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## The SEC's September 2020 Reform on Investor Eligibility to Advance Shareholder Proposals

At a publicly traded company's annual or special meeting, its shareholders typically vote to appoint board members and adopt or reject various shareholder- and management-sponsored business proposals, which generally require board adoption to be implemented. There were reportedly 858 shareholder proposals in 2020. The SEC recently adopted changes to the rules governing shareholder proposals; opponents of the changes have undertaken a number of initiatives seeking to undo them.

### Rule 14a-8 Rulemaking and Opposition

In September 2020, the Securities and Exchange Commission (SEC) commissioners voted 3-2 to amend Rule 14a-8. Principally, the reform would tighten the eligibility criteria needed for small investors in publicly traded companies to submit proposals. (A corollary reform not covered here is to require higher earlier supporting vote percentages for shareholders to be able to resubmit similar proposals at future meetings, the first such change since 1954.)

The rationale for the reform is that it is a needed modernization of proposal protocols that would reduce the number of frivolous proposals and their corporate costs and help to ensure that the interests of shareholders who submit and resubmit proposals are better aligned with those of other shareholders. It is largely supported by business interests, including the National Association of Manufacturers, the U.S. Chamber of Commerce (a national business trade group), and the Business Roundtable (an association of public company chief executive officers).

Opponents criticized the changes for curtailing shareholders opportunities to submit potentially corporate-enhancing proposals. Among the reform's critics were the SEC's Office of the Investor Advocate, the Consumer Federation of America, the Council of Institutional Investors (a large investor trade group), and the Interfaith Center on Corporate Responsibility (a faith-based investor coalition).

Opponents have undertaken several initiatives to vacate or undo the changes to Rule 14a-8. S.J. Res. 16 (Senator Sherrod Brown) and H.J. Res. 36 (Congressman Michael F. Q. San Nicolas) are joint resolutions under the Congressional Review Act (P.L. 104-121) that provide for congressional disapproval of the SEC adopted shareholder proposals. If the resolution had been passed by both chambers and signed by the President, the rule changes would have been vacated and the SEC would have been prohibited from issuing a rule that was "substantially the same." However, the timeline for Congress to use the Congressional Review Act's expedited procedures has expired.

On June 15, 2021, a group of investors, led by the Interfaith Center on Corporate Responsibility, filed suit against the SEC in the U.S. District Court in Washington, DC, asking the court to vacate the shareholder reforms.

In addition, with President Biden the composition of SEC commissioners has changed, and when the SEC released the Spring 2021 Unified Agenda of Regulatory and Deregulatory Action, it included newly appointed SEC Chair Gary Gensler's "Reg Flex Agenda." The agenda reflected the chairman's interest in revisiting and possibly attempting to reverse certain rulemakings finalized in the past two years under then-Chair Jay Clayton. The September 2020 Rule 14a-8 reform is part of that agenda.

### Background

State-based business incorporation laws (such as those in the dominant business incorporation state of Delaware) give states substantial authority over companies that are incorporated within a given state. Under these laws shareholders of publicly traded companies generally have the right to vote their shares to elect directors, approve or reject a company's generally binding management proposals, and submit and vote on the generally non-binding shareholder proposals.

Within the parameters of the state business incorporation laws, under Rule 14a-8, the SEC oversees the types of information shareholder proposals contain and how that information is disseminated. After a shareholder submits a proposal, the proposal faces three potential outcomes: (1) the corporation may allow it to appear on the ballot for a shareholder vote. (2) the proponent may withdraw the proposal after negotiation with the company, or (3) the company may omit the proposal from the ballot after receiving a no-action letter from the SEC. While the majority of shareholder proposals are non-binding, proposals with the best chance of adoption by a firm's board of directors generally garner a majority of votes.

Public companies are largely owned by institutional investors such as mutual funds and pension funds. However, small investors, including individuals and faith-based groups (sometimes referred to as "gadflies"), have historically played disproportionately large roles as submitters of shareholder proposals. According to one analysis (Nili and Kastiel, 2019) a small group of five individuals accounted for close to 40% of all shareholder proposals submitted to S&P 1500 companies in 2018.

Until recently, activist individual investors' proposals tended toward corporate governance proposals involving corporate board structures and shareholder rights. In recent

years, such as activist small shareholders have joined pension funds and faith-based investment groups in proposing a panoply of often controversial environmental, social, and governance (collectively, ESG) proposals. Among them are resolutions that have included disclosing political spending, climate-change-related disclosures, employee and board diversity, and disclosures on their worker and human rights policies. The 2021 proxy season set new records with at least 467 shareholder resolutions on such ESG issues.

### Key Changes: Ownership Thresholds

Prior to the 2020 amendments, a shareholder had to have owned at least \$2,000 (adopted in 1998) or 1% (adopted in 1983) of a company's voting stock for a period of at least one year to be entitled to have a shareholder proposal included in a company's proxy statement (a document with information that the SEC requires companies to provide to shareholders so they can make informed voting decisions on matters before them at the annual meeting).

The 2020 reform tightened the current requirements by amending Rule 14a-8(b) by narrowing when small investors are eligible to submit shareholder proposals. Under the measure, eligibility is allowed when a shareholder demonstrates continuous ownership of voting shares of at least:

- \$2,000 of the company's securities for at least three years;
- \$15,000 of the company's securities for at least two years; or
- \$25,000 of the company's securities for at least one year.

Relatedly, the adopted amendments also prohibit the aggregation of multiple shareholder holdings to meet the new ownership thresholds.

The new share ownership thresholds must be observed at corporate shareholder meetings that take place on or after January 1, 2023.

### Ownership Threshold Debate

Both critics and proponents of the shareholder ownership threshold reform indicate that gadfly investors would be particularly impacted by it. Both groups have marshalled arguments in support of their positions.

#### Key Arguments Supporting Narrowing Eligibility

- The \$2,000 ownership threshold was adopted in 1998. Given ensuing inflation and substantial stock appreciation, holding that amount for merely a year may no longer reflect meaningful shareholder interest in a company that would justify the corporate costs of dealing with such an investor's shareholder proposal. SEC commentary on the final rule cited certain estimates of direct and indirect corporate costs of incorporating shareholder proposals into proxy statements ranging between \$50,000 and \$150,000 per proposal, costs ultimately borne by shareholders.

- According to some observers, investor gadflies have taken advantage of the prevailing \$2,000-for-one-year ownership threshold to submit proposals to a broad spectrum of companies aimed at furthering their own parochial agendas rather than seeking to create overall shareholder value (for example, the Business Roundtable, 2016).
- In 2019, then-SEC Commissioner Robert Jackson's office conducted research that, among other things, concluded that proposals brought by the 10 most frequent individual submitters each year eroded long-run corporate value for ordinary buy-and-hold investors.
- While the reform requires investors in the smallest holding's tier to wait for at least three years to be eligible to submit proposals, such investors will still be able to communicate their interests to a firm through other means, including video conference calls, one-on-one meetings, shareholder surveys, and e-forums.

#### Key Criticisms of Narrowing Eligibility

- Some observers assert that the higher-ranging corporate cost estimates of shareholder proposals cited by the SEC raise some methodological questions, and the agency admittedly made little effort to quantify the offsetting value of the potential benefits of shareholder proposals that were not adopted (for example, Coates and Roper, 2020).
- According to some research, proposals advanced by investor gadflies have generally not reflected their parochial self-interests. Instead, these studies suggest they have largely involved "bread and butter" corporate governance issues, including majority voting, board declassification, the removal of corporate takeover defenses, and proxy access (for example, Nili and Kastiel, 2019).
- According to some observers, the number of overall shareholder proposals has been trending downward in recent years, with most firms rarely receiving a single shareholder proposal in any given year (for example, the Sullivan and Cromwell Law Firm, 2020).
- The reform will contribute to greater inequality among investors with different levels of wealth by narrowing the opportunities for less wealthy, smaller investors to advance proposals (for example, SEC Commissioners Allison Herren Lee and Caroline Crenshaw, 2020).
- The reform will negatively impact the advancement and ultimately the adoption of ESG-related proposals, whose numbers have been growing in recent years (for example, Herren Lee, 2020.)

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