STATEMENT OF
JOHN ENGLER
PRESIDENT OF BUSINESS ROUNDTABLE

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U.S. HOUSE OF REPRESENTATIVES

HEARING ON

"CORPORATE GOVERNANCE: FOSTERING A SYSTEM THAT PROMOTES CAPITAL FORMATION AND MAXIMIZES SHAREHOLDER VALUE"

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Good morning, and thank you, Chairman Garrett, Ranking Member Maloney and members of the Subcommittee.

I am John Engler, and I serve as President of Business Roundtable, an association of CEOs of major U.S. companies operating in every sector of the American economy.

Business Roundtable CEOs lead companies that produce $7 trillion in annual revenues and employ nearly 16 million workers. Business Roundtable member companies comprise nearly one-fifth of the total market capitalization of U.S. stock markets and invest $129 billion annually in research and development – equal to nearly 40 percent of U.S. private R&D spending. Our companies pay more than $222 billion in dividends to shareholders and generate more than $495 billion in sales for small and medium-sized businesses annually. Business Roundtable companies also donate more than $8 billion a year in charitable contributions.

We appreciate the opportunity today to provide the perspective of U.S. business leaders on improving the regulatory environment that governs America's capital markets and helps companies support stronger, long-term economic growth.

We also appreciate the efforts led by Chairman Hensarling already under way in this Committee. As we wrote in a recent letter to the Committee, the Chairman's *Financial CHOICE Act* would reform a series of provisions in the *Dodd-Frank Wall Street Reform* *and Consumer Protection Act* that Business Roundtable CEOs have long identified as detrimental to their ability to invest, hire and expand their business activities.[1]

In particular, Business Roundtable CEOs strongly support the legislation's increased oversight of, and accountability for, proxy advisory firms. We also strongly support the bill's repeal of the Securities and Exchange Commission's (SEC's) authority over proxy access; the SEC's authority over chairman and CEO structure disclosures; provisions related to executive compensation; the Volcker Rule; and specialized public company disclosure.

These smart reforms would foster a more modern, competitive business environment that would promote long-term value creation. We look forward to working with all of you on this legislation in the weeks ahead.

Also top of mind for CEOs are two issues that I want to focus on today: the current U.S. public company disclosure regime and the shareholder proposal process.

Business Roundtable CEOs agree that modernizing both would enhance communications between companies and shareholders, improve the quality of information made available to investors and help companies, in turn, advance the economic interests of shareholders, employees and consumers over the long term.

Let me explain why and briefly provide our recommendations.

Materiality Standard for Public Company Disclosure

As Business Roundtable detailed in its white paper on materiality and public disclosure, the concept of materiality has been the bedrock principle for U.S. securities laws since 1933.[2] It is intended to ensure that required disclosures – new and existing – provide investors with the useful information that is essential to making effective investing and proxy voting decisions.[3] The concept is sufficiently flexible to address new developments in the business environment and takes into account the facts and circumstances unique to each company.

Erosion of the Standard Over Time

Unfortunately, adherence to the bedrock principle of materiality has diminished over time. Congress and the SEC are increasingly turning to the disclosure system to address social, political and environmental issues that are irrelevant to reasonable investors' investment and proxy voting decisions and – while important – are more efficiently and effectively addressed through other means. As a result, investors today receive voluminous, complex information that is often immaterial to their investment or voting decisions.

In addition, with an increase in the volume and complexity of information included in annual and periodic disclosures – along with other burdensome regulations – comes an increase in compliance costs and complexity for public companies. These increased costs and administrative burdens directly lower the investment returns to shareholders and reduce the number of companies entering the public markets. As a result, the number of publicly traded companies has dropped from more than 6,000 in the year 2000, to fewer than 4,500 companies today. Fewer publicly traded companies means a decrease in the depth and quality of U.S. capital markets, which ultimately hurts every American seeking to save for retirement, buy a house or fund a child's education.

Adherence to the Materiality Standard

America's business leaders strongly urge Congress to abstain from enacting new mandates and review earlier actions that are contrary to the materiality standard. Such action would reduce the cost to registrants, and the investing public will benefit from useful, clear disclosures. The *Financial CHOICE Act* provides one avenue for such a review.

A disclosure regime firmly rooted in the principle of materiality will encourage more companies to go public, enabling America's public capital markets to better deliver increased value for the economy and the American public.

U.S. Shareholder Proposal Process

Responsible shareholder engagement is essential for a company to perform at a high level. The current shareholder proposal process under Rule 14a-8 remains key to the interaction between companies and investors. However, the current process is outdated and is being abused. This abuse imposes significant costs on companies and limits the ability of companies to focus their resources on long-term value creation.

Modernization Is Needed

The current shareholder proposal process has been hijacked by corporate gadflies and political activist investors.[4]

These individuals often have insignificant economic stakes in target companies, owning only the minimal amount of shares that it takes to file shareholder proposals. Not surprisingly, many of their proposals seek not to promote shareholder value, but to pursue idiosyncratic, social or political agendas that are immaterial to, or in direct conflict with, the interests of the shareholders as a whole. It has become enormously expensive for corporations to manage and respond to these types of shareholder proposals, and these costs may be passed along to ordinary investors.

Two factors are driving this negative trend:

1. The threshold for submitting a proposal is too low. Set decades ago, the threshold has fallen out of step with stock prices in the current market. To be qualified to submit a proposal, a shareholder must own only $2,000 in market value, or 1 percent – whichever is less – of a company's outstanding stock for at least one year. The $2,000 threshold, in particular, falls well short of any reasonable material ownership standard for public companies. For example, this year, JPMorgan Chase received a shareholder proposal requesting that the company amend its executive compensation policy to include various social factors. At the time of filing, the proponent held just 40 of JPMorgan's roughly 1 billion shares outstanding.

2. It is difficult for a company to exclude proposals relating to general social issues. For several decades, the SEC permitted corporate managers to exclude proposals submitted "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." In 1970, however, the D.C. Circuit Court of Appeals ruled against the SEC and found that shareholder proposals are not excludable when they raise issues of corporate social responsibility or question the "political and moral predilections" of management. In response, the SEC narrowed the "general economic, political, racial, religious, social or similar causes" exclusion to proposals that are "not significantly related to the business of the issuer nor within its control." This court-driven change in SEC policy has facilitated an influx of proposals on social issues. Last year, activist shareholders filed 479 social, environmental and political proposals, and this stream of proposals remains steady with more than 400 such proposals submitted for 2016 meetings. Most social, environmental and political proposals, which rarely garner meaningful shareholder support, have little connection to shareholder value and are not issues material to a company's business. Yet they are resubmitted year after year.

Options for Modernizing the Shareholder Proposal Process

To address the greatest concerns with the current shareholder proposal process, Business Roundtable CEOs recommend the following reforms:

- ***Replace the $2,000 holding requirement.*** The $2,000 monetary holding requirement – implemented in 1983 and last updated in 1998 to adjust for inflation – is no longer a reasonable standard for ownership. The SEC should employ a holding requirement based on the percentage of stock owned by a shareholder proponent.

- ***Increase the length of the holding requirement.*** The current holding period encourages a focus on short-term goals at the cost of long-term investing. Requiring a longer holding period would better align the interests of the shareholders making the proposals with the long-term success of the company.

- ***Enhance proponent disclosure requirements.*** While companies must include in the proxy the proponent's name, address and number of voting securities the proponent owns or an undertaking to provide the same upon request, proponents are not required to state their economic ownership in the company, the period of time of their investments or the breadth of their advocacy on the issue at hand. Congress and the SEC should amend the rules to require proponents owning less than a specified percentage of the company – and proponents by proxy – to disclose their motivations, economic interests and holdings in the company's securities. We also suggest amending the rules to require proponents to divulge their overall shareholder activity, including voting results. These changes would allow shareholders to make informed decisions about the proponent's proposal, its mission and the impact.

- ***Increase requirements for proposals by proxy.*** At times, a proponent has no material ownership of the company, but rather receives permission to act on behalf of a shareholder that meets the shareholder proposal eligibility threshold. As such, the true proponent of the proposal may have no significant economic ownership in, or material relationship to, the company. The rule should be revised so that when a proponent is relying on a proxy to submit a proposal, the shareholder giving the proxy must meet a higher eligibility threshold.

- ***Strengthen the resubmission thresholds.*** The current resubmission threshold allows a company to exclude a proposal focusing on substantially the same subject matter for a three-year period. To avoid possible exclusion, a proposal must have received at least 3 percent of the vote on its first submission, 6 percent on the second and 10 percent on the third. A proposal that is opposed by 90 percent of a company's shareholders can be resubmitted indefinitely, leading to a "tyranny of the minority." While a cost-benefit analysis is needed to determine what parameters should be used to update the thresholds, the thresholds should, at the very least, be updated.

- ***Better define the criteria for applying the ordinary business exclusion.*** No clear definition of "ordinary business" exists when a company seeks no-action relief under the "ordinary business" exclusion. Further, the SEC has indicated that in applying the "ordinary business" exclusion to proposals that raise social policy, it "applies the most well-reasoned standards possible, given the complexity of the task," but that, "from time to time, in light of the experience in dealing with proposals in particular subject areas, it adjusts its approach." Expanded review and oversight procedures, implemented with input from issuers and investors, should be implemented to prevent arbitrary changes in direction.

- ***Reinstate the conflicting proposal exclusion.*** In 2015, the SEC revised its approach to the conflicting proposal exclusion, materially departing from decades of guidance. The SEC's new interpretation limits issuers' abilities to exclude a shareholder proposal that conflicts with a company proposal unless "a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal." This new standard risks confusing shareholders, resulting in a lack of clear guidance from shareholders, and intrudes upon the fiduciary duties of directors.

- ***Reevaluate the standard for excluding proposals that are contrary to proxy rules.*** Rule 14a-8(i)(3) permits the exclusion of proposals that are contrary to the SEC's proxy rules, including proposals that are materially false or misleading or that are overly vague. In 2004, the staff significantly curtailed the ability of companies to use this exclusion when it took the position that it will not allow a company to exclude a supporting statement or proposal – even if it contains unsupported factual assertions, is disputed or countered, impugns the company or management or relies upon unidentified sources – unless the company "demonstrates objectively that a factual statement is materially false or misleading." The staff should reevaluate the deferential standard it is using to exclude proposals contrary to proxy rules and place the burden back on shareholders to demonstrate that their proposals are consistent with SEC rules.

- ***Revise the "no-action" letter process.*** The current no-action letter process is administered at the staff level at the SEC, and presidentially appointed SEC Commissioners who bear ultimate accountability for SEC actions have little authority to reconsider a staff decision. This decentralized, issue-by-issue review, especially over the course of time, leads to inconsistent guidance and interpretation of the rules.

These recommendations are not intended to be an exclusive list. Rather, they are a starting point to address the legitimate concerns America's leading CEOs have with a current system that fails to contribute positively to the creation of shareholder value.

Conclusion

In summary, Business Roundtable companies are committed to promoting an environment for U.S. capital markets that facilitates greater long-term value growth for shareholders, employees and consumers.

We appreciate the Committee's attention to these important issues and stand ready to work with Congress and other stakeholders to strengthen U.S. capital markets and the economy today and over the long run.

Thank you for the opportunity to testify before you today.

[1] See *Business Roundtable Letter Supporting Key Provisions of Financial CHOICE Act* (September 2016), available at: http://businessroundtable.org/resources/brt-letter-supporting-key-provisions-financial-choice-act.

[2] *See The Materiality Standard for Public Company Disclosure: Maintain What Works*, Business Roundtable (October 2015), available at: http://businessroundtable.org/sites/default/files/reports/Materiality%20White%20Paper%20FINAL%2009-29-15.pdf.

[3] See *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."); *Basic Inc. v. Levinson*, 485 U.S. 224, 983 (1988) (adopting the materiality standard set forth in TSC Industries in the Section 10(b) and Rule 10b-5 context).

[4] Hedge funds, mutual funds and other institutional investors without ties to organizational labor or social purposes unrelated to shareholder return account for only 2 percent of all shareholder proposals. See James R. Copeland, *Proxy Monitor 2011: A Report on Corporate Governance and Shareholder Activism*, Manhattan Institute (September 2011), available at: http://proxymonitor.org/forms/pmr_02.aspx.