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SHAREHOLDER PROPOSALS: AN EXIT STRATEGY FOR THE SEC

By

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WLF

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ABOUT THE AUTHORS

Commissioner Daniel M. Gallagher was confirmed by the United States Senate as a Commissioner of the Securities and Exchange Commission on October 21, 2011 and sworn in on November 7, 2011. During this time he has focused on initiatives aimed at strengthening our capital markets and encouraging small business capital formation, including staunchly supporting the changes introduced by the JOBS Act. He has been an early and outspoken advocate for conducting a holistic review of equity market structure; increasing focus on the fixed income markets; addressing the outsized power of proxy advisory firms; and eliminating special privileges for credit rating agencies. He also has addressed the creeping federalization of corporate governance as well as the concerted efforts of special interest groups to manipulate the SEC's disclosure regime. He is a critic of the Dodd-Frank Act and the encroachment of bank regulatory measures and prudential regulators into the capital markets, and a vocal opponent of the disturbing trend toward empowering supranational groups to enact "one world" regulation outside established constitutional processes.

Before 2011, he was alternately in the private sector and at the SEC, including serving as a partner at WilmerHale; as counsel to SEC Commissioner Paul S. Atkins, counsel to SEC Chairman Christopher Cox, and Deputy Director and Co-Acting Director of the SEC's Division of Trading and Markets; and as the General Counsel of Fiserv Securities, Inc.

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The views expressed herein are those of the authors, and do not necessarily reflect the views of the Commission or any of the other Commissioners.

SHAREHOLDER PROPOSALS: AN EXIT STRATEGY FOR THE SEC

The 2015 proxy season brought yet another round of controversy for the Securities and Exchange Commission ("SEC" or "Commission") and its perennial problem child: the shareholder proposal process. A shareholder proposal is a shareholder's recommendation that a company or its board take a particular action, which the shareholder intends to bring for a vote at the company's next annual shareholders meeting.[1] This process is meant to replicate actual attendance and participation by the shareholder at the company's annual meeting. SEC rules require a company to include any shareholder proposal, and the shareholder's statement in support of the proposal, within the company's own proxy—at the company's expense—if the proposal meets the requirements of SEC Rule 14a-8. Such a requirement is completely anomalous within the securities laws.

Passions over the shareholder proposal process run deep. It is a cheap and easy way for an activist shareholder who is otherwise unsuccessful in engaging with a company,[2] and who cannot bear the expense of mounting a proxy contest, to force a vote on a pet issue. Sometimes that issue is actually germane to shareholder rights or corporate governance; other times, and with increasing regularity, it's an issue (*e.g.*, a social or political hot topic) that is important only to the activist proponent, and perhaps a small circle of similarly-situated investors. But either way, certain activist shareholders find the rule advantageous

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[1] *See* Rule 14a-8(a).

[2] "Activist" here is used broadly to indicate shareholders who seek to use their shareholdings to effect change at the company (*i.e.*, rather than selling their shares to express their dissatisfaction). While the term expressed this broadly would include the narrow class of "activist" hedge funds, it is notable that these funds typically do not rely on shareholder proposals to pursue their goals.

and are loath to permit even small alterations to the current ruleset. Issuers on the other hand tend to resent the distraction and diversion of corporate resources necessary to respond to shareholder proposals, including either by seeking to exclude proposals that are improper or by campaigning against proposals that must be included.

When passions run high on shareholder proposals, the SEC staff is inevitably trapped in the middle. Given the hot debate around the rule, it is regrettable that the Commission has shied away from offering much-needed rulemaking or official guidance. Meanwhile, every proxy season the SEC staff must respond, often within a compressed timeframe, to hundreds of "no-action" requests sent by issuers seeking to exclude shareholder proposals. It is an overwhelming and unfair burden to place on the staff, particularly when the ambiguity of Rule 14a-8, and the process by which the Commission has declared it will be administered, all but ensure controversial outcomes.

While some incremental improvements could be made within the current regime to better promote the usefulness of the shareholder proposal regime, it is not clear that the political will exists to move these forward—or, even if it did, that they would be a complete answer. Instead, the best solution would be to revisit an idea last raised in the late 1990s: devolve shareholder proposals back to the states, which traditionally and appropriately have been allotted authority over corporate governance matters. The state in which a company is incorporated would have the latitude to decide under what circumstances to permit shareholder proposals, and would adjudicate any questions about whether a proposal must be included. The SEC staff's role could be limited to determining whether the proposal and any supporting or opposing statements authorized by state law contain any material misstatements or omissions.

I. ORIGIN OF SHAREHOLDER PROPOSALS

Shareholder proposals have their origin in the longstanding tension that exists between state and federal law regarding corporate governance matters. U.S. corporations are incorporated under the law of a state, and the parameters of the rights and obligations of boards, management, and shareholders are all governed by that state's law. By contrast, the SEC's remit is to require corporations that are subject to the SEC's periodic reporting requirements (typically, because they are exchange-listed or because they have a widely-dispersed shareholder base) to make proper disclosures to their shareholders to permit them to make informed investment or voting decisions. But frequently, these two spheres of regulatory responsibility intersect, and shareholder proposals are one such area. State corporation laws provide shareholders with the right to present a proposal on the floor of the annual general meeting of shareholders ("AGM"). But communications in advance of the AGM, including solicitation of proxies for items to be voted on at the meeting, are governed by federal securities laws.

Very soon after the SEC's formation, the question was presented to the SEC of what, if anything, a company's proxy solicitation should say about a shareholder proposal. In 1939 the SEC announced that if a shareholder were to tell a company in advance of the shareholder's intent to bring a proposal on the floor of the AGM, it would be misleading for the company to remain silent in its proxy materials.[3] In 1940, the SEC determined that a

[3]Fifth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1939 (1940) at 62, available at https://www.sec.gov/about/annual_report/1939.pdf (relating a matter in which, prior to the preparation of the company's proxy solicitation material, a stockholder informed the company's president that he intended to bring forward at the annual meeting certain amendments to the company's bylaws; "[t]he Commission took the view that, since the proposed amendments pertained to matters to which the stockholders might properly address themselves, and since the management was advised of the proposed

company must allow shareholders to vote by proxy on floor proposals, and must describe that process.[4] The fatal flaw occurred in 1942, when the SEC required companies to include within their proxy materials *any* proposals they had received on reasonable notice from a proponent that are proper for stockholder action.[5] In 1945, the SEC wisely clarified that proper subjects for stockholder action would be determined under state law, but that proposals raising matters of a general political, social, or economic nature were *not* appropriate for a shareholder proposal.[6] The first modern version of the rule was adopted in 1947, directing issuers who intended to omit a proposal from the issuer's proxy (because it was not a proper subject for action or was untimely) to send the Commission notice of this

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amendments prior to the time its proxy soliciting material was prepared and sent to stockholders, and since the proxies were apparently to be used for purposes of a quorum supporting action upon the proposed amendments, the omission from the proxy soliciting material of information concerning such amendments rendered [the company's solicitation] misleading within the meaning of Regulation X-14 [the name of the proxy rules then in effect]").

[4]Sixth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1940 (1941) at 114, available at https://www.sec.gov/about/annual_report/1940.pdf ("For example, a stockholder who desires to secure Corporate action on a suggestion of his own can be assured that in most cases his proposal will be submitted to the other stockholders of the corporation if he gives timely notice to the management of his intention to present the matter at the annual meeting. *Thereafter, if the management solicits proxies, it must include in its own proxy material a description of the proposal and must give the stockholders an opportunity to state whether their proxies shall be voted for or against the proposal*. In cases where independent solicitation is deemed desirable, however, the proxy rules provide that a management soliciting proxies must cooperate in mailing soliciting literature of minority groups" (emphasis added)).

[5]Rel. No. 34-3347, Solicitation of Proxies Under the Act (Dec. 18, 1942) [7 Fed. Reg. 10655 (Dec. 22, 1942)] (adopting new Rule 14a-7, providing that management must set forth shareholder proposals in the company's proxy, if reasonable notice is given of the shareholder's intent to do so (with 30 days deemed reasonable), and the proposal is a proper subject for action by the security holders, and providing further that if management opposes the proposal, it must publish a proponent's statement in support of not more than 100 words, responsibility for which is the security holder's, not management's).

[6]Rel. No. IA-735, Letter of the Director of the Division of the Corporation Finance Division relating to section 20 and to Rule X-14A-7 under the Securities Exchange Act of 1934 (17 CFR, 240.14a-7) (Jan. 3, 1945) [11 Fed. Reg. 10995 (Sept. 27, 1945)] ("Speaking generally, it is the purpose of Rule X-14A-7 (17 CFR, 240.14A-7) to place stockholders in a position to bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matters relating to the affairs of the company concerned as are proper subjects for stockholders' action under the laws of the state under which it is organized. It was not the intent of Rule X-14A-7 to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature. Other forums exist for the presentation of such views.").

intent, along with a copy of the proposal and a statement of the grounds for omission.[7] Unsurprisingly, companies then began asking the SEC for concurrence with their determination before omitting the proposal from the proxy. As a result, the SEC was thrust into the position of adjudicating whether shareholder proposals could be excluded from the proxy.

The current shareholder proposal rule follows much the same format as the version adopted in 1947: it requires companies to include a shareholder's proposal in the company's proxy, unless a ground for exclusion is met; if a company intends to rely on a ground for exclusion, it must provide that justification to the SEC in advance. The main adjustments since 1947 have been to refine the grounds for exclusion, some of the more controversial of which are discussed in Section II below, and also to add shareholding requirements for the proponent.[8] These modifications over time have resulted in the current version of the rule.

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[7]Rel. No. 34-4037, Solicitation of Proxies (Dec. 16, 1947) [12 Fed. Reg. 8768 (Dec. 24, 1947)] (adopting amendments to what was reclassified as Rule 14a-8 to direct issuers to file with the Commission a notice of the issuer's intent to exclude a shareholder proposal from the proxy, a copy of the proposal, and a statement of the grounds therefor (i.e., not a proper subject for action by security holders, or lack of required notice before the meeting)).

[8]Specifically:

•In 1948 the SEC added exclusions for proposals redressing personal grievances, proposals from proponents who failed to show up at the meeting and submit their proposal, and a bar on proposals similar to those receiving less than a 3% vote. Rel. No. 34-4185, Solicitation of Proxies (Nov. 5, 1948) [13 Fed. Reg. 6678, 6679 (Nov. 13, 1948)].

•In 1952, the SEC added an exclusion for proposals raising general economic, social, racial, religious, social, or similar causes (codifying the 1945 interpretation). Rel. No. 34-4775, Solicitation of Proxies (Dec. 11, 1952) [17 Fed. Reg. 11431, 11433 (Dec. 18, 1952)].

•In 1954 the SEC added the ordinary business exclusion and updated the resubmission bar. Rel. No. 34-4979, Solicitation of Proxies (Jan. 6, 1954) [19 Fed. Reg. 246, 247 (Jan. 14, 1954)].

•In 1967, the SEC adopted an exclusion for proposals that conflict with management proposals. Rel. No. 34-8206, Proxy and Stockholder Information Rules (Dec. 14, 1967) [32 Fed. Reg. 20960 (Dec. 29, 1967)].

The qualification requirements for the proponent were added in 1983: that the proponent must have owned at least 1% or $1,000 (whichever is lesser) of the company's shares for at least a year. Rel. No. 34-20091, Specifically, today, a shareholder bringing a proposal must have held either (1) $2000 in market value, or (2) at least 1%, of the company's securities entitled to vote on the proposal for at least one year before the proposal is submitted.[9] The proposal, and any accompanying statement in support, cannot exceed 500 words, and must be submitted at least 120 calendar days before the company's proxy statement for a regularly-scheduled annual meeting is released to shareholders. Moreover, under Rule 14a-8(i), the proposal must:

> (1) be a proper subject for action by shareholders under the laws of the company's state of incorporation;
>
> (2) not, if implemented, cause the company to violate state, federal, or foreign law;
>
> (3) not be contrary to any of the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials;
>
> (4) not seek to redress a grievance or further an interest not shared by all shareholders;
>
> (5) not be irrelevant by relating to less than 5% of total assets, net earnings, or gross sales;
>
> (6) be within the company's power to implement, if adopted;
>
> (7) not relate to the company's ordinary business operations;
>
> (8) not relate specifically to the election of directors;
>
> (9) not conflict with an item the company has placed on the proxy;
>
> (10) not have been substantially implemented already;
>
> (11) not duplicate another proponent's proposal that will be included in the proxy;
>
> (12) not deal with a matter voted on in prior years unless a certain percentage of votes were cast in favor in those years; and
>
> (13) not relate to specific amounts of dividends.

Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders (Aug. 16, 1983) [48 Fed. Reg. 38218 (Aug. 23, 1983)].

[9]The securities must be held through the date of the meeting.

Unfortunately, the shareholder proposal requirement has become completely unmoored from its historical antecedents. Rather than simply reflecting what was likely to occur *procedurally* at the AGM, the SEC has created *substantive* corporate governance regulations by defining what may or may not be brought as a shareholder proposal within the SEC's lengthy set of rules. While these grounds for exclusion may be well-intentioned (*e.g.*, anti-abuse in the case of resubmissions, or reflective of fundamental state corporate law tenets in the case of the ordinary business exception), they are nonetheless a use of the SEC's disclosure authority to enact substantive corporate governance regulations. But the substance of corporate governance has historically been, still generally is,[10] and *should be left* to the states. Some key flashpoints with the shareholder proposal rule show exactly why the SEC is ill-suited to this task.

II. KEY CONTROVERSIES

A. Social Policy in the 1970s—*Dow Chemical*

As noted above, in 1945, the Commission published an opinion of the Director of the Division of Corporation Finance ("Division") dictating that proposals dealing with general political, social, or economic matters were not encompassed within the scope of the shareholder proposal rule. In 1954, the Commission first added the "ordinary business" ground for exclusion, permitting management to exclude "a proposal which is a recommendation or request with respect to the ordinary business operations of the

[10] Although there has been an increased federalization of corporate governance rules over the past 15 years, beginning in earnest with the Sarbanes-Oxley Act of 2002, and greatly increasing in the Dodd-Frank Wall Street Reform and Consumer Protection Act, these provisions still remain the exception, not the rule.

issuer."[11] This combination of rules was effective at limiting proposals to corporate governance for a time, but a combination of a push by certain activists in the 1960s[12] and the *Dow Chemical* case in 1970 opened the floodgates.

With regard to the latter, in 1968 the Medical Committee for Human Rights ("MCHR") had sought to introduce a shareholder proposal at the Dow Chemical Company's AGM regarding Dow's manufacturing of napalm—specifically, that it only be sold to those who promise not to use it on other humans. After no action was taken, MCHR advanced the proposal again in 1969. Dow refused to include the proposal in the proxy, and the Division concurred. MCHR then sued to force the inclusion of the proposal.

The D.C. Circuit remanded to the Commission, strongly criticizing the effect of the SEC's rule as trying to impale the proposal on the horns of a dilemma: too general, and a proposal is excludable as a general social matter; too specific, and it is excludable for relating to ordinary business. While recognizing that the shareholder proposal rule is not a vehicle for shareholders to "vent their spleen about irrelevant matters," nor should it be a vehicle for "investors [to] assert the power to dictate the minutiae of daily business decisions," the court in *dicta* stated that there is no reason why shareholders should not be able to present "to their co-owners, in accord with applicable law, the question of whether they wish to have their assets used in a manner which they believe to be more socially responsible but less profitable than that which is dictated by present company policy."[13]

[11]*See supra* note 8 (1954 Release).

[12]*See*, *e.g.*, Maya Mueller, Note, *The Shareholder Proposal Rule: Cracker Barrel, Institutional Investors, and the 1998 Amendments*, 28 STETSON L. REV. 451 (1998) (noting the origins of this movement with Ralph Nader's Campaign GM).

[13]*Medical Committee for Human Rights v. Securities and Exchange Commission*, 432 F.2d 659, 678-679, 681 (D.C. Cir. 1970). Of course, the holding was not based on that expansive note, but rather on evidence in the

The SEC responded to this perceived rebuke by adopting pro-proponent revisions to its shareholder proposal rules, most notably by narrowing the general social, political, or economic matters ground for exclusion to proposals that are "not significantly related to the business of the issuer or not within its control." (And, by the latter, meaning "beyond its power to effectuate.") Proponents responded accordingly: in 1972 there were 6 proposals involving public policy issues; in 1976, there were *322*.[14]

In 1976, the SEC furthered the trend, this time by narrowing the ordinary business ground for exclusion. Although the SEC re-adopted Rule 14a-8(c)(7) declaring that registrants may omit proposals relating to the ordinary business operations of the registrant, it recognized that the "standard for omission has created some difficulties in the past, and that, on occasion, it has been relied upon to omit proposals of considerable importance to security holders." Therefore the SEC directed that the provision must be "interpreted more flexibly than in the past" to include issues whose magnitude pushes them out of the realm of ordinary business.[15]

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record that Dow's management was continuing to produce napalm *despite* its being unprofitable to do so, and that the notion of corporate democracy was inconsistent with a result that permitted managers to "treat modern corporations with their vast resources as personal satrapies implementing personal political or moral predilections." *Id*. at 681. The case was appealed to the Supreme Court, but subsequently mooted when Dow agreed to include the proposal.

[14]See Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984) (noting the increase but saying that it was not clear whether *Dow Chemical*, the 1972 amendments, or the general "political unrest of the times" was the primary cause for it).

[15]Rel. No. 34-12999, Adoption of Amendments Relating to Proposals by Security Holders (Nov. 22, 1976) [41 Fed. Reg. 52994 (Dec. 3, 1976)] (providing the example of a shareholder proposal to a utility company to construct a nuclear power plant—such proposal had previously been excluded as ordinary business but the economic and safety considerations of nuclear power would make the issue of "such a magnitude that the determination whether to construct one is not an 'ordinary' business matter" and that "proposals of that nature, as well as others that have major implications, will in the future be considered beyond the realm of an issuer's ordinary business operations").

B. 1980s Amendments

In 1982, the Commission proposed for comment several alternatives for fundamental changes to the rule, as part of a wide-ranging proxy review program. Intriguingly, the Commission very briefly teed up the question of whether "security holder access to the issuer's proxy statement should be provided under the Securities Exchange Act of 1934 or left to regulation under state law." [16] However, most of the release focused on a set of alternative proposals that assumed that the Commission would retain jurisdiction over the matter. One proposal was to tweak existing provisions; the second proposal was to permit a company and its shareholders to adopt their own set of procedures, to be approved by the shareholders, governing shareholder proposals. The third proposal was to require companies to include all proposals that are proper under state law and do not involve the election of directors. Comments on the more radical approaches were not favorable. On the threshold question, comments expressed "extensive support" for the continued administration of the rule by the Commission.[17] Although issuers supported Proposal 2, some commenters expressed concerns about the lack of uniformity that it could create. Only a handful of commenters supported Proposal 3. Thus, the 1983 revisions only changed the existing rule incrementally.

C. 1997 Amendments—Cracker Barrel

In 1992, the SEC via no-action letter to Cracker Barrel Old Country Stores announced that shareholder proposals addressing corporate employment policies could be excluded as

[16]Rel No. 34-19135, Proposed Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders (Oct. 14, 1982) [47 Fed. Reg. 47420 (Oct. 26, 1982)].

[17]Rel No. 34-20091, Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders (Aug. 16, 1983) [48 Fed. Reg. 38218 (Aug. 23, 1983)].

ordinary business, across the board. There, shareholders had sought to challenge the store's policy, adopted in 1991, to cease hiring or employing gay or lesbian workers. The shareholder challenged the SEC in court, and any application of Rule 14a-8(i)(7) was held in abeyance until the Second Circuit vacated the federal district court's injunction in 1995. The Court held that the no-action letter was not a legislative rule and thus notice and public comment were not required.[18]

In 1997, in response to a congressional mandate in the National Securities Markets Improvement Act that the SEC conduct a comprehensive study of shareholder proposals,[19] the SEC distributed to the public a non-scientific questionnaire to the public on shareholder proposals.[20] Taking into account the responses to the questionnaire plus additional staff-solicited views, the staff's proposed rule suggested that the SEC could

> withdraw entirely from the area, leaving it to each state to adopt its own shareholder proposal rule to govern what proposals are appropriate to be included in companies' proxy materials. The shareholder proposal process affects the internal governance of corporations, and it is state law—not federal securities law—which is primarily concerned with corporate governance matters.[21]

In releasing that proposal, the Commission did solicit comment on this option, despite seeming to stack the deck against it by indicating that the respondents to the prerelease solicitation of comments were not in favor of fundamental changes to the shareholder proposal process. Specifically, the release relayed that shareholder-respondents to the

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[18] *N.Y. City Employees' Retirement Sys. v. SEC*, 45 F.3d 7 (2d Cir. 1995).

[19] The inclusion of this provision in the legislation had been prompted by the Cracker Barrel controversy. *See* Mueller, *supra* note 12 at 482-84.

[20] Rel. No. 34-39093, Amendments to Rules on Shareholder Proposals (Sept. 18, 1997), available at https://www.sec.gov/rules/proposed/34-39093.htm (describing the distribution of "a Questionnaire on shareholder proposals" that was "not design[ed] . . . to obtain a scientific sampling" but rather to provide "some indication of the views of interested shareholders and companies").

[21] *Ibid*.

questionnaire overwhelmingly rejected two of the chief alternatives: permitting companies to agree with their shareholders on company-specific mechanics, and devolving Rule 14a-8 to the states. They also generally disfavored the 1982 alternative (all proposals permitted under state law, up to a numerical cap). Companies, interestingly, were evenly split on the question of company-specific rules; companies generally disfavored the other two views.[22]

The final rule declined to pursue any fundamental change, without much explanation of why.[23] It did, however, reverse its Cracker Barrel no-action letter, returning to a case-by-case determination of whether the employment policy at issue raises social issues that transcend the day-to-day operations of the company.[24] While arguably this position makes more sense—there does not seem to be a basis for treating employment policies any different than other policies covered by ordinary business—the continued case-by-case analysis of issues under (i)(7) is deeply inefficient.[25]

III. CURRENT LANDSCAPE FOR SHAREHOLDER PROPOSALS

According to Institutional Shareholder Services ("ISS"), there were more than 1,030 shareholder proposals submitted during the 2015 proxy season, with 470, or 45%—a

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[22] *Id*. at n.28.

[23] Rel. No. 34-40018, Amendments to Rules on Shareholder Proposals (May 21, 1998), available at https://www.sec.gov/rules/final/34-40018.htm.

[24] *Ibid* ("In addition, as a result of the extensive policy discussions that the Cracker Barrel position engendered, and through the rulemaking notice and comment process, we have gained a better understanding of the depth of interest among shareholders in having an opportunity to express their views to company management on employment-related proposals that raise sufficiently significant social policy issues.").

[25] The other main "achievement" of the 1997 amendments was to recast them into a question-and-answer format that was in vogue at the time as a way to make regulations more readable for the public. Unfortunately, because the shareholder proposal rules address both the obligations of shareholder proponents and the issuers that are the target of the proposals, the language was quite tortured. For example, Question 10 is "What procedures must the company follow if it intends to exclude my proposal?"—*i.e.*, the shareholder is still treated as the subject of the regulation, even though the topic clearly makes the company the regulated party.

plurality of all proposals—focused on Environmental and Social ("E&S") matters. However, such matters had attracted only a *single* majority vote, and support overall for E&S shareholder proposals averaged 20.1%.[26] With approximately 40% of E&S proposals withdrawn, however,[27] one wonders how frequently companies are agreeing to some package of concessions in exchange for withdrawal of the proposal—even where, if the proposal went to a vote, a majority of shareholders might vote against the proposal.[28] As for the remainder: 43% of all proposals were for governance issues, and 12% addressed compensation issues.[29] Those proposals were slightly more popular than E&S proposals, garnering an average level of support of 43.7% and 29.2% respectively.[30]

The identity of proponents continues to overwhelmingly represent gadflies, social activists, and organized labor. Looking at proposals submitted in 2015 to the Fortune 250, gadflies were responsible for 33% of proposals, social investors for 29%, and labor-affiliated investors for 28%. Institutional investors accounted for less than 1% of proposals[31]—in fact, there was but a *single* proposal by an activist (Nelson Peltz's Trian Fund at DuPont).[32]

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[26]Patrick McGurn & Edward Kamonjoh, INST'L SHAREHOLDER SERVICES, Preliminary 2015 Postseason Review 5-6 (July 30, 2015), available at http://www.issgovernance.com/file/publications/1_preliminary-2015-proxy-season-review-united-states.pdf.

[27]*Ibid*.

[28]Obviously, it is difficult to tell whether the companies are agreeing to some concession because they believe that the proposal, if it went to a vote, would be more likely to pass than at companies that are putting up a fight — or whether such companies simply find it less of a distraction to expend shareholder money to take such actions as would mollify the proponents than it is to contest the issue.

[29]McGurn, *supra* note 26 at 10.

[30]*Ibid*.

[31]James R. Copeland, Proxy Monitor, 2015 Proxy Season Wrap-up, at http://www.proxymonitor.org/Forms/2015Finding4.aspx. The extra 10% not included are other individuals, such as John Harrington, who runs a socially-responsible investment fund, Harrington Investments, making proposals in his own name.

[32]*Ibid*.

“Ordinary” institutional investors directed no proposals in 2015 to the Fortune 250.

Against this backdrop of burgeoning numbers of proposals, including proposals that are continually overwhelmingly rejected by investors when put to a vote, three recent developments in particular have exposed serious fault lines in the SEC’s administration of the shareholder proposal rule.

A. Express Scripts

In 2014, a district court in Missouri granted summary judgment to Express Scripts Holding Co., ruling that the company could exclude a shareholder proposal brought by John Chevedden “seeking adoption of a policy requiring the chairman to be independent of company management.” The proposal and statement in support contained four separate misstatements regarding the company’s existing corporate government practices, which the court determined were material to a stockholder’s decision about whether to vote for the shareholder proposal. The district court determined that the proposal was excludable under Rule 14a-8(i)(3) and Rule 14a-9.[33]

Remarkably, Express Scripts did not bother to engage with the Division of Corporation Finance’s no-action process. Rather, it simply filed a letter on December 18, 2013 notifying the Division of its intent to exclude the proposal, and then filed the declaratory judgment action with the court. As the court correctly noted in the opinion, the Division has consistently maintained that “[o]nly a court such as a U.S. District Court can decide whether a company is obligated to include shareholder proposals in its proxy materials.” So while the Company was completely within its rights to seek injunctive relief, it

[33] *Express Scripts Holding Co. v. Chevedden*, 2014 WL 631538 (E.D. Mo, Feb. 18, 2014).

was remarkable that it had to: the company's 2013 proxy statement and other corporate filings clearly contradicted the assertions made in the shareholder proposal, and so determining that the proposal could be excluded should not have been difficult.

Unfortunately, SEC Staff Legal Bulletin ("SLB") 14B extricated the staff from the determination of the truth or falsity of statements subject to Rule 14a-8(i)(3).[34] Express Scripts apparently felt that, in light of SLB 14B, the staff no-action process would be futile. Given that a federal court determined that there were material misstatements, this is a perfect example of the infirmities of the staff no-action process.

The SLB 14B approach to 14a-8(i)(3) matters is understandable from a resource allocation perspective, but it results in the under-administration of what is a legitimate ground for exclusion. This abdication does a disservice to issuers, forcing them to engage in expensive litigation to vindicate their substantive rights under SEC's own rules. And if the SEC's expectation is that issuers must include potentially misleading statements by proponents in the issuers' proxies, and let investors fend for themselves, then this approach does a significant disservice to those investors. If the SEC staff, with all its resources, finds it too difficult to make sensitive determinations about whether a proposal or statement in support contains a false or misleading statement, the solution cannot be to throw the matter over to investors already struggling to get through dense, turgid disclosure documents. And yet that is where the SEC is today: rather than squarely placing the burden on the proponent to ensure that the proposal is accurate and clear, proponents are

[34]In Staff Legal Bulletin 14B, issued in 2004, the Staff curtailed the use of this ground for exclusion in light of the extensive Staff resources that were being consumed in their line-by-line review of shareholder proposals, instead forcing issuers to use their statement in opposition to take issue with factual inaccuracies or vagueness.

permitted to put incomplete or wrong information before investors, in the vague hope that companies might use their precious resources to rebut the falsehoods.

In the 2015 proxy season, the staff did reject one shareholder proposal on the ground that it was false or misleading,[35] but this was an exception rather than the rule. The underlying numbers speak more loudly: grants of exclusion under (i)(3) were down *significantly* in the 2015 proxy season, indicating that this problem may be getting worse, not better. Specifically, whereas in the 2014 proxy season 18% of proposals were excluded for being false or misleading, or vague, in the 2015 proxy season only *2%* of proposals were excluded on (i)(3) grounds. The low rate here is all the more remarkable when you consider that 58% of company no-action submissions contained an (i)(3) argument.[36] So it seems that, rather than improving administration of (i)(3) to make the SEC a more reliable arbiter of whether proposals fall afoul of Rule 14a-8(i)(3) in the wake of Express Scripts' exclusion effort, the staff has become even more hesitant to issue no-action letters on this basis.

B. *Trinity Wall Street v. Wal-Mart Stores, Inc.*

In July 2015, the U.S. Court of Appeals for the Third Circuit handed down an opinion reversing a district court determination that Wal-Mart Stores, Inc. must include in its proxy statement a shareholder proposal seeking that Wal-Mart's board develop and implement standards on whether to sell products that "especially endanger[] public safety," that have

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[35] *See* Ferro Corporation (Mar. 17, 2015) ("In our view, you have demonstrated objectively that certain factual statements in the supporting statement are materially false and misleading such that the proposal as a whole is materially false and misleading.").

[36] *See* Gibson, Dunn & Crutcher LLP, Shareholder Proposal Developments During the 2015 Proxy Season (Jul. 15, 2015). To be sure, some or even a large part of this trend may be attributable to the fact that (i)(3) arguments are frequently included in no-action requests as part of a kitchen sink strategy—it is relatively easy to argue that a word-limited proposal is vague in some manner. But the magnitude of the drop over historical antecedents is nonetheless concerning.

"the substantial potential to impair the reputation of Wal-Mart" or that "would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand."[37] While phrased neutrally, the proposal sought to get at the issue of high-capacity ammunition magazines. The Division had issued a no-action letter to Wal-Mart permitting the retailer to exclude the proposal under Rule 14a-8(i)(7), relating to ordinary business. Indeed, what could be more ordinary business for a retailer than a decision of what products to stock? Trinity sued, and ultimately won in District Court, before being rebuffed by the Third Circuit.

The Third Circuit determined that the substance of the proposal should govern over its form, and that the proposal related to Wal-Mart's inventory decisions—a matter at the core of a retailer's ordinary business operations. Thus the proposal was properly excludable unless it also raised a "significant social policy" exception that transcends Wal-Mart's day-to-day operations. The majority of the panel found that it did not; it did raise a significant social policy issue, but the issue is so interwoven with the ordinary business of Wal-Mart that it does not qualify. The concurring judge would have determined that because the proposal did not actually focus on high-capacity magazines, the significant social policy bar was not even met.[38]

It's perhaps telling that the court could not even agree on the proper methodology to apply to analyses under Rule 14a-8(i)(7): the one-step test of the concurrence, or the two-step test of the majority. Other commentators have argued that the court got the analysis

[37] *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 792 F.3d 323, 327 (3d Cir. 2015).

[38] Trinity has reportedly now appealed the Third Circuit's ruling to the Supreme Court. *See* Sarah Nassauer, *New York Church Appeals to Supreme Court in Lawsuit Against Wal-Mart*, WALL ST. J. (Sept. 17, 2015). While it is not clear that the Supreme Court would have the appetite to take up an appeal of this issue, it is obvious that the controversy over this issue has not yet run its course.

wrong entirely.[39] One might take this as a critique of the court, but in truth it is more fundamentally a critique of Rule 14a-8 and the administration thereof. In closing out its opinion, the court bluntly suggested that the SEC needed to get its act together and clarify how parties should be interpreting Rule 14a-8.[40] This was an extraordinarily unusual rebuke—but good advice.

This case raises a smorgasbord of issues, starting with one of the thorniest questions in the Rule 14a-8 space: what does "ordinary business" mean and, then, what does "significant social policy" mean, and how do those interrelate? These were the key questions at issue in *Dow Chemical*, and remain no less controversial in *Trinity*—nearly 45 years later. That the SEC has been struggling for 45 years to come up with a coherent approach to shareholder proposals raising significant social policies, and is no closer now to a solution that eliminates some of the heated controversy, indicates a deeper problem in the basic formulation of this rule.

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[39] *See*, *e.g.*, J. Robert Brown, Jr., *Trinity Wall Street v. Wal-Mart Stores, Inc.: Judicial Rewriting of the Proxy Rules*, TheRacetotheBottom.org (Sept. 2, 2015); Stephen M. Bainbridge, *Two Cheers for* Trinity Wall Street v. Wal-Mart: *The Awkward New Test for Ordinary Business Exclusion*, Washington Legal Foundation LEGAL BACKGROUNDER, Aug. 21, 2015, available at http://www.wlf.org/upload/legalstudies/legalbackgrounder/082115LB_Bainbridge2.pdf.

[40] *See Trinity Wall Street*, *supra* note 37 at 351("Although a core business of courts is to interpret statutes and rules, our job is made difficult where agencies, after notice and comment, have hard-to-define exclusions to their rules and exceptions to those exclusions. For those who labor with the ordinary business exclusion and a social-policy exception that requires not only significance but 'transcendence,' we empathize. Despite the substantial uptick in proposals attempting to raise social policy issues that bat down the business operations bar, the SEC's last word on the subject came in the 1990s, and we have no hint that any change from it or Congress is forthcoming. As one former SEC commissioner has opined, 'it is neither fair nor reasonable to expect securities experts [like the Commission and its staff] to deduce the prevailing wind on public policy issues that have yet to be addressed by Congress in any decisive fashion.' That remains true today. We have no doubt that the Commission is equipped to collect 'relevant data and views regarding the best direction for its regulatory policy.' *We thus suggest that it consider revising its regulation of proxy contests and issue fresh interpretive guidance*. In the meantime, we hold here that Trinity's proposal is excludable from Wal-Mart's proxy materials under Rule 14a-8(i)(7)" (emphasis added) (internal citations omitted).

One manifestation of this flawed formulation is that it places the staff on the hot seat to determine which social policies are or are not significant. Despite their incredible talents, the SEC staff is not well-placed to make this judgment. That the initial inquiry often involves online searches to see how much “buzz” there is about the topic is pragmatic, but disheartening. After all, what else could the staff be expected to do? But the permissibility of an entire class of proposals should not turn on the number of search results for an issue. Moreover, there is no mechanism for the Commissioners to have any input on what constitutes a significant social policy issue. As this decision is made by the staff, and not through delegated authority that a Commissioner can traditionally use to force a full Commission review of a staff action, it evades meaningful oversight and review by the presidentially-appointed, politically-accountable members of the Commission.[41] This evasion is bad for Commission policymaking and unfair to the staff. The Commission’s five presidential appointees should not be hiding behind career staff on major policy issues.

Thus, the ordinary business exception generates outsized controversy for the shareholder proposal rule. SEC often sees dubious “significant policy issue” proposals, such as “net neutrality” back in 2012.[42] There is also the seeming inconsistency of determining an issue not to be significant in one year, and then reversing it in another.[43] Whereas it is entirely possible that an issue could have attained an additional degree of significance in the

[41] 17 CFR § 202.1(d) does provide for the staff to seek the informal views of the Commission on complex matters, but this is a “push” from the staff rather than a “pull” from the Commission. Moreover, there is no established way to apply that rule in the context of shareholder proposals.

[42] In 2012, the staff denied no-action relief to AT&T, Verizon, and Sprint on a net-neutrality proposal, even though in prior years proposals on that same topic were deemed excludable as ordinary business.

[43] For example, the staff in 2013 denied no-action relief to PNC Bank with respect to a proposal requesting a report on greenhouse gas emissions resulting from its lending portfolio, on the grounds that climate change is a significant policy issue—arguably a reversal of a prior staff position.

period since the last decision was made, given the lack of guidance for making the initial determination, the grounds on which the staff might change its mind are even less clear. Finally, there is the perennial problem with significant policy issues being treated as a one-way ratchet: once a matter is deemed significant, it is nearly impossible to pull back that decision.[44]

C. Whole Foods and Proxy Access

After the entirely proper demise of the ill-considered proxy access rule in 2011,[45] it was left to private ordering to determine how to engage in proxy access. There was little discussion about the issue until the 2015 proxy season, when the topic roared back with a vengeance. Two factors contributed to bringing this issue to the front burner. First, the New York City Comptroller, acting on behalf of the various New York City pension funds, launched the Boardroom Accountability Project—a campaign to get proxy access, on terms largely paralleling the Commission's rebuffed rule, passed across 75 companies.[46] Second, the SEC granted, then withdrew following tremendous public outcry, a no-action letter to Whole Foods Market Inc. permitting it to exclude a proxy access proposal.[47]

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[44] *Trinity Wall Street* also raised another significant problem: that the court was forced to look to antique Commission releases for guidance because staff no-action letters are not an articulation of the Commission's views, and the subsequent body of interpretive positions that have been built up over the years by the staff is therefore not entitled to judicial deference, except insofar as they were given "careful consideration as 'representing the views of persons who are continuously working with the provisions of the statute [the regulation in our case] involved' or whether the lack of Commission response to consistent staff interpretations "may signal Commission approval of these positions." *See Trinity Wall Street*, *supra* note 37, at 342 n.11 (internal citations omitted). Issuers, shareholders, and apparently the courts deserve better.

[45] *See Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission*, 647 F.3d 1144 (D.C. Cir. 2011).

[46] Office of the New York City Comptroller, Boardroom Accountability Project, at http://comptroller.nyc.gov/boardroom-accountability/ (last visited Sept. 15, 2015).

[47] *See* Whole Foods Market, Inc. (Jan. 16, 2015), available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2015/jamesmcritchiecheveddenrecon011615-14a8.pdf.

As for the Project, there is clearly a time and place to have the debate about proxy access. Indeed, it is entirely appropriate, given that one of the primary reasons for striking down a mandatory proxy-access rule was that private ordering between companies and their shareholders can give rise to appropriate proxy-access provisions. But important corporate governance issues requiring nuanced debate are better suited for a forum other than a series of shareholder proposals. Commissioner Gallagher has been advocating for Harvard Professor Guhan Subramanian's approach, set out earlier this year in the Harvard Business Review—that we need a "clean sheet" approach to corporate governance based on bargaining among the interested parties.[48] The SEC should take up the mantle of convening and intermediating a forum for this type of bargaining since, in theory, the agency is or should be a third-party neutral among the interested parties, as the regulation of corporate-governance rights and obligations should be a matter of state law. Professor Subramanian's paper and other research suggest that proxy access is beneficial for public companies, but that it should be part and parcel of a negotiated approach to a better system of corporate governance.[49]

This would be a welcome development, but it is not advanced (or, one could argue, has been hindered) by the availability of shareholder proposals, which are narrow, single-issue votes on discrete matters that too often suffer from a lack of context. A well-functioning shareholder proposal regime might have a relief valve that refers important new corporate governance developments to a consultative or deliberative body, to work on best

[48]Guhan Subramanian, *Corporate Governance 2.0*, HARV BUS. REV. (Mar. 2015), available at https://hbr.org/2015/03/corporate-governance-2-0.

[49]*Ibid*.

practices and recommendations,[50] rather than putting it on the ballot at hundreds of companies and hoping for the best. Unfortunately, "well-functioning" is not an attribute of Rule 14a-8.

Putting aside such aspirational goals for a model of how to debate corporate governance, the SEC still needed to administer Rule 14a-8 with respect to the proxy-access proposals that were received this past proxy season. Unfortunately, this did not happen. Specifically, in December 2014, the Division granted no-action relief to Whole Foods Market Inc., which had sought to exclude a proxy-access proposal on the ground that it intended to put a proposal of its own on the ballot, even though the company's competing proposal was structured such that it would be nearly impossible for any investor to make use of the new right. But Rule 14a-8(i)(9) provides that if the company is offering a competing proposal, then the company can exclude the shareholder's proposal, on the theory that split voting on the proposals may create an outcome that is confusing for the company to implement. In the end, the company put forth a competing proposal that was much less severe than the one that it had submitted for no-action relief, but the damage was done: the overreaching nature of the original proposal provoked substantial controversy.[51]

To address the uproar, in January 2015 SEC Chair Mary Jo White directed the Division to withdraw Whole Food's no-action letter, and then also to cease issuing no action letters not only on proxy access proposals under Rule 14a-8(i)(9), but for *all* proposals sought to be

[50] For proxy access, matters for discussion might include the mechanics of the proxy access right (*e.g.*, which shareholders should be entitled to put forward candidates, and how much of the Board could be elected in such manner), or the characteristics of the company at which proxy access is sought to be advanced (*e.g.*, is it appropriate at every company, or only those lacking some alternative quantum of corporate governance safeguards).

[51] *See*, *e.g.*, Andrew Ackerman & Joann S. Lublin, *Whole Foods Dispute Prompts SEC Review of Corporate Ballots*, WALL ST. J. (Jan. 19, 2015).

excluded on (i)(9) grounds. This response proved problematic, as there are several other common proposals (*e.g.* bylaw provisions allowing shareholders to call a special meeting) for which Rule 14a-8(i)(9) is routinely used to exclude a shareholder proposal.[52] Advocates quickly took advantage, noting that they would look unfavorably upon any attempt by a company to exercise its right to proceed to exclude a proposal despite the lack of staff no-action concurrence.

The original no-action relief given to Whole Foods is certainly debatable. But it illustrates well the cat-and-mouse nature of the relationship between companies and proponents that Rule 14a-8 improperly promotes. Here, the ability to have a company "trump" a shareholder proposal with its own proposal, on conditions that are significantly changed from those the shareholder sought to advance, is eminently open to gamesmanship. And 14a-8(i)(9) is certainly not alone in this regard: rigid deadlines for submissions and the required proof of share ownership can introduce traps for the unwary—traps that a proponent acting in good faith to raise a novel issue might fall into, while professional proponents can navigate them all too well. The current system is thus unfair for issuers and investors alike.

The Whole Foods kerfuffle also pointed out another flaw in the system, similar to the point raised with respect to the significant social-policy issue. Because the no-action process is driven entirely by the staff, rather than to the Commission, it is performed entirely under

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[52]The special meeting bylaw frequently involves a dispute over the threshold at which a special meeting can be called. A shareholder proposal may put up, *e.g.*, 10%, and a company might then introduce a competing proposal with a 25% threshold and seek to have the proponent's proposal excluded.

the supervision of the Chairman, to the exclusion of the other four Commissioners.[53] Thus, the decision to grant the no-action letter in the first place, and then the decision to cease granting all Rule 14a-8(i)(9) no-action letters, and to launch a review of (i)(9) (and not the shareholder proposal rule more broadly) were solely within the control of the Chair's office. The controversy might have been avoided in the first place had the responsibility for making judgments about complex or novel matters been left with the full Commission. But certainly once the controversy erupted, it should have become the full Commission's responsibility to deliberate and vote on what, as a policy matter, would be the appropriate next steps. Yet Rule 14a-8 lacks this basic mechanism for accountability.

IV. PATCHING THE CURRENT SYSTEM

The key difficulty with the shareholder proposal system is that it permits the shareholder to externalize the cost of a solicitation onto the company's other shareholders. A shareholder seeking to force his or her own agenda item onto the company at a meeting has one chief alternative: make a motion from the floor of the meeting. Because the company will likely use discretionary voting authority given in the proxy to knock down any such proposal, the proponent must engage in a proxy solicitation. This process is expensive. Forcing the company to publish the proposal is cheap. There are many items that shareholders are undoubtedly quite willing to force the company to publish, but that are not so vital that shareholders are willing to engage in their own solicitation. So the forced subsidization of certain activist shareholders by the company's other shareholders causes

[53] *See* Reorganization Plan 10 of 1950, 15 Fed. Reg. 3175 (Mar. 13, 1950) (transferring certain functions from the full Commission to the Chairman of the Commission, including the "appointment and supervision of personnel employed under the Commission" (except that the "heads of major administrative units" are subject to full Commission approval), the "distribution of business among such personnel," and the "use and expenditure of funds").

overconsumption of this good. It is a tragedy of the commons.

As a way of bringing a bit of rationality to the current process, key reforms should ensure that shareholder proponents' incentives are adequately aligned with those of other shareholders. Next, the substantive rules governing which proposals are excludable should be administered more robustly. Finally, there should be a vigorous feedback mechanism from voting.

A. Aligning the Interests of Proponents with Shareholders as a Whole

The first step in aligning the interests of proponents with those of shareholders as a whole is to require a more substantial holding of stock by the proponent. The current threshold of $2,000 or 1% of stock, held for a year, is simply insufficient. 1% is nearly meaningless, because $2,000 is so low. Updating the ownership threshold, using rigorous economic analysis, is desperately needed. Dropping the flat dollar threshold in favor of a percentage-only test seems to make the most sense, as would lengthening the holding requirement.

The second step is to ensure that proponents directly own the shares themselves, rather than borrowing them from others. Proposal-by-proxy, where shareholders "lend" their shares to a third party, who in turn makes the proposal (putatively "on behalf" of the shareholder) is contrary to the SEC's current proxy rules,[54] but the practice nonetheless persists. Guidance clarifying the prohibition is welcome. At a minimum, the SEC should require a certification by the proponent describing the delegation of authority to the

[54]*See* Commissioner Daniel M. Gallagher, *Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College*, SEC (June 23, 2015), available at http://www.sec.gov/news/speech/activism-short-termism-and-the-sec.html.

representative, and an acknowledgement that the ultimate authority, and potential Rule 14a-9 liability, remains with the shareholder-proponent.[55]

As a final step, the Commission should more rigorously enforce Rule 14a-8(i)(4).[56] The Commission should have a mechanism that assesses whether a proponent is motivated by concerns that are separate and apart from those felt by the generalized base of shareholders. For instance, the SEC could require proponents to certify that they are not working in concert with any other undisclosed person, as well as to disclose any financial interests of third persons in the proponent, similar to disclosures that are made by *amici* filing briefs with federal courts. The certification could easily be made at the time the certification of share ownership is made, and would significantly protect shareholders by ensuring the proponent discloses any conflicts of interest.

B. Improvements to Administration

The lack of guidance and the Commission's hands-off approach over the past decades has left the staff to be the "fall guy" when it comes to the fair and timely administration of the shareholder proposal rule. Interjecting the Commission back into this process could alleviate some pressure from the staff, and could be done by either converting the no-action process to a Commission advisory-opinion procedure,[57] or by setting up another mechanism

[55] *Ibid*.

[56] While this is typically viewed as the personal grievance basis for exclusion, that is only one of the independent grounds under Rule 14a-8(i)(4) for exclusion. The other is whether the proposal "is designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large."

[57] The advisory opinions would be issued by the staff under delegated authority. Delegations of authority are able to be pulled up by any single Commissioner for review by the full Commission, which is a vital safeguard for ensuring accountability in outcomes. Moreover, an outcome that represents the Commission's view, rather than the staff's view, would be accorded more deference in court.

for bringing complex issues to the Commission for review.[58]

Another core issue, as discussed above, is the need for better staff policing of proposals or statements in support that are false, misleading, or vague. Taking the enumerated steps advocated in Section IV.A above could reduce the overall number of proposals, which would afford the staff more time to drill down on proposals that are alleged to be false, misleading, or vague—although allegations of the former should be accorded greater priority than the last.

Finally, the Commission should issue better guidance to the public. A Commission-approved adoption of Staff Legal Bulletins—which are now up to 14G—would help. Also, without disrupting the case-by-case review of shareholder proposals, there is more that the staff could do to identify common pitfalls for the public and explain how to avoid them. Such transparency could reduce the number of letters submitted for no-action relief. Companies have access to sophisticated experts who can use their understanding of lore and no-action letter history, plus access to expensive databases and treatises, to inform their decisions whether to pursue no-action relief.

C. Weeding Out Futile Proposals

Finally, resubmission thresholds should be raised, to avoid situations where

[58]For example, the Commission could send up for a Commission advisory vote a list of matters that will be considered "significant policy issues" in that proxy season, for purposes of administering 14a-8(i)(7). Commission votes would ensure that these decisions are being made with the relevant degree of scrutiny and accountability. In particular, where the staff proposes to add a new significant policy matter, that decision can be made with the requisite degree of debate and transparency. Moreover, it would provide an avenue for the staff to propose removing certain items when the debate is no longer active, rather than the current one-way ratchet, where it is difficult to reverse the designation of certain issues as significant. Similarly, Commission votes could also help resolve the (i)(9) problem: the Commission could determine general guidelines for different types of proposals involving numerical thresholds which types of tolerances outside the threshold would be considered so close as to be confusing to take a vote on. For example, the Commission could determine that an issuer 5% proxy access proposal can exclude a shareholder 3% proxy access proposal, but that greater than 5% would be too much.

proposals are made over and over again with little to no success. These should be strengthened both within companies and across companies. First, within companies, the current resubmission thresholds[59] are grossly inadequate. More restrictive resubmission thresholds are needed.[60] Second, if an issue fails to gain support at multiple companies, it should raise a question whether that proposal is properly made at all.[61] If new exclusionary grounds are needed to deal with perennial losers, then the staff should put forward those recommendations to the Commission.

V. A BETTER APPROACH: GIVE IT BACK TO THE STATES

While the aforementioned changes might help at the margins, they too will likely prove insufficient, or be artfully evaded by cagey proponents and issuers. Moreover, the likelihood of these changes getting through a politicized SEC given the pressures that are brought to bear around this rule is minimal. This Gordian knot needs a better solution—one

[59]The proposal needs 3, 6, or 10% of votes in support to stay alive, depending on whether the proposal has been brought once, twice, or three times or more in the past five years. So a proposal that ekes out 10% of votes can continue to be submitted indefinitely.

[60]A better rule would permit a proposal to achieve only a small amount in support in the first year, while shareholders may be unfamiliar with the issue—*e.g.*, 5%. The following year, there needs to be meaningful progress towards majority support—*e.g.*, 20%. If by the third year there is not majority support, that and all substantially similar proposals should be excludable for the following 5 years. There is no reason to continue to waste shareholders' time shooting down losing proposals. It's actually quite remarkable that increasing the resubmission thresholds was considered in 1997, and rejected, because the views of socially-motivated shareholders were that it would inhibit the presentation of socially-motivated proposals, which proposals "tend to receive lower percentages of the shareholder vote." *See* 1998 Amendments, *supra* note 23 at n.81. That is precisely the point of the resubmission exclusion. If shareholders are not interested in your proposal, then the company should not be required to include it. If shareholders are by and large uninterested in socially-motivated proposals, they should not be force-fed them at every meeting. Socially-motivated shareholders are more than welcome to mount their own solicitation of proxies, at their own expense, if they feel that the issue is sufficiently important to bring it to the attention of all shareholders. Or, they could engage in other avenues for promoting their views in the public space. They should not be entitled to force their view on an unwilling shareholder base, at that base's expense.

[61]For example, if the decision is made to permit votes on a proposal because it seems to raise a significant policy issue that overcomes the ordinary business exclusion, and then shareholders at the companies putting the proposal to a vote overwhelmingly reject the proposal, then there should be a threshold at which in some subsequent series of years the policy issue is deemed insufficiently significant, and similar proposals are excluded across the board.

that cuts through the complexity by devolving this issue back to the states.

A. What Would This Look Like?

As discussed above, the SEC injected itself into the shareholder proposal arena in a limited way, focused on the accuracy and completeness of the issuer's proxy disclosures. But since then, the SEC has essentially created a new *substantive* right—the right to have one's proposal appear in the corporate proxy, at the company's expense. The scope of this substantive right depends on the scope of the exclusionary grounds set forth in Rule 14a-8. But if the states are able to specify which shareholder proposals are appropriate subjects for floor votes at annual meetings, then states should be able to craft the permissible contours of shareholder proposals to be included in proxies.[62] Specifically, the state in which the issuer is incorporated should be vested with the administration of the substantive corporate governance issue of when a shareholder may invoke the corporate machinery to bring his or her issue to a vote of the shareholders through the corporation's proxy.

This is not a novel idea: as discussed above, the SEC briefly raised the issue in 1982, and then examined it in slightly more detail as part of the 1997 shareholder proposal amendments. But the proposal was given short shrift both times; in particular, it is not clear that the 1997 exercise reflected a truly representative set of views as to how companies and investors look at shareholder proposals. But even assuming that it did, the SEC's continuing and worsening struggles administering the shareholder proposal system call for a reexamination of this approach. Moreover, the SEC has a broader responsibility to

[62]The sole issue, however, being that it would seem to infringe on what is generally considered plenary SEC authority to set the form and contents of proxy statements. An expression of the right in a different way–*i.e.*, the right to have management bear the cost for providing notice to shareholders of the proposal and a copy thereof, which would just happen to be satisfied by the inclusion of the proposal in the proxy—might be necessary, although the article avoids this circumlocution in the hopes that it would not be.

administer its rules and regulations fairly and efficiently. Where, as here, it cannot reasonably do so, it should consider revising those rules, even if commenters have their own idiosyncratic reasons for preferring the status quo.

What would the state solution look like in practice? One approach a state could take would be to make co-extensive the right to present a proposal on the floor and the right to have the proposal appear in the corporate proxy. In other words, so long as the proposal is proper for a shareholder vote, it must appear in the proxy. This is quite similar to the 1942 formulation of the SEC's rule. States may at that point continue to leave the shareholder's right to bring proposals open-ended, or they may decide to restrict those rights in certain ways—restrictions that would apply to both the AGM and the proxy.

A state could also decide to create different criteria for floor proposals and for proxy proposals, similar to the bifurcated nature of the rule today. Proponents would be free to mount a proxy contest for items falling outside the scope of the new state equivalent to Rule 14a-8 that they wished to bring to a floor vote. The state regulation of what must be included in the proxy could be the functional equivalent of Rule 14a-8 (although that would seem unwise), or it could be some different, more nuanced, balance of corporate and shareholder rights.

Finally, a state could direct companies to establish the contours of the right to have a shareholder proposal included in a proxy through the companies' bylaws or in their charters. This is similar to one of the approaches explored in 1982 and 1997, although the legal impetus for the mandate would be state law, not federal securities law.[63] Or, most likely,

[63]To be sure, having the SEC mandate that shareholders and companies agree on the scope of shareholder proposal rights on a company-by-company basis, as suggested in the SEC's prior releases, would be

states would take a hybrid approach, setting out a few baseline rules (*e.g.*, of what must always be included, or what may always be excluded), and then permitting companies to engage in private ordering to fine-tune the contours of the proposal rights.[64]

States could also determine how to administer the proposal system. A state might determine that it's unnecessary to have an equivalent to the SEC no-action process; rather, disputes over the inclusion of proposals could go to the state's court system. Alternatively, it might be desirable to establish a specialized tribunal that could provide a resolution that would be as quick and informal as SEC no-action letters, but with the binding authority of a judicial process.

There is every reason to believe that states will be responsible guardians of this right. Delaware, of course, as the state of incorporation of choice for much of corporate America, will be the chief new battleground for the proposal right. Delaware is highly experienced in these matters, with an active and knowledgeable legislature, bar, and court system. For example, Delaware's solution to the controversy over fee-shifting bylaws, although unfortunately wrong on the merits, demonstrates that Delaware continues to have an acutely responsive system that attempts to ensure that corporate and shareholder rights are in equilibrium.[65] The fact that generally things go smoothly, and where they do not, there is

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a different way of effecting fundamental change to the shareholder proposal regime. However, some of the details of that plan—*e.g.*, whether the SEC rules would still remain as a default for companies that cannot reach an agreement, and who would have to resolve disputes between companies and shareholders when it comes times to apply the rules to specific proposals—could potentially result in the SEC retaining more of a role in the administration of shareholder proposals than the alternative present in this paper, an approach which would (almost) completely extract the SEC.

[64]For example, one interesting question that would likely arise is whether states would need a baseline rule similar to Rule 14a-8(i)(8), and specifically item (iv) thereunder, as a way to continue to separate matters relating to the election of directors from shareholder proposals.

[65]Perhaps a more sensible middle ground could have been found in the fee-shifting debate short of an all-out ban.

a robust, balanced debate about how to fix it problems, makes Delaware far superior to Washington, D.C. in that respect.

B. The SEC's Remaining Role

At the end of the process under a state-based system, a company's proxy filed with the SEC will either include one or more shareholder proposals or it will not, based on the state law, and as adjudicated by the state if a dispute arose. The SEC's sole responsibility will be to ensure that—whatever the proxy contains as a result of substantive state law on shareholder proposals—the proposal, any statement in support, and presumably a statement in opposition,[66] do not contain material misstatements or omissions.

That responsibility still flows from Section 14(a) of the Exchange Act and SEC Rule 14a-9, which would not be altered by shifting the responsibility for shareholder proposals to the states. Presumably, states would adopt some grounds for exclusion on the basis of false or misleading statements that is similar to current Rule 14a-8, but if not, the SEC would still have the burden of ensuring that corporate proxies are free of false or misleading statements. Freeing up SEC staff from the process of administering the nuts and bolts of the shareholder-proposal process should help adequately resource this critical function, unlike the status quo of under-administration of Rule 14a-8(i)(3).

C. Benefits of the Approach

One of the clear benefits of this alternative is that it does not do away with

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[66]Companies are able to say whatever they want in their proxies, subject to the requirements that they address each of the topics they are required to address, and that they do not say anything that they cannot say, including matters that are false or misleading. If one assumes a state-law right to put forth a proposal, then by default a company would be able to include its own rebuttal within the proxy, advocating for a vote against the proposal, so long as neither the SEC nor state law substantively prohibit a company from rebutting a proposal. The rebuttal, of course, would have to be not materially false or misleading.

shareholder proposals, particularly those that may relate to core issues of corporate suffrage. Some research has shown that shareholder proposals have a positive price correlation.[67] Taking no position on whether that research is right or wrong, returning shareholder proposals to state administration does not mean eliminating them entirely.[68] Rather, it simply means that states that are more familiar with core corporate-governance questions than is the SEC and can better calibrate which types of proposals should be permitted and who should be eligible to bring them.

D. Costs of the Approach

Many of the costs of this approach to either issuers or proponents would depend on how states would respond to the newfound authority to manage the shareholder proposal process. An expanded right would cost issuers (but benefit proponents), whereas a more limited right would have the opposite effect. Repeat or serial proponents might bear more of a cost to learn and navigate the shareholder proposal rules of multiple states, rather than the SEC's uniform ruleset, which is a key reason that this approach was disfavored in prior years. However, given the predominance of incorporation in Delaware and the potential that a uniform code approach could arise, it is unclear how much of an added burden this would prove to be in practice. These costs should be more than offset by the benefits of a state-based approach to shareholder proposals.

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[67] *See*, *e.g.*, Luc Renneboog & Peter G. Szilagyi, THE SUCCESS AND RELEVANCE OF SHAREHOLDER ACTIVISM THROUGH PROXY PROPOSALS (focusing on the effect of corporate governance-related shareholder proposals on share price).

[68] Interestingly, though, ISS has noted that "Some investors have found that letter writing campaigns can be just as effective as offering shareholder resolutions as a lever for triggering meaningful engagement with corporate issuers." McGurn, *supra* note 26 at 7.

CONCLUSION

Shareholder proposals are an accident of history that are causing the SEC more of a headache and distraction than they're worth. Giving the authority back to the states could result in a significantly better approach to shareholder proposals going forward, and is an approach that should be (re)examined fully in the near future.