Ceres
Sustainability is the bottom line.

November 13, 2018

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: The Decline in Initial Public Offerings and Shareholder Proposals

Dear Chairman Clayton:

On behalf of Ceres, I appreciate the opportunity to share our views about the shareholder proposals process. Specifically, I wish to address the misperception that shareholder proposals have contributed to the decline in initial public offerings ("IPOs") over the last two decades. To the contrary, shareholder proposals have played essentially no role in that decline. Instead, a variety of other factors have contributed to this decline; factors that would not be addressed by modifying the rules governing shareholder proposals and the proxy process. Accordingly, I urge the Securities and Exchange Commission ("SEC") to maintain Rule 14a-8 (the "Rule") as is. I hope that our comments on this matter will be helpful to the SEC as it prepares for its Roundtable on the Proxy Process on November 15.

Ceres is a non-profit organization that coordinates the Ceres Investor Network on Climate Risk and Sustainability (the "Ceres Investor Network"), which consists of 161 institutional investors that collectively manage more than $25 trillion. The Ceres Investor Network advances leading investment practices, corporate engagement strategies, and policy solutions to build an equitable and sustainable global economy.

The Growth of Private Capital Markets and Numerous Other Factors Have Contributed to the Decline in IPOs.

IPOs Have Been in Decline for Years

The decline in IPOs is not a new phenomenon. Rather, the IPO market has been in relative decline for much of the last two decades. IPOs exploded in the 1990s as a result, in part, of the

Internet bubble. In 1991, there were 218 IPOs.[1] Five years later, that number peaked at 624,[2] a number inflated by the height of the Internet bubble. IPOs declined to 404 in 2000[3] before falling further in the following decades. From 2001 to 2016, the number of IPOs never reached 300 in a single year.[4] 2014 had 291 IPOs, the highest number since 2000; however, by 2016, there was a 62% decline.[5] Partly due to this trend, there are fewer publicly traded companies today than in the 1990s or 2000s. Three years ago, there were 4,300 publicly traded companies, down nearly 50% from 1996.[6]

2018 has seen a slight rebound in the IPO market. At the end of the third quarter, the number of IPOs this year and the amount raised is on pace to exceed 2017's totals.[7] However, 2018 will likely not compare to 2014, itself very different from the height of IPOs in the 1990s or, potentially even, the pre-Great Recession era. Nearly half of capital raised this year was raised in the private market.[8]

The Private Capital Market Has Reduced Start-ups' Reliance on IPOs

Fewer start-ups are relying on IPOs to raise large sums as well. Before 1997, more than 85% of the start-ups that raised $150 million or more did so through an IPO.[9] From 2000 to 2017, however, 64% of start-ups raising that much capital did so through an IPO.

A major factor in the long-term decline in IPOs is the significant growth in the private capital market. Since 1992, private capital investment in start-up companies that are four or more years past their first round of financing has increased by a factor of 20.[10] Venture capital funds represent a substantial portion of this increased funding, approximately 40%.[11] In 2006, venture capital funds invested $31.2 billion in private U.S. companies; by 2015, they invested $77.3 billion.[12] Venture capital funds are not just investing more money; they are investing in more companies. Over that same time period, the number of private companies receiving venture capital

[1] Looking behind the declining number of public companies: An analysis of trends in US capital markets, Ernst and Young (May 2017), at 5, https://www.ey.com/Publication/vwLUAssets/an-analysis-of-trends-in-the-us-capital-markets/$FILE/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf.

[2] *Id*.

[3] *Id*.

[4] *Id*.

[5] *Id*.

[6] Louise Lee, *The Decline of the IPO: With fewer companies going public, corporate transparency gets murkier*, INSIGHTS, STANFORD GRADUATE SCHOOL OF BUSINESS (Apr. 12, 2018), https://www.gsb.stanford.edu/insights/decline-ipo.

[7] Yelena Dunaevsky, *2018 IPO Market is on Target to Exceed 2017*, Bloomberg, Corporate Transactions Blog (Aug. 7, 2018), https://www.bna.com/2018-ipo-market-b73014481482/.

[8] Lee, *supra* note 6.

[9] Michael Ewens and Joan Farre-Mensa, *The Evolution of the Private Equity Market and the Decline in IPOs*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Sept. 28, 2017), https://corpgov.law.harvard.edu/2017/09/28/the-evolution-of-the-private-equity-market-and-the-decline-in-ipos/

[10] Lee, *supra* note 6.

[11] *Id*.

[12] Ernst and Young, *supra* note 1, at 10.

funds increased by 47% from 2,249 to 4,244.[13] Private funds, sovereign wealth funds, hedge funds, mutual funds, and other private investors have also significantly expanded their investments in start-ups over the last decade.[14]

Legislative Reforms Have Increased Access to Private Capital

This rise in private capital has coincided with the reduced operational and regulatory barriers to accessing such capital. The widespread adoption of the Internet over the last two decades, for example, has made it easier for private capital to invest in late-stage start-ups by reducing transaction costs and the time and expense of finding suitable companies.[15]

Two legislative reforms in particular have helped improve start-up companies' access to private capital: the National Securities Market Improvement Act of 1996 ("NSMIA") and the Jumpstart Our Business Startups ("JOBS") Act of 2012. The NSMIA enabled start-ups to access private capital more easily by exempting sales of securities by private companies from states' "blue sky laws."[16] Moreover, the law facilitated a greater accumulation of private capital by increasing the maximum number of investors venture capital and private equity funds can have before registering with the SEC.[17] By doing so, the NSMIA allowed such funds to acquire additional resources necessary to increase their investments in late-stage start-ups.[18] The JOBS Act reinforced these efforts by raising the registration requirement from 500 accredited investors to 2,000, and excluding employees who receive exempt equity awards from the registration threshold.[19] Importantly, the JOBS Act also created a safe harbor for secondary private placements that are not registered with the SEC.[20] This safe harbor reduced the incentive to go public by affording private placement offerings additional protections.[21]

Founders and Private Investors Have Fewer Incentives to Seek IPOs

The growth of private capital markets has also led to founders of start-ups maintaining greater control over their companies than in the past. Finding themselves in a more advantageous financial and operational position, many founders have decided not to dilute their control by going public. Increased funding from private capital has allowed founders to maintain more equity ownership than they have had in the past.[22] Accordingly, they have more control over "exit decisions," such as whether to launch an IPO.[23] As a result, founders are using their equity stake to prevent their companies from going public. This trend is reinforced by mutual funds, which

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[13] *Id.*

[14] Lee, *supra* note 6.

[15] Ewens and Farre-Mensa, *supra* note 7.

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

have become sizable sources of capital for late-stage start-up companies. These funds have shown a willingness to hold illiquid private investments.[24] Their willingness to do so has reduced the pressure on founders to go public, thereby reinforcing their natural resistance to doing so.[25]

Other Factors—Listing Costs, Litigation Costs, Mergers, and Debt Financing

The rising costs of listing, class action litigation, increasing merger and acquisition activity, and the availability of cheap debt financing are also contributing to the decline in IPOs.
There is a massive fee differential for small and large IPOs. This fee makes it difficult for small companies to afford to go public. The size of the disparity suggests that micro cap IPOs are being actively discouraged. Such companies often pay a fee of approximately 7% whereas large cap companies like Facebook only pay 1 to 1.5%.[26] As Commissioner Jackson has pointed out, micro cap companies are essentially being taxed.[27] Like other taxes, this functional tax is discouraging micro cap companies from undergoing an IPO.

Since 2012, the number and cost of class action lawsuits filed against public companies has skyrocketed. From 2012 through 2016, the average cost to settle shareholder objections to a merger increased by 53% from $2.8 million to $4.5 million.[28] During this time period, approximately 85% of mergers by public companies were challenged.[29] Last year, more federal class action securities cases were filed than in any other year and by a significant margin.[30] 2017 experienced a 52% increase over 2016, and more than a 100% increase from the average during 1996–2016.[31] The risk of litigation is very real and very expensive.

More companies are also choosing to be acquired rather than stay independent and go public. In 2016, more than 4,800 private companies were acquired, compared with about 1,950 during the IPO peak in 1996.[32] Small and micro firms are increasingly more likely to choose a merger over an IPO, a trend that has been gaining steam since the late 1990s.[33] Mergers in general have become a leading cause of delistings, but particularly for small and micro firms.[34] In fact,

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[24] *Id.*

[25] *Id.*

[26] Frank Partnoy, *The Death of the IPO*, THE ATLANTIC (Nov. 2018), https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/.

[27] *Id.*

[28] *Rising Volume and Cost of Securities Class Action Lawsuits is a Growing Tax on U.S. Business, Chubb Data Reveals*, PR NEWSWIRE (July 19, 2018), https://www.prnewswire.com/news-releases/rising-volume-and-cost-of-securities-class-action-lawsuits-is-a-growing-tax-on-us-business-chubb-data-reveals-300678169.html

[29] *Id.*

[30] Securities Class Action Filings: 2017 Year in Review, Cornerstone Research https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-YIR.

[31] *Id.*

[32] Ernst and Young, *supra* note 1, at 12.

[33] What's behind the falling number of public companies? Vanguard (Nov. 2017), https://personal.vanguard.com/pdf/ISGPCA.pdf.

[34] *Id.*

according to Vanguard, "the shrinking number of publicly listed companies consists almost entirely of those [micro] securities . . . ."[35]

Finally, debt financing has been very inexpensive for much of the last two decades because of very low interest rates. Private companies have been able to issue debt rather than go public to meet their capital needs, and have chosen to do so, in part, due to the lower cost and the greater control over operations that debt financing allows.[36]

As a result of these economic, legal, technological, and regulatory trends, private assets under management grew from less than $1 trillion in 2000 to more than $5 trillion last year.[37] The economic reality is that many companies no longer need an IPO to raise capital.[38]

<u>Shareholder Proposals Have Had a Minimal Effect on the Decline in IPOs.</u>

Although there are numerous reasons why IPOs have declined for most of the last two decades, shareholder proposals are not one of them. Shareholder proposals do not meaningfully increase the operating costs of companies nor do they threaten management by serving as a tool for activist investors. On the contrary, shareholder proposals strengthen companies.

Shareholder Proposals Do Not Increase Costs Meaningfully

Shareholder proposals do not meaningfully increase costs for companies because, in part, few companies receive shareholder proposals. On average, 13% of Russell 3000 companies received a shareholder proposal in a particular year between 2004 and 2017.[39] In 2016, fewer than 1,000 total shareholder proposals were filed at all reporting companies in the U.S.[40] For companies that do receive shareholder proposals, these proposals raise less than marginal costs because many of them are not voted on. Only half of the proposals submitted by shareholders in 2016, for example, appeared in companies' proxies.[41] Consequently, relatively few companies—fewer than 500—held votes on issues submitted by shareholders.[42]

Importantly, only a small proportion of proposals are filed with companies that recently launched an IPO. Less than 9% of Russell 3000 companies that have had an IPO since 2004 have received a shareholder proposal.[43] Because large companies make up a larger portion of investors' equity portfolios than small companies, larger companies are more likely to receive shareholder proposals. Unsurprisingly, S&P 500 companies received 77% of the proposals Russell 3000

[35] *Id*.
[36] *Id*.
[37] Partnoy, *supra* note 26.
[38] Ewens and Farre-Mensa, *supra* note 7.
[39] An Investor Response to the U.S. Chamber's Proposal to Revise SEC Rule 14a-8, Ceres, et al. (Nov. 2017), https://www.iccr.org/sites/default/files/resources_attachments/investor_response_to_chamber_14a-8_nov_9_final_2.pdf.
[40] ISS Voting Analytics database.
[41] *Id*.
[42] *Id*.
[43] ISS Voting Analytics database. *See also*, Ceres, *supra* note 44.

companies received in 2017.[44] Moreover, only 3.7% of shareholder proposals in the Institutional Shareholder Services ("ISS") database were filed at companies with a market capitalization below $1 billion.[45] The largest public companies, therefore, receive the lion's share of shareholder proposals, so most companies considering an IPO would have a low likelihood, if any, to be significantly affected by the cost of shareholder proposals.

The current resubmission thresholds also minimize costs by making it difficult to resubmit a shareholder proposal. For a proposal that addresses substantially the same subject matter as another proposal that has been previously included in a company's proxy materials within the prior five (5) calendar years, the Rule allows a company to exclude the proposal for any shareholder meeting held within three (3) calendar years of the last submission if the proposal received: less than (i) 3% of the vote on its first submission; (ii) 6% on the second; or (iii) 10% on the third.[46] As a result of this high standard, resubmission of proposals receiving less than 20% support for a third or fourth time is very rare. For example, from 2010 to 2017, shareholders resubmitted environmental and social issue proposals only 35 times after receiving votes under 20% for two or more years, affecting only 26 companies.[47] According to the ISS database, of the 459 shareholder proposals that went to a vote at Russell 3000 companies as of the third quarter of 2017, 104 proposals (22.7%) received less than 10% of the For/Against vote.[48] In comparison, 252 proposals (54.9%) received less than 30% of the For/Against vote.[49] By ensuring that shareholder proposals are not resubmitted too easily, the Rule minimizes their costs.

Shareholder Proposals Are Not Abused by Activist Investors

Activist investors do not abuse shareholder proposals, so the decline in IPOs is not caused by private companies' concerns that activist investors will use shareholder proposals to disrupt operations. From 2004–2017, the Chevedden, Steiner, and McRitchie families submitted 14.5% of the 11,706 proposals filed.[50] On average, 40% of shareholders voted in support of these proposals when they went to a vote.[51] This level of support indicates that these filers provide a valuable service to fellow shareholders by promoting good corporate governance. It does not indicate that shareholder proposals discourage late-stage start-ups from engaging in an IPO for fear of the increased operational cost, and challenge to management such alleged activism raises.

Shareholder Proposals Strengthen Companies

Rather than raise costs and discourage companies from going public, shareholder proposals actually strengthen companies. Corporate managers benefit from investor input on

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[44] ISS Voting Analytics database.
[45] *Id.*
[46] 17 C.F.R. § 240.14a-8(i)(12).
[47] ISS Voting Analytics database.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*

environmental, social, and governance ("ESG") issues. The Department of Labor has recognized the importance of ESG issues commenting that:

> *To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.*[52]

Investors such as BlackRock, State Street, and more than 2,000 members of the Principles for Responsible Investment have also publicly proclaimed the importance of ESG issues to shareholder value.[53] These claims are backed by a robust set of academic research.[54,55] In fact, more than 25% of assets under management in U.S. markets are managed with some form of ESG strategy according to US SIF.[56] Clearly, ESG issues are frequently financially material. Receiving investor input on such important issues can help managers steer their companies in the right direction.

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IPOs have been in decline for most of the last two decades, and for a variety of reasons. Shareholder proposals, however, are not a meaningful contributor to this trend. Accordingly, we do not believe revision of Rule 14a-8 is necessary at this time. The existing Rule allows institutional investors of all sizes and individual shareholders alike to engage corporate boards and senior management on their need to address important ESG issues and long-term risk management. The current process also allows investors to communicate with boards, management, and other shareholders about the most effective, proactive way to protect investor interests with respect to corporate governance, risk, and policy issues affecting companies prior to a crisis. The current process does not and has not, on the other hand, contributed to the decline in IPOs over the last two decades.

As such, the existing process serves an important self-regulatory function for U.S. capital markets, allowing shareholders a means to protect their interests through a form of shareholder democracy.

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52 Field Assistance Bulletin No. 2018-01, Employee Benefits Security Administration, Department of Labor, https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

53 Robin Berridge, *Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How about Your Funds?* Ceres (Dec. 21, 2017), https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about.

54 See the studies cited: Moskowitz Past Winners, Berkeley Haas, https://responsiblebusiness.haas.berkeley.edu/research/moskowitz-past-winners.html.

55 Performance & SRI, The Forum for Sustainable and Responsible Investment, https://www.ussif.org/performance.

56 Report on US Sustainable, Responsible and Impact Investing Trends 2018, The Forum for Sustainable and Responsible Investment, https://www.ussif.org/files/2018%20_Trends_OnePager_Overview(4).pdf.

Thank you for considering these views. I welcome the opportunity to work with you to address these concerns. Please do not hesitate to contact me if you have any questions.

Sincerely,

Mindy S. Lubber
CEO and President
Ceres

Cc: Commissioner Robert J. Jackson, Jr.
Commissioner Hester M. Peirce
Commissioner Kara M. Stein
Commissioner Elad L. Roisman