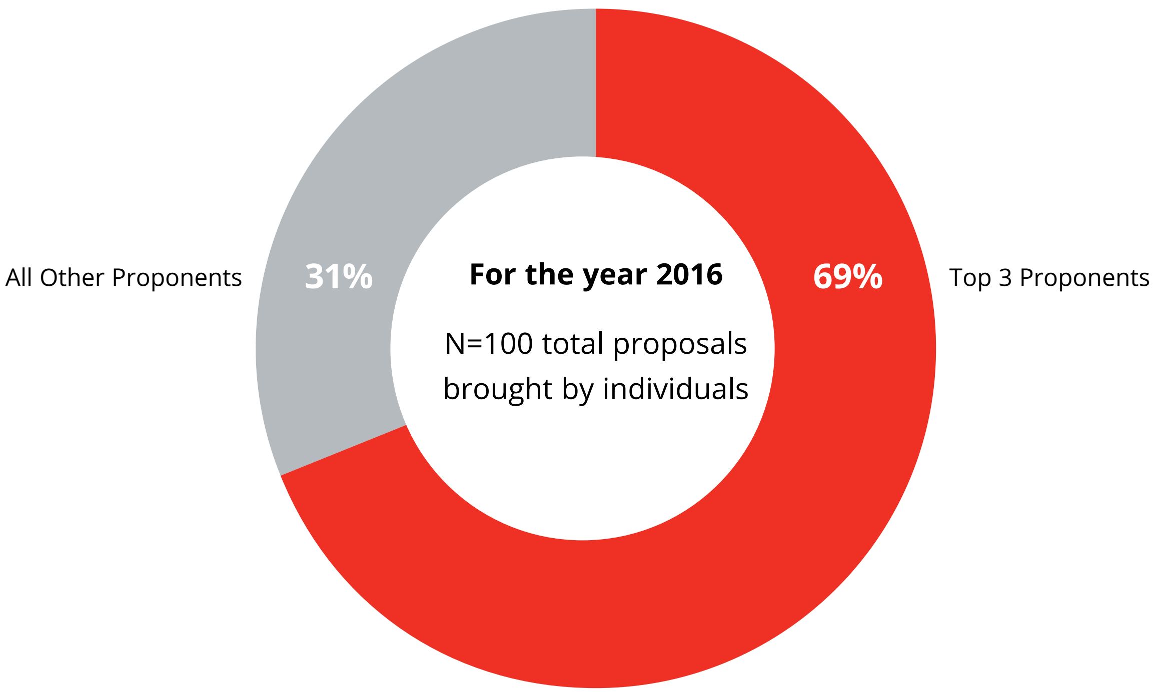
Percentage of All Proposals Brought by Individuals, Fortune 250 Firms



Source: Proxymonitor.org

Strengthen the resubmission thresholds. The current resubmission threshold allows a company to exclude a proposal focusing on substantially the same subject matter for a three-year period. To avoid possible exclusion, a proposal must have received at least 3 percent of the vote on its first submission, 6 percent on the second and 10 percent on the third. As the rule currently stands, a proposal that is opposed by 90 percent of a company's shareholders can be resubmitted indefinitely, leading to a "tyranny of the minority" situation. In 1997, the SEC proposed to increase these thresholds to 6 percent on the first submission, 15 percent on the second submission and 30 percent on the third submission, noting that "a proposal that has not achieved these levels of support has been fairly tested and stands no significant chance of obtaining the level of voting support required for approval." Since the SEC's decision in 1998 not to revise the resubmission rule, there have been continuing calls for reform. A cost-benefit analysis is needed to determine what parameters should be used to update the thresholds, with a focus on establishing thresholds high enough to demonstrate that a resubmitted proposal is realistically on the path to majority approval. At the very least, however, the thresholds should be updated to implement the increases proposed by the SEC in 1997: 6 percent on the first submission, 15 percent on the second and 30 percent on the third.

Better define the criteria for applying the ordinary business exclusion. No clear definition of "ordinary business" exists when a company seeks no-action relief under the "ordinary business" exclusion. Further, the SEC has indicated that in applying the "ordinary business" exclusion to proposals that raise social policy, it "applies the most well-reasoned standards possible, given the complexity of the task," but that "from time to time, in light of the experience in dealing with proposals in particular subject areas, it adjusts its approach." Absent a clear definition and in light of shifting approaches to the exclusion, the SEC staff is granted wide discretion in determining whether to issue no-action relief. As a result, a number of dubious proposals are allowed each year. Again, expanded review and oversight procedures, developed with input from issuers and investors, should be implemented to prevent whimsical changes in direction.

Reinstate the conflicting proposal exclusion. In 2015, the SEC staff issued a Staff Legal Bulletin (SLB) that revised its approach to the conflicting proposal exclusion, materially departing from decades of guidance. Prior to the adoption of this new guidance, the conflicting proposal exclusion had been used in a variety of contexts to, among other things, avoid ambiguous and inconsistent results at shareholder meetings. The SEC's new interpretation dramatically limits public companies' ability to exclude a shareholder proposal that conflicts with a company proposal unless "a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal."

For example, the SEC staff gave the following as an example of proposals that would not be in conflict: (a) a shareholder proposal for proxy access that would permit shareholders holding at least 3 percent of the stock for at least three years to nominate up to 20 percent of the directors and (b) a company proposal for proxy access that would allow shareholders holding at least 5 percent of the stock for at least five years to nominate up to 10 percent of the directors. The company could not exclude the shareholder proposal, the staff explained in the SLB, because "both proposals generally seek a similar objective, to give shareholders [proxy access] and the proposals do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals."

This new standard risks confusing shareholders while intruding upon the fiduciary duties of directors. Further, this departure from long-established practice was adopted in an SLB without formal rulemaking. As a result, the SEC should reinstate the prior interpretation of the conflicting proposal exclusion.

Reevaluate the standard for excluding proposals that are contrary to proxy rules. Rule 14a-8(i)(3) permits the exclusion of proposals that are contrary to the SEC's proxy rules, including proposals that are materially false or misleading or are overly vague. In 2004, the staff significantly curtailed the ability of companies to use this exclusion when it took the position that it will not allow a company to exclude a supporting statement or proposal — even if the statement or proposal contains unsupported factual assertions, is disputed or countered, impugns the company or management, or relies upon unidentified sources — unless the company "demonstrates objectively that a factual statement is materially false or misleading." Since that time, the staff has found that very few statements meet this standard. Instead, the staff has indicated that companies should use the "opposition statement" as a means to respond to any false or misleading statements in a shareholder proposal. Given this position, in recent years, some companies, frustrated with the staff's position, have decided to forgo the Rule 14a-8(i)(3) no-action letter exclusion process and instead challenge proposals in court as being materially false or misleading. In one such case, which the company won, the court's holding suggests that the SEC's approach to Rule 14a-8(i)(3) may be too narrow. In no-action letter requests following this court case, however, the staff continues to apply a standard for exclusion that appears stricter than that presented by the court. As a result, companies may be forced to choose between including in their proxies a proposal that contains misstatements but is not deemed excludable under SEC staff standards or engaging in expensive litigation to enforce the right to exclude the proposal. The responsibility instead should be on proponents to make sure their proposals are accurate and clear. The staff should reevaluate the deferential standard it is using to exclude proposals contrary to proxy rules and exclude all proposals that contain materially false or misleading information or are overly vague.

Revise the no-action letter process. The current no-action letter process is administered at the staff level at the SEC, and politically appointed SEC commissioners have little or no authority to reconsider a staff decision. This decentralized, issue-by-issue review leads to inconsistent guidance and interpretation of the rules, especially over the course of time. For instance, in December 2014, the staff concurred that Pfizer could exclude an independent chair shareholder proposal on the basis of it being too vague under Rule 14a-8(i)(3). However, just 66 days later, the staff denied similar no-action letter requests, reversing its position in Pfizer. In the later responses, the staff stated: "Although the staff has previously agreed that there is some basis for your view, upon further reflection, we are unable to conclude that the proposal, taken as a whole, is so vague or indefinite that it is rendered materially misleading." To make the guidance process more consistent, the SEC could convert the no-action letter process into an SEC advisory opinion process, whereby the SEC issues opinions on major policy issues rather than issuing no-action letters. Alternatively, if the current no-action letter process is maintained, the SEC should establish enhanced review and oversight mechanisms to achieve greater consistency.

IV. Conclusion

The shareholder proposal process has evolved considerably since first introduced in the 1940s. Increasingly, the current shareholder process fails to promote an effective channel of communication between shareholders and companies, especially with regard to matters material and of long-term value to the company. Instead, it is being used by a small number of shareholders attempting to advance litmus test issues that are not only rarely specific to the company but also largely irrelevant. Compounding that irrelevancy, yet reflecting it, these proposals often repeatedly fail to obtain meaningful shareholder support. Modernization is needed. The modernization options presented are not meant to be an exclusive list but a starting point to address the legitimate concerns with the current system that foments waste and rarely contributes to progress in matters affecting shareholder value.

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