Davis Polk

The Financial CHOICE Act and the Debate Over Shareholder Proposals

June 21, 2017 | Client Update | 4-minute read

A lively debate is erupting over a provision in the House-approved Financial CHOICE Act that would increase the stock ownership threshold for submitting shareholder proposals in the company's proxy statement from the current level of $2,000 to 1% of common stock outstanding, and would extend the stockholding duration requirement from one year to three years.

The New York State Comptroller, who manages $186 billion in retirement funds but whose ownership of any particular company is often less than 1%, called it "outrageous and inequitable that we would not be able to make requests of corporate boards through shareholder resolutions." Other critics of the proposed change have pointed out that even investors with small holdings can have good ideas, and the *Wall Street Journal* quoted an asset manager's view that "Shareholder proposals provide an early warning of risks a company may not be aware of, as well as an opportunity to gauge investor sentiment on a wide range of issues."

These may be valid observations, but they overlook the fact that the owner of a single share is usually able to present a proposal for a vote by the shareholders, and for this reason the by-laws of most companies typically impose no minimum ownership or duration requirements whatsoever.

The question is who bears the cost of someone's shareholder proposal: the individual who wants to put the proposal forward, or all of the shareholders? Since most investors do not attend the annual meeting in person and instead register their votes by proxy, this boils down to whether the shareholder-proponent has a right to compel the company to include his or her proposal in the company proxy, instead of undertaking their own proxy solicitation. The costs are real: for the shareholder-proponent, they include expenses of identifying beneficial owners, sending out proxy cards and persuading other shareholders to vote. For the company, they include expenses of determining whether the proposal meets the SEC's requirements, and if not, challenging the proposal through a time-consuming process, as well as more abstract costs of loading the company's proxy statement with discussions of matters the board may have already determined do not justify the time and effort, or are not in the overall shareholders' best interests. The latter costs may be harder to quantify, but distraction has a price.

Rule 14a-8, the SEC's shareholder proposal rule, was first adopted in the 1950's. To submit a proposal for inclusion in the company's proxy statement, a shareholder need hold only $2,000 worth of the company's common stock for a period of one year. As a result, a shareholder with an insignificant economic interest can shift the cost of his or her personal proposal to all other shareholders. Often these proposals have little to do with the company's business and operations, and more to do with a political point that the shareholder-proponent is interested in making. Nevertheless, companies must devote time and resources to dealing with these proposals, even those that ultimately garner very little interest from the company's shareholders in general. In fact, a shareholder is currently permitted to re-submit the same proposal the next year if it achieved a scant 3% of the vote.

In the last three years, hundreds of companies have adopted "proxy access" by-laws; some on their own motion, and others at the urging of their shareholders. Under a proxy access by-law, a shareholder who meets the requirements can require the company to include a director nominee in the company's proxy. The wave of proxy-access bylaws is a highly relevant example of “private ordering,” in which companies and investors came together to negotiate the terms on which proxy access would be available without a regulatory mandate to do so (the SEC’s own proxy-access rule having been vacated by the federal courts).

Under the most prevalent set of criteria that investors and companies have agreed to, a shareholder invoking proxy access must have held at least 3% of the company’s stock for at least three years. The 3%/three year standard reflects a compromise by both companies and investors that shareholders whose investment is less significant or of less duration should not have the right to command corporate resources in a proxy contest, but instead should be required to bear their own costs. While there are differences between director nominations and shareholder proposals, requiring either to be included in the company proxy imposes costs on the company and its shareholders as a whole, and each has the capacity to be disruptive and time-consuming for the company and its management. The gross disparity between a $2,000/one year threshold for shareholder proposals and a 3%/three year threshold for proxy access isn’t justified – private ordering tells us this.

Perhaps the Financial CHOICE Act goes too far in seeking a 1%/three year hurdle for shareholder proposals, but surely it’s long overdue for the SEC, and if not the SEC, then Congress, to revisit the $2,000 threshold.