December 3, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing & Urban Affairs
United States Senate
Washington, D.C. 20510

Re: <u>Proxy Process and Rules: Examining Current Practices and Potential Changes</u>

Dear Senator Crapo:

Mercy Investment Services, Inc., as the investment program of the Sisters of Mercy of the Americas, has long been concerned not only with the financial returns of its investments, but also with the ethical implications of its investments. We believe that a demonstrated corporate responsibility in matters of the environment, social and governance concerns fosters long-term business success for the companies we hold shares in our investment programs. Excellent and sustainable investment returns are essential for the long-term financial support of the Sisters of Mercy and their many sponsored schools, colleges, and health care and social service agencies.

We believe that the current rules and thresholds under Rule 14a-8 work well for investors and issuers and should be maintained. Under Rule 14a-8, a company is required to include shareholder proposals from eligible shareholders in its proxy materials unless the proposals do not meet the eligibility and procedural requirements of the Rule or are subject to exclusion for reasons described in the Rule. Shareholders who rely on the Rule may submit only one proposal per corporate annual meeting and are required to have continuously owned at least $2,000 in market value, or 1%, of an issuer's outstanding voting securities for a year or more by the date the proposal is submitted.

Currently, there are a number of bases upon which a company may rely to exclude shareholder proposals, including the provision of the Rule that governs the resubmission of such proposals. Pursuant to this provision, if the proposal addresses substantially the same subject matter as another proposal that has been previously included in the company's proxy materials within the prior five (5) calendar years, the proposal may be excluded 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.[1]

[1] 17 C.F.R. § 240.14a-8(i)(12).

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Critics of the benefits of shareholder proposals and the way Rule 14a-8 has effectively governed the proposal process express various arguments purporting to justify unnecessary reforms and prohibitive requirements, which we address in the following sections. Their proposed new requirements would restrict shareholders' ability to put forth and vote on important proposals; however, these arguments do not withstand scrutiny:

Shareholder Proposals Should Remain Open to Investors of All Sizes

Some critics argue that the SEC makes it too easy for shareholders to submit a proposal. Currently, a shareholder owning $2,000 worth of a company's shares for at least one year is permitted to submit a shareholder proposal. While at one time, ownership of a single share of stock came with the right to submit a proposal; in 1983 the SEC decided it made sense to have a modest but still low requirement, setting the threshold at $1,000 held for at least one year. The SEC in 1998 raised this to $2,000, "to adjust for the effects of inflation," but did not raise it further "in light of rule 14a-8's goal of providing an avenue of communication for small investors." Such a requirement helps to ensure that smaller, 'Main Street' investors have the same rights to file a proposal as wealthier individuals and institutional investors. As such, the filing threshold ensures a form of shareholder democracy that is open to nearly all investors, as it should be.

Shareholder Proposals Cannot Currently be Re-submitted Too Easily

Critics of Rule 14a-8 suggest that resubmission thresholds should be raised to reduce the number of proposals filed repeatedly for a number of years. The data, however, do not support that re-filings are a problem. According to Institutional Shareholder Services ("ISS") data, from 2010 to 2017, shareholders resubmitted environmental and social issue proposals only 35 times after receiving votes under 20% for two or more years. This affected only 26 companies.[2] In other words, resubmission of proposals receiving less than 20% support for a third or fourth time is very rare.

Experience also indicates that it often takes several years for a proposal regarding an emerging issue to gain enough traction with investors to achieve double-digit votes. In many cases, these proposals eventually receive substantial support, leading to widespread adoption by companies. For example, in 1987 an average of 16% of shareholders voted in favor of shareholder proposals to declassify boards of directors so that directors stand for election each year. In 2012, these proposals enjoyed an 81% level of support on average. Ten years ago, fewer than 40% of S&P 500 companies held annual director elections compared to more than 66% of these companies today.[3] The current thresholds provide a reasonable amount of time for emerging issues to gain support among investors while ensuring that only those proposals that garner meaningful support remain on the ballot for multiple years.

Shareholder Proposals are Not Abused by Activist Investors

Abuse of the proposal process by alleged activist investors is another misguided argument used in favor of restricting shareholders' rights. According to this allegation, a small number of activist investors abuse the system by accounting for a disproportionate volume of proposals. While the ISS database does show that the Chevedden, Steiner, and McRitchie families submitted 14.5% of the 11,706 proposals filed between 2004 and 2017, *the average vote on these proposals was 40%*.[4] This average vote level indicates that these filers provide a valuable service to fellow shareholders by promoting good corporate governance.

[2] ISS Voting Analytics database.
[3] AFL-CIO letter to Stanford professors Larcker and Tayan, January 18, 2013
[4] ISS Voting Analytics database.

For example, these investors frequently focus on encouraging companies to adopt best-practice corporate governance reforms such as eliminating supermajority voting requirements, appointing an independent board chair, eliminating staggered boards, and giving shareholders a "say on pay" and "proxy access" to nominate candidates for board elections.[5]

Shareholder Proposals Are Not the Cause of the Reduction in Public Traded Companies

Only a small proportion of proposals are filed at companies with a recent IPO -- less than 9% of Russell 3000 companies that have had an IPO since 2004 have received a shareholder proposal.[6] Because large companies make up a larger portion of investors' equity portfolios than small companies, larger companies are more likely to receive shareholder proposals.

There are numerous factors contributing to the reduction in the number of public companies in the U.S. According to Vanguard, these include:[7]

- A steep drop in the number of small and micro-firm IPOs compared with the number of IPOs during the tech bubble in the late 1990s. Vanguard explains: "It appears that companies are choosing to be acquired by larger public companies rather than go public themselves."
- In 2016, more than 4,800 private companies were acquired, compared with about 1,950 during the IPO peak in 1996.[8]
- Mergers are also the leading cause (and a generally growing proportion) of delistings.
- Overall, Vanguard concludes that "the shrinking number of publicly listed companies consists almost entirely of those [micro] securities that would not have been invested in by active and passive funds anyway."
- Vanguard also points out that growth in private equity is outpacing growth in public equity. Contributing to the growth in private funding of companies is a series of regulatory changes. The 1996 Securities Markets Improvement Act made it easier for private companies to sell stock to "qualified purchasers," meaning institutional investors and wealthy individuals.[9] The SEC also adopted rules to encourage "private placements," allowing private firms to raise millions of dollars while avoiding public reporting.[10]

Due to these factors, among other macro forces such as low interest rates spurring debt financing,[11] private assets under management grew from less than $1 trillion in 2000 to more than $5 trillion last year. As a result, many companies no longer need an IPO to raise capital.[12]

These changes in market structure, and the deregulation of private investments, are far more important than shareholder proposals in reducing the number of public companies and offerings. In fact, there is no evidence that shareholder proposals are a factor in reducing IPOs, or in increasing the number of mergers, or companies going private.[13]

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[5] https://www.lexology.com/library/detail.aspx?g=b6ad9d24-4a68-4736-8b28-3bbbadfbd7f5

[6] ISS Voting Analytics database, and https://www.iccr.org/sites/default/files/resources_attachments/investor_response_to_chamber_14a-8_nov_9_final_2.pdf

[7] https://personal.vanguard.com/pdf/ISGPCA.pdf

[8] 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

[9] https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/

[10] Ibid.

[11] Ibid.

[12] Ibid.

[13] https://www.iccr.org/sites/default/files/resources_attachments/investor_response_to_chamber_14a-8_nov_9_final_2.pdf, p. 10

Shareholder Proposals Do Not Meaningfully Increase Costs

Most public companies do not receive any shareholder proposals. On average, 13% of Russell 3000 companies received a shareholder proposal in a particular year between 2004 and 2017 according to the ISS database.[14] In other words, the average Russell 3000 company can expect to receive a proposal once every 7.7 years. For companies that receive a shareholder proposal, the median number of proposals is one per year.

Importantly, the cost to companies of the existing shareholder proposal process is generally low (and something companies have control over managing),[15] and the process often results in benefits to companies. As noted, most companies receive few, if any, shareholder proposals. In 2016, there were fewer than 1,000 total shareholder proposals filed at all reporting companies in the U.S.[16] Only half of the proposals submitted by shareholders appear in companies' proxies and, consequently, relatively few companies (fewer than 500 in 2016) held votes on issues submitted by shareholders.[17] This is in part due to meaningful dialogues that happen between investors and management that leads to win/win agreements - resulting in the withdrawal of resolutions. In any given year, one quarter to one third of resolutions on environmental and social issues, for example, are withdrawn because of such agreements. And some governance issues like majority vote for directors and access to the proxy result in even higher rates of agreement, making a vote unnecessary.

Finally, the SEC oversees a robust "no-action letter" process that allows companies to exclude proposals from the proxy ballot that do not meet specific procedural or substantive hurdles.

Investors Benefit from the Valuable Services Proxy Advisors Provide to Advance Good Corporate Governance

Some argue that investors over-rely on proxy advisors ISS and Glass Lewis who account for 97% of market share in the industry. The alleged result is that ISS and Glass Lewis functionally control substantial voting shares of thousands of companies in their portfolios, and that this control empowers them to set standards for corporate governance by choosing which shareholder proposals to support. While many institutional investors do rely on proxy advisors for advice and administrative help, voting decisions remain the ultimate responsibility of investors. As the Council of Institutional Investors (CII) states in their letter to the House Committee on Financial Services, dated November 9, 2017:

> *"Indeed, many pension funds and other institutional investors contract with proxy advisory firms to review their research, but most large holders have adopted their own policies and employ the proxy advisory firms to help administer the voting of proxies during challenging proxy seasons."*

In fact, Mercy Investment Services has implemented a set of proxy voting guidelines that assure that the proxy votes made by our proxy advisor are consistent with our voting preferences and guidelines.

Proxy Advisors Decrease Costs for Investors

Reliance on proxy advisers provides cost savings and market externality benefits to investors. Large, widely diversified institutional investors must manage proxy voting related to up to 38,000 annual

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[14] Ibid.

[15] The Dangerous "Promise of Market Reform": No Shareholder Proposals, Harvard Law School Forum on Corporate Governance and Financial Regulation, Adam Kanzer, 2017

[16] ISS Voting Analytics database

[17] Ibid.

meetings globally each year according to CII. Clearly, it is more efficient for most investors to rely on assistance from proxy advisors who can spread some of the costs of voting across thousands of clients than for each institutional investor to try to manage this herculean ask on their own.

Corporate Managers Benefit from Investor Input on Environmental, Social, and Governance Issues

One complaint argues that the shareholder proposal process is redundant because company management already considers environmental, social and governance (ESG) issues. However, if management already addresses a particular ESG issue set forth by the proposal, investors are far less likely to waste time filing the proposal in the first place, and the proposal can be challenged and rejected as "substantially implemented." A second complaint concerns an alleged lack of connection between ESG issues and shareholder value. For example, investors such as BlackRock, State Street and more than 1,700 members of the Principles for Responsible Investment have all publicly proclaimed the importance of ESG issues to shareholder value.[18] These claims are backed by a robust set of academic research.[19] [20] In fact, more than 20% of assets under management in U.S. markets are managed with some form of ESG strategy according to US SIF.[21] Clearly, ESG issues are frequently financially material.

Conclusion

Mercy Investment Services does not believe revisions of Rule 14a-8 are necessary at this time. The existing Rule currently allows institutional investors of all sizes, and individual shareholders alike, who are long term investors in these companies, to engage corporate boards and senior management to address important environmental, social, and governance issues and long-term risk management that can have a direct financial impact on their investments, which in many cases are used to provide financial support during retirement and for important social services such as schools, health care and social services. Shareholder proposals frequently address emerging systemic risks to the U.S. and globally economies, such as the predatory lending that contributed to the 2008 financial crisis.

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. 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. Additional government interference in this private ordering process is not necessary or advisable.

For these reasons, we oppose further restricting shareholder proposals, which are helpful to companies, investors, and the economy as whole. Thank you for considering these views. We welcome the opportunity to work with you to address these concerns.

Sincerely,

Susan S. Makos

Susan Smith Makos
Vice President of Social Responsibility

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[18] https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment
[19] https://responsiblebusiness.haas.berkeley.edu/research/moskowitz-past-winners.html
[20] https://www.ussif.org/performance
[21] https://www.ussif.org/files/SIF_Trends_16_Executive_Summary(1).pdf