Reforming the Proxy Process to Safeguard Investor Interests

Testimony of Dr. Joshua T. White
July 13, 2023
Chairwoman Wagner, Ranking Member Sherman and members of the Subcommittee on Capital Markets: Thank you for inviting me today to appear to discuss critical reforms to the proxy process to safeguard investor interests. I am an Assistant Professor of Finance and the Brownlee O. Currey Jr. Dean’s Faculty Fellow at Vanderbilt University’s Owen Graduate School of Management. I have been a tenure-track faculty member since 2017. Over 2012 to 2018, I served as a financial economist and expert consultant in the Division of Economic and Risk Analysis at the U.S. Securities and Exchange Commission (SEC).

1. General Description of Proxy Voting

Currently, the House Financial Services Committee is considering several legislative proposals aimed at overhauling the proxy process and protecting the interests of investors. Investor-related issues are paramount for ordinary Americans who put their hard-earned money into public equities to achieve financial objectives. These goals often include home purchase savings, funding their children’s college education, or creating a retirement savings capable of keeping pace with inflationary trends.

The procedure of proxy voting holds an incredible significance for investors. This importance is embodied by the way I structure my corporate financial policy classes at Vanderbilt. I start each new MBA course by emphasizing the crucial role that the proxy process plays in corporate governance by allowing shareholders to vote on director nominees and issues that are critical to an issuer’s long-term value creation.

Shareholder relinquish day-to-day business operation decisions to managers, who are overseen by a board of directors who are fiduciaries for the shareholders. Shareholders’ principal means of oversight over the board of directors is through the voting process. Thus, shareholder voting rights are critically important to investor protection.

Shareholders exercise their voting rights at annual or special meetings. Annual meetings enable voting on an array of matters, including director appointments, auditor ratification, proposals related to governance modifications; and non-binding advisory votes on executive compensation or proposals sponsored by shareholders. Prior to annual meetings, issuers deliver proxy materials to shareholders. These documents detail the resolutions to be voted on and are accompanied by board recommendations on voting.

Today, I will address three current issues vital for safeguarding investor interests. First, I will discuss the rising trend of a multitude of shareholder proposals, commonly known as ESG (Environmental, Social, and Governance) initiatives. I will discuss how the quantity of E&S proposals by special interest groups has surged while shareholder support has plummeted. I will present data that demonstrates that this trend is largely due to changes in SEC Staff Guidance made in 2021 and that the costs are ultimately borne by all investors. Second, I will outline the role of proxy advisory firms and their impact on investor returns and corporate conduct that are inconsistent with shareholder value maximization. Third, I will highlight the trend of the SEC introducing rules that mandate non-material E&S information disclosure and its expected consequences. If these compliance costs are not offset by information benefits, it can deter companies from going public, ultimately restricting retail investors’ investment opportunities.
2. Shareholder Proposals

2.1. SEC Staff Fundamentally Altered the Shareholder Proposal Process in 2021

Rule 14a-8 of the Securities Exchange Act of 1934 sets the guidelines for including shareholder proposals at annual or special meetings. This rule lists the reasons that an issuer may exclude a shareholder proposal from being voted upon. When a shareholder introduces a proposal, managers can: 1) put the proposal on the proxy for a vote at the meeting; 2) engage in negotiations with the proposal’s sponsor to facilitate its withdrawal; or 3) request a no-action relief from the SEC under specific paragraphs of Rule 14a-8, which would allow them to exclude the proposal if granted.

Historically, the most frequent reasons for exclusion under Rule 14a-8 are for proposals that deal with ordinary business operations (paragraph (i)7); and for proposals that are already substantially implemented (paragraph (i)10) (Burke, 2023). These reasons for exclusion represent 34% and 26% of granted no-action relief by the SEC, respectively, based on data downloaded from the ISS Voting Analytics database over 2018 to 2022. Stock prices tend to respond positively to the announcement of a no-action relief by the SEC, indicating that managers typically challenge the proposals that have the potential to destroy value (Matsusaka, Ozbas, and Yi, 2021; Burke, 2023).

The SEC staff regularly offers interpretative guidance that summarizes or elucidates adopted or amended rules. In the context of Rule 14a-8, this guidance sets an informal precedent and aids participants in estimating probable outcomes of no-action relief requests for proposals. By offering and following clear guidance, SEC staff can reduce uncertainty, and consequently save time and costs for managers and shareholders, as well as the SEC.

In November 2021, the SEC staff rescinded its prior guidance and amended its longstanding position on how it would treat requests for no-action relief under Rule 14a-8. In Staff Legal Bulletin No. 14L (“SLB 14L”), the SEC staff revised its interpretations of Rule 14a-8 to limit the ability of issuers to receive relief for proposals with significant social policy implications. The new guidance reduced the predictability of no-action relief requests, thereby complicating the decision-making process for managers wishing to exclude shareholder proposals and for shareholders wishing to sponsor them.

According to information shared by SEC Commissioner Mark Uyeda, before the release of SLB 14L, the SEC staff disagreed with requests to omit proposals for ordinary business operations under paragraph i(7) 25% of the time. However, after SLB 14L’s issuance, the staff disagreement rate with i(7) surged to 54%. These data demonstrate a similar pattern for requests to exclude proposals that issuers argued were substantially implemented under (i)(10) (Uyeda, 2023).

The decline in no-action relief suggests that the issuance of SLB 14L transformed the shareholder proposal process. In July 2022, the SEC proposed changes to exclusion parameters for shareholder proposals as defined in paragraphs (i)(10), (i)(11), and (i)(12), which concern substantial implementation, duplication, and resubmissions respectively (SEC, 2022). Although these changes have not been adopted, if we consider the trends post-SLB 14L, we could anticipate that these finalized rules might further intensify the challenge for managers to exclude shareholder proposals that they view as value destroying.
2.2. E&S Shareholder Proposals Proliferated after SLB 14L but with Less Shareholder Support

The alterations brought about by SLB 14L align with a notable increase in shareholder proposals that failed to be excluded and were ultimately presented for a shareholder vote. This surge in shareholder proposals is primarily focused on Environmental and Social ("E&S") aspects, rather than Governance ("G") factors based on data discussed below and figures presented in the Data Appendix. The support for these E&S proposals drops precipitously. Taken together, these two facts suggest that SLB 14L likely resulted in an overload of E&S proposals that shareholders perceive as not beneficial, or even detrimental, to long-term value.

2.2.1. Shareholder Proposals Voted Upon

Figure 1 illustrates the annual count of shareholder proposals voted upon from 2018 to 2022 for issuers that are members of the S&P500 index. The data were sourced from the ISS Voting Analytics database and divided into two categories, E&S (black bars) and G (gray bars), according to ISS’s resolution type coding. This figure excludes proposals that were initially submitted but later withdrawn or omitted following the SEC’s no-action relief.

The graph indicates that, while the volume of governance shareholder proposals voted upon was nearly double that of E&S proposals, they followed similar patterns versus E&S proposals up to 2021, just before SLB 14L. However, in the year following SLB 14L, voted E&S proposals voted upon surge by 100%, jumping from 131 in 2021 to 262 in 2022. Meanwhile, the count of governance proposals remained relatively unchanged.

- The key insight from Figure 1 is that SLB likely had a significant impact on the number of E&S proposals voted upon by shareholders.

2.2.2. Voting Support for Shareholder Proposals

In Figure 2, I present the voting support for shareholder proposals from 2018 to 2022 for S&P500 companies using the same database. I define voting support as the median ratio of votes for to the sum of votes for and against, excluding abstentions. Until 2021, voting support for both governance and E&S proposals follows a consistent pattern, with governance proposals obtaining support in the range of 31-35%, and E&S proposals receiving between 27-34% support. However, these similarities diverge in 2022. Governance proposals maintain their slight upward trend, with an increase in voting support by 1% in 2022. This pattern is consistent with shareholders viewing some of the G proposals as potentially enhancing governance and possibly reducing managerial entrenchment. Yet, E&S proposals exhibit a 32% drop in the voting support.

- The main conclusion from Figure 2 is that shareholders show reduced support for the flood of E&S proposals voted upon after SLB 14L.

2.2.3. Submitted Shareholder Proposals

Figure 3 presents the yearly count of submitted shareholder proposals from calendar year 2018 to 2022 for companies that are members of the S&P500 index. This figure encompasses all proposals, including those that were voted upon, withdrawn, or omitted due to a No-Action Letter from the...
SEC. From 2018 to 2020, the volume of E&S and G submitted proposals followed similar patterns and levels. However, there was a 39% surge in E&S submitted proposals in 2021, increasing from 283 to 392. Interestingly, this increase predates SLB 14L, thus the deviation from the previously similar trend occurred prior to SLB 14L in terms of submitted proposals. The surge of E&S proposals persisted into 2022, with an additional increase of 24% to 486. Yet, the count of governance proposals saw an 18% decrease. When combined with the findings in Figure 1, this graph indicates that special interest groups increased the volume of E&S proposals prior to SLB 14L, but many of these proposals were excluded until after SLB 14L.

- The key takeaway from Figure 3 is that the increase in submitted E&S shareholder proposals slightly pre-dates SLB 14L but further increases after the revised staff guidance.

Recent analysis by Gerber and Adams (2023) shows that, after the high rate of SEC staff disagreements in 2022, issuers submitted fewer requests for no-action exclusions in 2023. The downturn in no-action requests in 2023 suggests that managers and proposal sponsors assume that the SEC is less likely to provide no-action relief for most E&S proposals after SLB 14L.

2.3. Shareholder Proposals are Costly Even if they Receive Low Support

Shareholder proposals impose direct and indirect costs. Direct costs relate to legal fees, which the SEC estimates at up to $150,000 for a single proposal (SEC, 2020). However, the more substantial cost is likely indirect: the unproductive use of time by boards and management. This cost includes the time required to thoroughly evaluate each proposal, formulate a recommendation, and draft an informed response in the proxy statement. Any time spent on a proposal that does not add value is a misallocation of scarce resources. Thus, the current upward trend in unsupported E&S proposals is concerning as it allows special interest groups to burden management with a significant cost that are ultimately borne by all investors, including retail.

Beyond the direct legal costs and time investment, inundating shareholders with proposals can obscure crucial voting decisions. Take Amazon’s 2023 proxy statement as an example, where shareholders faced 18 proposals (Amazon, 2023). These proposals and the board’s responses took up 61 pages and nearly 40,000 words, over half of the 116-page proxy statement. The proposals primarily addressed E&S aspects of ESG, ranging from the carbon intensity of companies in the default employee retirement plans to the use of facial recognition technology and content removal policies. All 18 proposals failed to gain majority shareholder support. Thus, most investors believed that these proposals would either not impact or harm long-term shareholder value in Amazon’s stock. Allowing almost all E&S proposals on a proxy card likely engulfs investors with voting matters and results in less informed voting on other critical issues, especially for widely diversified retail investors who have limited time and resources to investigate them.

3. Proxy Advisory Firms

3.1. Proxy Advisory Firms Provide Fee-Based Voting Recommendations

Proxy advisory firms conduct research on issuers and provide fee-based voting recommendations to institutional investors. Over 75% of annual meetings occur within the months of March, April, and May. By analyzing extensive data on director nominations and proposals, proxy advisors can
help institutional investors lower their fiduciary costs of making informed voting decisions. This cost reduction could be particularly beneficial for passive portfolio managers who typically manage vast portfolios comprising hundreds or even thousands of issuers, thereby reducing their costs of reviewing tens of thousands of pages of proxy statements each year. However, as discussed below, some institutional investors blindly follow proxy advisor recommendations, likely to satisfy fiduciary duties at a low cost. Such “robo-voting” could be problematic as proxy advisory recommendations do not always maximize shareholder value.

3.2. Proxy Advisors have an Outsized Influence on Shareholder Value due to Market Power and Robo-Voting

Voting advice that does not benefit all shareholders is concerning because proxy advisory firms’ recommendations are highly influential. Extensive academic research demonstrates that voting recommendations by proxy advisory firms significantly and causally influence large changes in voting outcomes (Malenko and Shen, 2016). One reason for their strong influence is that two advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, control more than 90% of the market share for advisory services. Thus, institutional investors have few alternatives for outside voting advice.

Another factor contributing to the sway of proxy advisory firms is the propensity of asset managers to resort to robo-voting, which involves aligning with nearly all voting recommendations provided by a proxy advisory firm. One study uncovered that 175 institutional investors, who collectively manage over $5 trillion in assets, voted in accordance with Institutional Shareholder Services (ISS) recommendations more than 95% of the time (Doyle, 2018). Other studies indicate that almost a quarter of mutual funds heavily rely on ISS recommendations, and these funds often underperform, yielding lower shareholder returns (Iliev and Lowry, 2015). This evidence suggests that robo-voting could potentially impair shareholder value, and that the advice provided by proxy advisory firms does not always align with preserving shareholder interests.

3.3. Proxy Advisory Recommendations do not Always Maximize Shareholder Value

The net effect of proxy advisory firms’ voting advice is highly dependent on the quality of its recommendations (Malenko and Malenko, 2019). Several studies identify how proxy advisory research can harm shareholder value due to standardization of pay plans, a one-size fits all approach to voting advice, reductions in independent information acquisition, and conflicts of interest (Larcker, McCall, and Ormazabal, 2015; Li, 2018; Cabezón, 2022; Malenko et al., 2022).

Research also indicates that some proxy advisors may skew their recommendations on E&S proposals due to pressure from funds focused on socially responsible investment (Matsusaka and Shu, 2022). These asset managers and pension funds often prioritize social objectives like environmental conservation over maximizing shareholder value, which can detrimentally affect shareholder returns (Woidtke, 2002; Riedl and Smeets, 2017). By pressuring proxy advisory firms to support E&S proposals, these funds aim to gain backing from institutional investors that automatically vote following all advice from proxy advisors (Matsusaka and Shu, 2022), a process known as “robo-voting.”
3.4. Managers Might Adopt E&S Proposals to Avoid Negative Proxy Advisory Firm Recommendations

Shareholder proposals are advisory and non-binding. However, managers might opt to implement a costly non-binding proposal to avoid losing support from proxy advisory firms. These firms have established policies whereby if a shareholder proposal garners majority support, they anticipate issuers to disclose outreach efforts by the board and whether they enacted the proposal. Even if the proposal does not gain majority backing, directors might still implement proposals that do not increase shareholder value to sidestep negative recommendations against their board appointment from proxy advisors. In the context of other advisory votes, studies illustrate that the policies of ISS prompt directors to engage shareholders when non-binding votes on remuneration fail to receive 70% support, even if the vote receives majority approval (Dey, Starkweather, and White, 2023).

4. Trends in SEC Rule Rulemaking

4.1. Recent SEC Proposed Rules Mandate Disclosures that are Likely Non-Material to Most Investors

In addition to a rise in potential value-destroying E&S proposals, the SEC recently proposed climate related disclosures that some commentators argue would include non-material information (e.g., Lewis and Kothari, 2022). These commentators note that proposed changes in the disclosure requirements represent a significant shift away from the established materiality standard that underpins financial statements. Academic scholarship argues that “materiality forms the conceptual bedrock of corporate reporting.” (Eccles and Youmans, 2016). Relying on materiality provided issuers with clear, principles-based operational guidance that removed the burden of supplying expensive overproduction of information that did not benefit shareholders.

4.2. Overly Burdensome Compliance Costs have a Negative Effect on Issuers and Investors

The mounting prevalence of non-value adding E&S proposals, alongside escalating compliance costs due to non-material disclosure mandates, places a substantial burden on public issuers. These costs deter companies from either entering or remaining in the public sphere, thereby negatively influencing investors, impeding job creation, and diminishing the allure of U.S. capital markets. The journey to becoming, or remaining, a public company carries substantial administrative, legal, and reporting expenses. Heightened compliance obligations magnify these costs, and for smaller firms or startups, this burden can be overwhelming (Lewis and White, 2023). Consequently, these firms may opt to stay private or, if already public, contemplate delisting or merging to reduce these costs (Leuz, Triantis, and Wang, 2008).

A decrease in the number of public companies limits diversification and investment opportunities for investors, particularly retail investors who often have restricted access to private equity markets. The more limited set of investment opportunities curtails retail investors’ potential for wealth generation through equity ownership.
Elevated compliance costs could also diminish the appeal of U.S. capital markets. Companies around the world might prefer to list in regions with less burdensome regulations. This change could adversely impact the liquidity, size, and overall competitiveness of U.S. capital markets.

**Conclusion**

In closing, I believe there are pressing issues in proxy voting that are essential for the protection of investor interests. First is the growing trend of environmental and social shareholder proposals. The proliferation of these proposals by special interest groups has intensified while shareholder support has drastically declined. My analysis indicates that this trend largely results from changes in SEC Staff Guidance towards no-action relief implemented in 2021, with the costs ultimately falling on all shareholders, including retail investors.

Second, the substantial influence of proxy advisory firms on asset manager voting and corporate behavior can sometimes deviate from maximizing shareholder value. Proxy advisory firms have a large influence on voting outcomes due to concentration of market power and the propensity for some institutional investors to predominately follow all their voting recommendations.

Third, I note that the SEC is considering implementing E&S-based rules that many argue would require non-material information disclosure. The repercussions of this such mandates could impact companies deciding whether to go or remain public, the cost of capital formation, and the scope of retail investment opportunities.
References


References (continued)


Data Appendix

Figure 1. Shareholder Proposals Voted Upon at S&P500 Issuers Over 2018-2022

Figure 2. Voting Support for Shareholder Proposals at S&P500 Issuers Over 2018-2022
Data Appendix (continued)

*Figure 3. Submitted Shareholder Proposals at S&P500 Issuers Over 2018-2022*

![Bar chart showing the number of submitted shareholder proposals at S&P500 issuers over the years 2018 to 2022. The chart compares proposals focusing on Environmental, Social, and Governance (E&S) issues with those focusing on other topics (G). The number of proposals increases significantly from 2021 onwards.]