Commissioner Daniel M. Gallagher

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Thank you, David [Katz], for that kind introduction. I’m very pleased to be here with you this afternoon.

In April 2010, when my friend and former colleague Troy Paredes spoke at this conference, he expressed his misgivings about the draft legislation moving through Congress that ultimately became the Dodd-Frank Act.[i] Today, nearly four years after its enactment, the fundamentally flawed nature of the Act has become clear—or, to those of us who recognized its many faults from the start, clearer.

Title I of Dodd-Frank, for example, created the apparently unaccountable and inherently politicized Financial Stability Oversight Council, or FSOC. The FSOC is dominated by bank regulators, and Title I authorizes it to designate non-bank financial services companies as systemically important financial institutions, thereby making them subject to prudential regulation. This can happen without regard for whether that regulatory paradigm is appropriate for non-bank entities operating in the capital markets—or, as I like to call them, the “non-centrally controlled” markets.

I believe it is important for the SEC and other capital markets regulators to openly debate and resist where necessary the encroachment of the bank regulatory paradigm into the capital markets. I hope that market participants and lawmakers will join the debate about the proper regulatory framework for non-bank markets. To be clear, this is not a partisan issue. The structure of FSOC vests tremendous authority to appointees from the President’s party. Those who enthusiastically support FSOC today may well be singing a different tune upon a change in administration.

I should also make clear that I’m not motivated by turf wars or empire building. In fact, I believe the SEC should be willing to recognize areas where we should be the ones to stand down in favor of an alternative legal regime that is a better fit.

And so today I’d like to focus on an area where the SEC should be taking less of a role: the regulation of corporate governance.

I. Federalization of Corporate Governance

Unfortunately, the trend towards increased federalization of corporate governance law seems well-entrenched.[ii] The Sarbanes-Oxley Act included significant incursions into state corporate governance regulation, but Title IX of Dodd-Frank may cause some of you to long for the simpler days of SOX § 404.

Title IX mandates an array of new federal regulations relating to matters traditionally left to state corporate governance law, the most infamous being a requirement to hold a shareholder vote on executive compensation, or “say on pay.” Concerns that a negative vote may harm a company’s reputation or encourage litigation can lead companies to expend significant resources to guarantee passage of the vote. Even more concerning, boards of directors could substitute proxy advisors’ views on pay for their own judgment as a means of minimizing potential conflict.

And that’s just one of the new Dodd-Frank requirements encroaching on corporate governance. Others include the politically-motivated pay ratio disclosure requirement, proposed by a majority of the Commission in September 2013,[iii] as well as mandated rules micromanaging certain incentive-based compensation structures, which were proposed jointly with other regulators, again by a majority of the
Commission, in March 2011. In addition, Dodd-Frank calls for rules regarding compensation clawbacks in the event of an accounting restatement, pay for performance, and employee and director hedging of company stock.

Some of these requirements unashamedly interfere in corporate governance matters traditionally and appropriately left to the states. Others masquerade as disclosure, but are in reality attempts to affect substantive behavior through disclosure regulation. This mandated intrusion into corporate governance will impose substantial compliance costs on companies, along with a one-size-fits-all approach that will likely result in a one-size-fits-none model instead. This stands in stark contrast with the flexibility traditionally achieved through private ordering under more open-ended state legal regimes.

II. Shareholder Proposals

One area where the SEC’s incursions into corporate governance have had a particularly negative effect is shareholder proposals.

1. The Problem

While the conduct of the annual shareholder meeting is generally governed by state law, the process of communicating with shareholders to solicit proxies for voting at that meeting is regulated by the Commission. The Commission’s rules have for decades permitted qualifying shareholders to require the company to publish certain proposals in the company’s proxy statement, which are then voted upon at the annual meeting.

Unfortunately, the Commission has never adequately assessed the costs and benefits of this process. Currently, a proponent can bring a shareholder proposal if he or she has owned $2,000 or 1% of the company’s stock for one year, so long as the proposal complies with a handful of substantive—but in some cases discretionary—requirements. Activist investors and corporate gadflies have used these loose rules to hijack the shareholder proposal system.

The data and statistics are striking. In 2013, the number of shareholder proposals rose with an amazing 41% of those proposals addressing social and environmental issues. And while proposals calling for disclosure of political contributions or lobbying activities continued to predominate, these proposals received particularly poor support from shareholders. Overall, only 7% of shareholder proposals received majority support in 2013.

These proposals are not coming from ordinary shareholders concerned with promoting shareholder value for all investors. Rather, they are predominantly from organized labor, including union pension funds, which brought approximately 34% of last year’s shareholder proposals, as well as social or policy investors and religious institutions, which accounted for about 25% of 2013’s proposals. Approximately 40% were brought by an array of corporate gadflies, with a staggering 24% of those proposals brought by just two individuals.

In other words, the vast majority of proposals are brought by individuals or institutions with idiosyncratic and often political agendas that are often unrelated to, or in conflict with, the interests of other shareholders. I find it particularly notable that corporations that donated more funds to Republicans than to Democrats were more than twice as likely to be targeted with political spending disclosure proposals sponsored by labor-affiliated funds.

Astonishingly, only 1% of proposals are brought by ordinary institutional investors—including hedge funds. As you all know, hedge funds are not shy about elbowing their way into the boardroom when they believe a shake-up is overdue. The low level of hedge fund activism here implies that their concerns with corporate management are being addressed using avenues other than shareholder proposals—as most legitimate concerns can be.

Given all of this, it’s time we asked whether the shareholder proposal system as currently designed is a net
negative for the average investor.[xiii]

2. **Needed Reforms**

   a. **Who should be able to bring a proposal?**

   All of this isn’t to condemn shareholder activism per se. I’ll leave that debate to Marty Lipton and Lucian Bebchuk. But existing shareholders who are unhappy with management have a range of well-accepted responses other than proposals. Given the depth and liquidity of today’s markets, passive investors can simply sell their position—taking the s0-called “Wall Street Walk.” Activist investors can threaten to take this Walk as a means of influencing management. Investors can also vote against directors who are not sufficiently overseeing management—this strategy doesn’t have a clever name, but perhaps “vote the bums out” will do.

   And, of course, where management is breaching its fiduciary duties, investors can have recourse to the courts. This “see you in court” strategy is particularly viable given the outstanding job the Delaware courts do, day in and day out, in refereeing disputes between shareholders and management. Given these and other strategies, I’m not sure we need shareholder proposals at all.

   But if we must have shareholder proposals, the SEC’s rules can and should do a better job ensuring that activist investors don’t crowd out everyday and long-term investors—and that their causes aren’t inconsistent with the promotion of shareholder value.

   One thing is clear: we can’t continue to take the approach of our current regulatory program, especially the all too liberal program of the last five years, and simply err on the side of over-inclusion. It is enormously expensive for companies to manage shareholder proposals. They must negotiate with proponents, seek SEC no-action to exclude improper ones, form and articulate views in support or opposition in the proxy, include the proposal and the statement in the proxy itself, then take the vote on it at the annual meeting. Conversely, companies can simply fold and acquiesce to the activists’ demands. Both approaches are costly, and these costs are borne by all shareholders. Taking money out of the pocket of someone investing for retirement or their child’s education and using it instead to subsidize activist agendas is simply inexcusable. It is incumbent on the Commission to create a regulatory environment that promotes shareholder value over special interest agendas. I have a few suggestions.

   **First,** the holding requirement to submit proxies should be updated. $2,000 is absurdly low, and was not subject to meaningful economic analysis when adopted.[xiv] The threshold should be substantially more, by orders of magnitude: perhaps $200,000 or even better, $2 million. But I don’t believe that this is actually the right fix: a flat number is inherently over- or under-inclusive, depending on the company’s size. A percentage threshold by contrast is scalable, varies less over time, better aligns with the way that many companies manage their shareholder relations, and is more consistent with the Commission’s existing requirements. Therefore, I believe the flat dollar test should be dropped, leaving only a percentage test.

   Of course, we’d have to make sure we get the percentage holding requirement right. Requiring a sufficient economic stake in the company could lead to proposals that focus on promoting shareholder value rather than those championed by gadflies with only a nominal stake in the company. We would need to apply rigorous economic analysis to determine what percentage would be an appropriate default, as well as what factors should be taken into account when deviating from that default. This could be an opportunity to address the practice of “proposal by proxy,” where the proponent of a resolution—typically one of the corporate gadflies—has no skin in the game, but rather receives permission to act “on behalf” of a shareholder that meets the threshold. While I would support banning proposal by proxy, we could also consider alternatives such as requiring a proponent acting on behalf of one or more shareholders to meet a higher percentage threshold of outstanding shares than would be the case for a proponent who owns the shares directly.
I also think we need to take another look at the length of the holding requirement. A one-year holding period is hardly a serious impediment to some activists, who can easily buy into a company solely for the purpose of bringing a proposal. All that's needed is a bit of patience, and perhaps a hedge. A longer investment period could help curtail some of this gamesmanship.

Making adjustments along these lines will go a long way towards ensuring that the proposals that make it onto the proxy are brought by shareholders concerned first and foremost about the company—and the value of their investments in that company—not their pet projects.

b. **What issues should proponents be able to raise?**

I also believe that we need to do a better job setting requirements as to the substance of proposals. While I don't think a complete reevaluation of the existing categories for exclusion is necessary, we do need to re-think their application.

For example, the “ordinary business” criterion for exclusion in our rules has been perennially problematic.\[^{15}\] This provision permits exclusion of a proposal that deals with the company’s “ordinary business operations,” unless it raises “significant policy issues.” However, these terms are not defined and the Commission has given no guidance, leaving the Staff to fend for itself in determining whether to issue no-action relief pursuant to the provision.

As a result, we have seen a number of dubious “significant policy issue” proposals. For example, in 2013 the Staff 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.\[^{16}\] And, in 2012, Staff denials of no-action relief forced AT&T, Verizon, and Sprint to include a net neutrality proposal, even though proposals on that same topic were excludable in prior years as ordinary business. That year, 94% of AT&T shareholders voted “no” on the net neutrality proposal despite the best efforts of Michael Diamond, who some of you will know as Mike D. of the Beastie Boys—who, by helping to bring the proposal to a vote, at least succeeded in his fight for the right to proxy.\[^{17}\]

It is a disservice to the Staff—and, more importantly to investors—when the Commission promulgates a discretion-based rule for the Staff to administer without providing guidance as to how to exercise that discretion. In addition to providing better guidance, the Commission needs to become more involved in the administration of this rule. In particular, I believe that the Commission should be the final arbiter on the types of proposals for which the Staff proposes to deny no-action relief on “significant policy issue” grounds. The Presidential appointees should vote on these often-thorny policy issues and not hide behind the Staff.

We also need to take another look at the rule which permits the exclusion of proposals that are contrary to the Commission’s proxy rules—including proposals that are materially false and misleading or that are overly vague.\[^{18}\] In Staff Legal Bulletin 14B, issued in 2004,\[^{19}\] 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.\[^{20}\] I believe issuers have raised some legitimate concerns with this approach. For example, while issuers are not legally responsible for the proposals or statements in support, they are still being forced to publish, in their proxy, statements they believe are false or misleading. Moreover, use of the statement in opposition is sometimes an incomplete remedy. Taking valuable space to correct misstatements distracts from a substantive discussion about the proposal itself, and proposals that are overly vague make it difficult to draft a sensible rebuttal.

In light of these competing concerns, I believe the pendulum has swung too far in the direction of non-intervention. And I’m not alone in this belief. Recently, a district court in Missouri granted summary judgment to Express Scripts, permitting it to exclude a proposal that contained four separate...
misstatements. While I support companies exercising their right to take matters to the court system, which can serve as a useful external check on the SEC’s no-action process, companies shouldn’t have to go through the time and expense of litigation to vindicate their substantive rights under our rules. The burden to ensure that a submission is clear and factually accurate should be placed on the proponent, not the company. I believe that the Staff should take a more aggressive posture toward proponents that fail to meet that burden. And I hope issuers would refrain from using our rule to quibble over minutiae. If this happy medium is not achievable, I believe the SEC needs to revisit our rules: we as a Commission either need to give the Staff the capacity to enforce the rule as it is currently written, or craft a rule that is enforceable.

c. **How many times may a proposal be repeated?**

The final issue I want to raise today with respect to the shareholder proposal process is the frequency of reproposals. Currently, once a proposal is required to be included in the proxy, it can be resubmitted for years to come, even if it never comes close to commanding majority support. Proposals need only 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 gets a bare 10% of the votes, year after year, is not excludable on that basis under our current rules. Such proposals are an enormous waste of time and shareholder money.

We need to substantially strengthen the resubmission thresholds, perhaps by taking a “three strikes and you’re out” policy. That is, if a proposal fails in its third year to garner majority support, the proposal should be excludable for the following 5 years. The thresholds for the prior 2 years should be high enough to demonstrate that the proposal is realistically on the path toward 50%, for example, 5% and 20%.

3. **Conclusion**

Implementing these kinds of reforms can, I believe, help provide some much-needed improvement to the shareholder proposal system. I hope the Commission can consider such common-sense issues in the near future. These are real and substantial issues, and the Commission has the authority to effectuate needed change. We should not dare Congress to intervene due to our inaction, as it had to with the JOBS Act.

III. **Remaining the Right Regulator**

Finally, I want to return to my original theme: good government requires that, when we must regulate, we should do so in the most efficient manner possible. This means assigning the right regulator to the issue and minimizing unnecessary regulatory overlap. And of course, the Commission must continue to ensure that its regulatory approach advances its core goals of investor protection and the promotion of efficiency, competition, and capital formation.

That means, for example, pressing ahead with much-needed reforms to our corporate disclosure requirements to ensure that our filings provide investors with the information they need to make informed investment decisions and are not overwhelmed by extraneous information—like conflict minerals reports.

We must also take exception to efforts by third parties that attempt to prescribe what should be in corporate filings. It is the Commission’s responsibility to set the parameters of required disclosure.

The somewhat confusingly-named Sustainability Accounting Standards Board provides a good example of an outside party attempting to prescribe disclosure standards. I say “confusingly-named” because the SASB does not actually promulgate accounting standards, nor does it limit itself to sustainability topics, although I suppose it is in fact a Board. The SASB argues that its disclosure standards elicit material information that management should assess for inclusion in companies’ periodic filings with the Commission.
I don’t mean to single out the SASB, but it’s important to stress that, with the sole exception of financial accounting—where the Commission, as authorized by Congress, has recognized the standards of the Financial Accounting Standards Board as generally accepted, and therefore required under Regulation S-X—the Commission does not and should not delegate to outside, non-governmental bodies the responsibility for setting disclosure requirements. So while companies are free to make whatever disclosures they choose on their own time, so to speak, it is important to remember that groups like SASB have no role in the establishment of mandated disclosure requirements.

With respect to information that the Commission requires to be included in filings, we need to be sure that our requirements are eliciting decision-useful and up-to-date information. We should be willing to reexamine all of our disclosure requirements. Indeed, the Commission should be engaged in a comprehensive program of periodic re-assessment of its disclosure rules to ensure that the benefits of disclosure continue to justify its often-substantial costs.

This is of course a tall order, but I know the fine men and women who serve the public at the Commission are up for the challenge.

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Thank you all for your time and attention today, and I hope you enjoy the rest of the conference.

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[v] James R. Copeland & Margaret M. O’Keefe, *Proxy Monitor 2013: A Report on Corporate Governance and Shareholder Activism* (Manhattan Institute, Fall 2013) at 2 (average Fortune 250 companies faced 1.26 proposals in 2013 versus 1.22 in 2012); Gibson, Dunn & Crutcher LLP, *Shareholder Proposal Developments During the 2013 Proxy Season* (July 9, 2013) at 1 (noting more proposals in 2013 (~820) than 2012 (~739)).


[vii] Proxy Monitor 2013 at 12 (“[P]roposals related to corporate political spending or lobbying have been more numerous than any other class of proposal in each of the last two years.”).

[viii] ISS reports political contribution/lobbying activity approval percentage at 29%, an increase of 7.3% over 2012. See Gibson Dunn at 6. However, Proxy Monitor finds the opposite trend, at least with respect to the Fortune 250 companies. See Proxy Monitor 2013 at 2. Specifically, disaggregating lobby and political spending proposals shows a decline in y-o-y support for both proposal classes: 22% in 201 to 20% in 2013 for lobbying, and 17% to 16% for political spending. *Id.* But a change in the mix of proposals—there were more lobbying-related proposals, which typically garner higher support, given that 2013 is a non-election year—creates the impression of an increasing overall rate.

Proxy Monitor 2013 at 6–7.

Proxy Monitor 2013 at 8 ("Those companies [giving at least $1.5 million to candidates or PACs] as a group, were much more likely to be targeted by shareholder proposals introduced by labor-affiliated pension funds in 2013: 44 percent of these politically most active companies faced a labor-sponsored proposal, as opposed to only 18 percent of all other companies. What's more, those corporations that gave at least half of their donations to support Republicans were more than twice as likely to be targeted by shareholder proposals sponsored by labor-affiliated funds as those companies that gave a majority of their politics-related contributions on behalf of Democrats.").


See Rel. 34-40018, Amendments to Rules on Shareholder Proposals (May 21, 1998) (describing the change from $1,000 to $2,000 as an adjustment for inflation).


See, e.g., Hunton & Williams, Client Alert, SEC Refused to Allow Bank to Omit Climate Change Proposal from Proxy Materials (Mar. 2013). It has been argued, however, that PNC was not a reversal, rather was driven by some substantive differences with PNC’s lending portfolio. See Gibson Dunn at 9–10 (citing a “SEC spokesman” commenting to that effect). This may indicate a need for the Staff to provide fuller statements of their reasoning in no-action letters, so as to avoid confusion among practitioners and the public.


Exchange Act Rule 14a–8(i)(3).


Of 90 denials of exclusion during the 2013 proxy season, 63% of them had raised (i)(3) arguments. Gibson Dunn at 2. While there could be several reasons for this trend, it calls for further examination.


Waste Connections v. Chevedden, No. 13-20336, slip op. (5th Cir., Feb. 13, 2014) (affirming court’s subject matter jurisdiction over company’s declaratory judgment action despite Chevedden’s promise not to sue if company excluded the proposal).


See, e.g., SASB, Commercial Banks Sustainability Accounting Standard, Provisional Version (Feb 2014) (“SASB Standards are comprised of (1) disclosure guidance and (2) accounting standards on sustainability topics for use by U.S. and foreign public companies in their annual filings (Form 10-K or 20-F) with the U.S. Securities and Exchange Commission (SEC). To the extent relevant, SASB Standard may also be applicable to other periodic mandatory filings with the SEC, such as the Form 10-Q, Form S-1, and Form 8-K. SASB’s disclosure guidance identifies sustainability topics at an industry level, which
may be material—depending on a company’s specific operating context—to a company within that industry. Each company is ultimately responsible for determining which information is material and is therefore required to be included in its Form 10-K or 20-F and other periodic SEC filings.

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