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The Value of the Shareholder Proposal Process

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Early in June, the House of Representatives passed a piece of legislation, dubbed the Financial CHOICE Act, which would gut much of Dodd-Frank. One of its provisions would make it impossible for all but the largest investors to file shareholder proposals by requiring that investors must hold at least one percent of the outstanding shares for three years in order to file a proposal. This would remove a key tool that investors use to communicate with corporate boards.

Some of the impetus for the inclusion of the shareholder proposal process in this legislation may have come from the Business Roundtable (BRT), which sent a letter to the Administration highlighting 16 regulations that the organization believed would "directly and negatively impact economic growth." One of those was the shareholder proposal process, which the letter described as "activist investors with insignificant stakes in public companies make shareholder proposals that pursue social or political agendas unrelated to the interests of the shareholders as a whole."

Notably, the BRT's statement following the passage of the Financial CHOICE Act singled out the provision that would essentially eliminate the shareholder proposal process, which the BRT described as "helping companies concentrate more effectively on investment, innovation and economic growth." However, neither the BRT's original letter nor its statement offered any evidence supporting the idea that shareholder resolutions impede corporate performance or harm innovation or economic growth. Perhaps that's because that view is hard to support with facts.

Three points are worth some honest illumination:

1. Shareholder resolutions usually focus on material issues aimed at improving corporate financial performance.
2. Shareholder proposals under the current SEC rules are not burdensome, and in the vast majority of cases, are not even binding.
3. The voice of shareholders is valuable both to companies and to investors alike.

Materiality and Performance

Shareholders file proposals with companies to help them perform better, not to annoy them. The fact that many resolutions now get votes in the 30-50 percent range, and many pass with majority votes, demonstrate that shareholders often see these resolutions as being in their financial interests.

This point is easy to illustrate with examples. In 2016, there were about 1,000 shareholder proposals filed in the United States, of which about 400 were on social and environmental issues. The remainder concerned corporate governance. None of these categories are trivial or peripheral to protecting a company's reputation or its value, as reams of research demonstrate.

For instance, one governance topic, board diversity, has been a popular focus of shareholder proposals over the past two decades. There is substantial and growing literature showing that diverse boards make better decisions and are value-enhancing for investors. That research comes from places like Credit Suisse, Morgan Stanley, McKinsey, RobecoSAM, MSCI, and a range of academic institutions. Credit Suisse found that companies with at least one woman on their boards outperformed those with none by nearly 40 percent between 2006 and 2016. But action to diversify boards was often not initiated by companies: it took more than a decade of shareholders persistently asking companies to include women and minorities in every director search to bring more management attention to the issue. This often included filing shareholder proposals.

Another popular topic is reporting on and managing risks related to climate change, which accounted for votes on more than 175 resolutions in 2016. The costs to the global economy of ignoring the possibility of catastrophic climate change run into the trillions of dollars according to sources like Ernst & Young and the London School of Economics. That will impact the fortunes of countless companies and their investors if not addressed effectively. Companies that are leaders in assessing and managing climate risks outperformed their peers substantially, according to a report by Bloomberg. This is certainly an issue closely related to investors' financial interests. Investors made this abundantly clear recently, in response to shareholder proposals at Occidental Petroleum and Exxon asking the companies to report on the business impacts of climate change. The proposals passed, garnering 67 percent of the votes at Occidental and 62 percent of the votes at Exxon. Over a dozen other companies receiving a similar resolution garnered votes in the 40 to 50 percent range, a clear sign that investors understand the financial importance of addressing and planning around climate change.

A growing number of investors also like the idea of more transparency on both election spending and lobbying—as evidenced by a vote at FirstEnergy this year of 41.5 percent in favor of more complete reporting on lobbying. Companies have embraced this idea with relative alacrity—now fully 75 percent of the S&P 500 explain how they govern these lobbying expenditures and more than 60 percent disclose some details about lobbying. These numbers are up from much lower levels before the Citizens United case roiled the political landscape, as research from the Sustainable Investments Institute notes.

Governance reforms, diversity, human rights in the supply chain, environmental issues, safety of products, lobbying disclosure and consumer fraud are all issues that can have a meaningful impact on a company's reputation and bottom line. Most resolutions describe the business case for the request embodied in the resolution and provide a strong case supporting the long-term business and financial interests of the company.

It is encouraging to see the expanding conviction in the business community that leadership in sustainability is good for a company's long term financial value. In short, this is not simply an investor initiative appealing to companies for changes. It is becoming a norm for business itself.

Hundreds, if not thousands, of companies:

- Report on their sustainability and corporate responsibility programs;
- Adopt proxy access rules, providing investors with the right to nominate directors for vote by shareholders;
- Actively promote diversity programs and commit to non-discrimination in employment;
- Publicly disclose greenhouse gas emissions and their plans to reduce emissions as a contribution to combatting climate change.

And the list goes on. Companies themselves are championing leadership in governance and corporate responsibility.

When reviewing the list of more than 200 BRT CEO members, it is ironic to see that the majority publicly and proudly publish corporate responsibility reports and all report on their governance policies and commitments. They have embraced many of the themes raised through the resolution process. In addition, a significant number of BRT members actively and effectively engage with their shareholders on a wide range of issues. And many respectfully acknowledge the role shareholder resolutions play as part of those dialogues.

This leaves us perplexed about why their trade association, the BRT, has been such a fierce critic of the shareholder resolution process and the issues they raise.

Burdensome?

The ability of shareholders to communicate with boards, who are elected to represent them, is one of the fundamental rights that shareholders have, in exchange for providing capital to corporations. The shareholder resolution tradition stretches back approximately 75 years and has addressed hundreds of environmental, governance and social issues (without, we should add, impairing our ability to grow the economy and create jobs). It cannot—and should not—be dismissed as a process driven by shareholders with nonfinancial bees in their bonnets.

What is motivating the BRT to try to essentially eliminate this fundamental right of shareholders? While BRT states that this is a "member priority," in discussions with their members we haven't found one company that embraces the public goal of ending the current resolution process using an approach some investors call the "nuclear option" (eliminating virtually all shareholder resolutions). And let's be clear: this nuclear option is being proposed to stop something that is hardly a major threat.

There are about 4,300 publicly traded companies in the U.S. on NASDAQ and NYSE. In 2016, there were under 1,000 proposals filed. And, according to ISS, as of June 2017 there were approximately 485 resolutions on environmental, social issues and another 350 on traditional governance matters, figures that will grow by year end. Approximately 432 went to a vote since others were withdrawn by agreement or allowed to be omitted by the SEC.

That means less than one fifth of public companies in the United States received even one resolution. Since some companies received multiple resolutions, the percentage of listed companies that receive shareholder resolutions is likely far smaller. In addition, the vast majority of shareholder proposals are nonbinding. They communicate shareholder concerns, but do not oblige the companies to take specific actions. This is hardly a significant drag on the financial markets.

Much has also been made of the expense that companies bear in dealing with these proposals. Though the figure of $87,000 has been argued as the cost companies bear to deal with shareholder proposals, this number has been thoroughly critiqued as being overinflated, since it includes, for example, the entire cost of printing a proxy. We checked at random the most recent proxy statements of 20 of the members of the BRT, and came up with an average length of around 43,000 words. Shareholder proposals are limited by regulation to 500 words, meaning that any additional printing cost of the resolution and company response is essentially negligible. And considering that many shareholder proposals are withdrawn by their proponents after reaching agreement with the companies, even one percent is likely a high estimate. Adam Kanzer's post on this Forum presents a thorough and thoughtful critique of this misleading figure.

The Value of Listening

Listening to alternative points of view has been shown to be valuable to business. An article from HBR, for example, noted that teams with diverse backgrounds tend to focus more on facts than homogeneous teams and are more likely to constantly reexamine facts and stay more objective. Scientific American made similar points, noting that "people with different backgrounds bring new information," and "interacting with individuals who are different forces group members to prepare better, to anticipate alternative viewpoints and to expect that reaching consensus will take effort." These qualities are desirable for well-functioning boards of directors. Since most boards have less than 20 people on them, and many long-standing board members serve together for years, the tendency toward groupthink is natural even for good boards. Openness to ideas from outsiders—in this case, shareholders—can be a source of the alternative viewpoints that serve to make boards more diligent, more faithful to facts and better informed.

Moreover, boards are there to represent and serve the interests of shareholders. It seems logical that those shareholders should have a meaningful mechanism to communicate with boards that is not overly burdensome for the shareholders, especially minority shareholders, whose very presence has intrinsic value to the corporation, according to a very recent post on this Forum. Like the literature on diverse groups' decision making cited earlier, this post notes that "the wisdom from the multitude of retail shareholders might actually lead to better decisions than the wisdom of the few (controlling shareholder or managers.)"

It can be annoying to listen to the ideas of others, but over and over, we find that the ability to consider multiple points of view makes for better decision making, no matter what the context, whether it be a board of directors or a PTA.

While not every idea is worth pursuing, silencing them would be a very bad idea.