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Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

December 29, 2019

Re: File No. S7-23-19

Dear SEC Commissioners and Staff:

The Costs and Benefits of Shareholder Democracy (download from SSRN at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3269378) by Nickolay Gantchev and Mariassunta Giannetti was referenced multiple times in the SEC's proposed rulemaking to "modernize" the shareholder proposal process by making corporations less accountable to shareholders. The research was also referenced by two SEC Commissioners at the meeting when the proposal was initially voted on and passed 3 to 2.

Since the paper uses loaded terms and biased methods, the Commission should not rely on its conclusions to support their proposed rules. I also urge Commissioner Jackson to revise his own follow-up paper to exclude methodological assumptions that bias his findings.

The Costs and Benefits of Shareholder Democracy: Unedited Conclusion of the Authors

> Corporations are often compared to democracies (*Gompers, Ishii, and Metrick, 2003*), in which the ultimate authority rests with voters. An advantage of well-working democracies is that virtually anyone can make proposals to change policies. The responsibility to weed out bad ideas and select proposals that are likely to be beneficial resides ultimately with voters. Thus, democracies work only to the extent to which voters are well-informed and select the right representatives and policies.
>
> We provide evidence that this is also the case for corporations. Low-cost shareholder activism appears necessary to discipline the managers of large companies with low profitability and growth opportunities, which cannot be profitably targeted by hedge fund activists. By virtue of being low-cost, however, this type of activism may become excessive and generate too many uninformed proposals. Whether these proposals pass and are ultimately implemented depends on the other shareholders of a firm. If these other shareholders collect information, bad and potentially harmful proposals are weeded out and low-cost shareholder activism manifest its full benefits.

Gantchev and Giannetti believe low-cost activists may generate too many "uninformed proposals." Their solution is for other shareholders to "collect information" and weed out the "bad" proposals in order to reap the full benefits of low-cost shareholder activism. Whether or not they are valid, those findings do not support the SEC's proposed rulemaking, which seeks

to forgo a large proportion of the benefits of low-cost shareholder activism by disallowing proposals from small shareholders, unless they have held stock for at least three years. (This reflects an arbitrary and capricious standard with no bearing in law or academic research, versus the current standard of one year, which comports with the tax code.)

In setting higher dollar thresholds to submit shareholder proposals, the SEC is essentially adopting a variant of the class-based decision making that America rejected in its Declaration of Independence. The SEC's underlying assumption is that decisions made by wealthy shareholders and professional money managers, who often have conflicts of interest, are inherently better than those of Main Street investors. No evidence is provided to support the assumption that larger shareholders submit better proposals. That is simply assumed, much like it was long assumed that land owning men made better decisions than women, slaves, indigenous people or citizens without substantial land holdings.

A Better Alternative

Contrary to the study cited, the SEC's proposed rule does nothing to encourage shareholders to collect more or better information prior to voting. When reviewing comments, the Commission is bound by law to consider alternatives. My recent petition to the SEC would better accomplish the avowed goals of Gantchev and Giannetti, the study cited by the SEC. Making thousands of votes available in user accessible format prior to voting deadlines stimulate widespread discussion on the merits of vote options, leading to more informed votes. (*Rulemaking Petition for Real-Time Disclosure of Proxy Votes*, SEC File 4-748, Jul. 9, 2019, https://www.sec.gov/rules/petitions/2019/petn4-748.pdf)

The Costs and Benefits of Shareholder Democracy: Rulemaking Citations

The proposed rule concerning the *Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8* cites *The Costs and Benefits of Shareholder Democracy*.

- "Relatedly, an academic study, using a sample of shareholder proposals submitted to S&P 1500 companies between 2003 and 2014, shows that five individual proponents submitted 78 percent of all proposals submitted by individuals and 27 percent of all proposals submitted by all proponents."
- "Gantchev and Giannetti (2018) show that market reaction is higher for proposals submitted by individuals that submit proposals infrequently."
- "Two academic papers suggest that proposals submitted by individual investors elicit a stronger market reaction than proposals submitted by institutional investors, while one suggests otherwise."

Since management is less willing to negotiate with individual investors, a disproportionate number of proposals from individual investors get submitted and go to a vote. Unsurprisingly, a small number of shareholders do most of the work of monitoring and filing proposals. Margaret Mead is frequently quoted as having acknowledged a similar pattern in civil society: "Never doubt that a small group of thoughtful, committed citizens can change the world. Indeed, it is the only thing that ever has."

Citations by Commissioners Clayton and Jackson

In his remarks before taking a vote on the proposed rule (*Statement of Chairman Jay Clayton on Proposals to Enhance the Accuracy, Transparency and Effectiveness of Our Proxy Voting System*, 11/5/2019, https://www.sec.gov/news/public-statement/statement-clayton-2019-11-05-open-meeting#_ftn19), Chairman Clayton noted his belief that shareholder proposals that are repeatedly submitted but fail to gain substantial support should be given a "time out." He went on to cite the following statistic from *The Costs and Benefits of Shareholder Democracy:*

> Similarly, it is clear to me that a system in which five individuals accounted for 78% of all the proposals submitted by individual shareholders would benefit from greater alignment of interest between the proposing shareholders and the other shareholders —who hold more than 99% of the shares. Yes, you heard that right, five individuals accounted for 78% of all the proposals submitted by individual shareholders.

Although he implies that proposals from the five individuals are not aligned with the interests of other shareholders, Chairman Clayton presents no evidence, substantial or otherwise, for his arbitrary and capricious belief. If five players in baseball hit 78% of the home runs, would their interests be necessarily unaligned with those of other players?
Commissioner Jackson cited *The Costs and Benefits of Shareholder Democracy* several times (Statement on Proposals to Restrict Shareholder Voting, 11/5/2019 https://www.sec.gov/news/public-statement/statement-jackson-2019-11-05-open-meeting#_ftn9). First, he uses the study to support an argument that fewer good proposals would be adopted.

> Take, for example, proxy-access proposals—initiatives to allow significant shareholders to put their own candidates up for election to the board. These are popular proposals: they hold underperforming executives' feet to the fire with a more realistic threat of a contested election. The evidence shows that these proposals often add value for shareholders over the long run. But today's rule would remove 40% of these proposals from the ballot after three tries—and keep them off for three years.

Jackson's analysis of the impact of raising resubmission thresholds is convincingly demonstrated for several types of proposals using graphs. His analysis comports with my own experience as a long-time advocate of proxy access. In 2003, the Council of Institutional Investors wrote the rulemaking petition that Les Greenberg and I filed with the SEC "re-energized" the "debate over shareholder access to management proxy cards to nominate directors." It took another decade of shareholder proposals and resubmissions for proxy access to take hold as a best practice in corporate governance.

However, when Commissioner Jackson goes on to agree with Chairman Clayton that a small number of shareholders submit a disproportionate number of proposals, he appears to lend support to Clayton's assumption it leads to negative results.

> Important work has shown that many investor initiatives are advanced by a small group of individuals sometimes derisively called "gadflies." And recent research suggests that the long-run value implications of those proposals may be meaningfully different from the effects of other kinds of proposals.

Commissioner Jackson wanted to know what the long-term implications are for proposals advanced by "gadflies," so he examined the evidence based on data presented in *The Costs*

and Benefits of Shareholder Democracy. I discuss his analysis below, after discussing the larger study.

The Costs and Benefits of Shareholder Democracy: Overview

Gantchev and Giannetti find “at least some of the proposals submitted by the most active individual sponsors seem to be ill-conceived. Not only do these proposals receive less support and produce negative abnormal returns if they pass with a majority in the shareholder meeting, but they are also less likely to be implemented by management, and if implemented, produce negative long-term abnormal returns.” (p. 2)

“Costs associated with low-quality shareholder proposals are less likely to emerge in companies in which a larger fraction of shareholders collects information before voting in the shareholder meeting because a more informed vote weeds our bad proposals.” (p. 2) “We conjecture that mutual funds that always follow the recommendations of proxy advisory firms are unlikely to collect vote-relevant information.” (p. 2)

“Our results show that if a larger proportion of a company’s shares are held by discerning mutual funds, harmful proposals are more likely to be weeded out. Importantly, shareholder proposals yield on average positive abnormal returns in firms with an informed shareholder base.” (p. 3) “We also show that informed shareholders who vote against harmful proposals are more likely to sell if the proposal passes, but not otherwise.” (p. 4)

“Our objective is to study under what conditions shareholder democracy works and to what extent the voting process weeds out bad proposals. For this reason, we focus on proposals that go to a vote and do not consider proposals for which the SEC allows exclusion or that shareholders withdraw after negotiations with management… We are the first to highlight that funds’ propensity to acquire information reduces the extent to which harmful proposals receive majority support, and hence, enhances the benefits of low-cost shareholder activism. (pp. 5-6)

The Costs and Benefits of Shareholder Democracy: Methodology

The authors obtained data on shareholder proposals between 2003 and 2014 for all firms in the Standard & Poor’s 1500 index from Institutional Shareholder Services (ISS). 4,878 shareholder-sponsored proposals were included in their sample. Individuals put forward over 35% of all shareholder proposals that were voted in shareholder meetings and are by far more frequent sponsors than pension funds, unions or investment companies, who are presumably better able to negotiate with management.

The authors find that proposals submitted by individual shareholders are significantly more likely to pass than proposals submitted by institutions. (p. 12)

The concentration of submitted proposals is much higher among individuals than among institutions – the top three individuals account for about 50% of all individual proposals, whereas the top three institutions account for about 30% of all institutional proposals. (p. 14)

To focus on proposals whose valuation effects are less likely to have already been incorporated in prices, we consider shareholder proposals that fall within 20 percent (above and below) of the company’s passing threshold. (p. 17)

Note: This methodology only makes sense if the market knows what proposals or potential proposals have been submitted to all companies and is knowledgeable about which will likely be adopted by boards without going to the proxy and which that do go the proxy are likely to win or fail. However, the market's knowledge of proposals is very limited.

A significant number of proposals are submitted to companies and are adopted without the market ever knowing. Some are agreed to through negotiation without a proposal being submitted, under the understanding that a proposal may be filed if agreement cannot be reached. Others are submitted and are withdrawn, contingent on nondisclosure by shareholder proponents. Other firms ask that proponents hold off until the company announces the changes, rarely giving credit to proponents.

As one of the most frequent filers cited by the study, my own experience offers information, which the study fails to consider. In the case of my own proposals, 10 out of 46 (22%) were withdrawn during the 2019 season because boards agreed to adopt or submit similar proposals. (McRitchie 2019 Proxy Season Win for Market Beta, https://www.corpgov.net/2019/08/mcritchie-2019-proxy-season-win-for-market-beta/) The market has no way of knowing about these proposals or crediting their benefits to small shareholder advocates.

I also doubt the market can predict, with any high degree of accuracy, which proposals are likely to pass and which are not. Will the proponent even show up to present at the meeting? Will the company solicit proxies? Will company share price be impacted by an unusual event? What consideration was given to these and other factors?

The methodology of discounting a large number of proposals, which win or lose by higher margins, undercounts the work of activists. Many proposals never appear on the proxy or are passed by high margins and are eventually implemented but companies would not take the actions requested without the proposals.

The Costs and Benefits of Shareholder Democracy: Preliminary Critique

Table 2 in the study compares the characteristics of firms targeted by different types of sponsors.

> The targets of institutional and individual sponsors appear to have remarkably similar characteristics; in addition, active (i.e., top 10) individual and institutional sponsors target very similar firms. Thus, any differences between the valuation effects of the proposals submitted by active individual sponsors and other sponsors are more likely to capture differences in the merits of the proposals – as we argue – rather than differences in firm characteristics. (p. 15)

However, a closer look at Table 2 reveals that companies targeted by active individual sponsors are less profitable than those sponsored by active institutional investors and substantially less profitable than those sponsored by most institutional investors. Active individuals during the study period filed mostly governance proposals at less profitable companies, often filing the same and/or additional reforms over and over again until companies finally adopt best practices, such as allowing shareholders to vote on poison pills or to call special meetings.

Column 1 in Panel A of Table 3 shows that proposals sponsored by individuals typically receive more support in terms of the percentage of votes “For” than proposals submitted by other sponsors, unless they are submitted by active individual sponsors, as seen by the negative coefficient on the interaction between *Individual* and *Top 10 sponsor*. (p. 16) However, this is not surprising given the authors’ methodology. Many proposals filed by active individual sponsors pass by more than 70%.

John Chevedden is the most prolific filer. A quick review of his winning proposals in the SharkRepellent database on November 25, 2019 revealed that out of 241 passing proposals, 91 (38%) won more than 70% of the vote. Excluding these proposal from the count makes no sense for evaluating the effectiveness of proponents, although it may have some validity in evaluating the impact of proxy advisors as seems to have been the desire of Gantchev and Giannetti.

In column 6, where researchers control for the percentage of votes cast in favor, proposals sponsored by individuals are more likely to be implemented than those submitted by other sponsors, unless the individual proponents are “too active.”

Again, this is no doubt a result of not counting a substantial number of overwhelming wins sponsored by individual proponents that are “too active.” As mentioned above, the research methodology undercounts winning proposals by John Chevedden by 38%, not to mention proposals never submitted or withdrawn because of negotiated agreements.

Columns 1-6 of Panel B present regression models of a firm’s cumulative abnormal returns (CARs), calculated in excess of the CRSP value-weighted index, during a three-day window around the shareholder meeting… According to the authors, Columns 1 and 2 in Panel B of Table 3 provide clear evidence that proposals submitted by active individual sponsors generate negative short-term abnormal returns. Consistent with the interpretation that individual proposals by top 10 sponsors may be costly to the firm, researchers find that such proposals generate about 2% lower short-term returns than proposals by other individual sponsors, even after controlling for firm characteristics, and year and proposal type fixed effects.

This conclusion is specious, since the authors remove a large proportion of victories from activist data, as noted repeatedly above, and do not include proposals submitted and withdrawn based on agreement with the issuer. As mentioned above, 10 out of 46 (22%) of my own proposals were withdrawn during the 2019 season because management agreed to adopt or submit a similar proposal. (McRitchie 2019 Proxy Season Win for Market Beta, https://www.corpgov.net/2019/08/mcritchie-2019-proxy-season-win-for-market-beta/)

Commissioners should also question who is buying and selling shares based on shareholder proposals passing or not passing? The largest shareholders, such as BlackRock, Vanguard, and State Street mostly use an index strategy. They certainly are not selling shares because a proposal submitted by John Chevedden or any other individual activist managed to win. If individual activists are really generating negative short-term returns, as the researchers contend, they should use their research to short those stocks.

Additionally, it is unclear if the researchers accounted for market capitalization weighting in their regression analysis. For example, a 2% increase in a large company like Apple (AAPL) adds a lot more value to shareholders than what a 2% decrease in small-cap company like

Duluth Holdings (DLTH) subtracts from shareholder value. The authors appear to have introduced a small-cap bias into their analysis. As investors know, small-cap returns are much more volatile (yielding a wider variance) than larger-cap returns. That can lead to misleading conclusions about shareholder value because stock returns do not follow a gaussian ("normal") distribution.

Even if we suspend disbelief and assume the authors are correct, the "observed" underperformance associated with individual investor proposals is vanishingly small and likely nothing more than random noise. The conclusion that "such proposals generate about 2% lower short-term returns" translates for a typical $20 stock, into a 3-day underperformance of maybe 4 one-hundredths of a penny [$20 (multiply by say an 8% annual return in a typical stock) (divide by 252 trading days in a year) (multiply by 3 days in the authors' window) (multiply by the authors' 2%) = $0.0004]

Maybe these deficiencies explain why the authors have not retired from their professorships to short companies where proposals are filed by the top 10 individual sponsors?

The authors set up a prejudicial typology of "good" and "bad" proposals based not on the characteristics of proposals but of the sponsor. Proposals are *Generic* if the sponsor targets multiple companies within the same year with precisely the same proposal. Proposals are *Unfocused* if sponsors put forward many different types of proposals in the same year. A proposal is defined as *Unfocused* if it is submitted by an unfocused sponsor. *Fad* proposals are ones that are submitted in a year when both the number of this type of proposals and the number of sponsors submitting such proposals are in the top tercile of all years. Collectively, these proposals are labeled as *bad proposals*.

How is such a typology in any way scientific? They are simply assigning pejorative labels to proposals largely based on the behavior their sponsors, not based on an objective criteria such as a statistical association between the type of proposal and long-term shareholder value.

Panel B of Table 4 purports to show that a lower percentage of votes are cast in favor of generic, unfocused, and fad (collectively, "bad") proposals by individual sponsors. (p. 23) How can these "findings" be given any credence, given the unfathomable typology used?

The researchers then go on to provide unsubstantiated judgments of the advice of proxy advisors ISS and Glass Lewis. "We conjecture that a fund is less likely to gather information about the issues being voted on at a firm if it always follows the recommendations provided by ISS, a proxy advisory firm." (p. 25) "We use the *Informed* ratio to measure the proportion of mutual fund families in a firm's shareholder base that do not closely follow ISS recommendations or their own preferences, but vary their votes when the same issue is raised at different forms." (p. 27)

> In Panel B of Table 5, we define an indicator variable – Informed base – equal to one if the firm's Informed ratio is above the median, and zero otherwise. We are interested in the interaction between Individual, Informed base and the three specific definitions of harmful proposals – generic, unfocused, and fad. As shown in columns 1-3, generic, unfocused, and fad proposals sponsored by individual investors receive 21-25% lower percentage of votes in favor if firms have more informed shareholders. In columns 4-6, we also find that bad proposals sponsored by individual investors are between 40% to

> 70% less likely to pass with majority support. Columns 7-9 show that harmful proposals are also substantially less likely to be implemented, especially in the case of generic and unfocused proposals. Thus, having an informed shareholder base decreases the costs associated with harmful shareholder proposals. (p. 27-28)

The researchers create an unfathomable typology of “bad” proposals, not based on the characteristics of the proposals, but on characteristics of the proponents. Researchers then contend that shareholders that vote against the recommendations of ISS (advice they pay to obtain), are more “informed” than those taking ISS’ advice.

Contrast these findings with those of the study, *Who Calls the Shots?: How Mutual Funds Vote on Director Elections (*https://scholarship.law.upenn.edu/faculty_scholarship/374/)*.* Funds that account for less than 10% of the assets in our sample exhibit a strong tendency to follow ISS recommendations, a much smaller percentage than funds that virtually always follow management recommendations (approximately 25% of assets).

A more recent study, *“The Role of Proxy Advisors and Large Passive Funds in Shareholder Voting: Lions or Lambs**”** (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2831550) concludes the following:*

> Large passive mutual funds and proxy advisory firms have faced criticism both for being too powerful and not exercising diligence in proxy voting. We document that the “Big 3” passive fund families, Blackrock, State Street, and Vanguard, are increasingly likely to vote with management, and their support is paramount in approving controversial proposals.

Are funds that always or are most likely to follow management recommendations really more “informed” than those voting with ISS? What is the basis for such an assumption? Blackrock, State Street, and Vanguard are more likely than most funds to have a conflict of interest because a high portion of their businesses depend on selling retirement services (running 401k plans) for companies. It would logically be in their self-interest *not* to be seen by those companies as activists voting against Board recommendations. Yet, under the Gantchev / Giannetti typology these funds are the most “informed” voters, because they are among those least likely to follow the advice of ISS. How is that credible?

Given that ISS annually surveys its customers to determine what its proxy voting policies should be, it would be more reasonable to assume those voting with ISS are actually more informed voters than those not taking the advice of ISS. For example, see ISS 2019 Global Policy Survey at https://www.issgovernance.com/file/policy/2019-2020-iss-policy-survey-results-report.pdf.

The study may also suffer from observer bias. The authors appear to use a study with one objective – determine if a subset of “voter,” (informed vs uninformed mutual fund companies) screens out shareholder proposals with deleterious effects on long term stock returns – to draw conclusions about a much broader objective (Have individual shareholder proposals added long term shareholder value?) While the research authors may have some recognition of that bias, because their overt conclusions focus on informed vs uninformed voting, not “bad” shareholder proposals, the Commission has focused more on the implicit observer bias of who submits “bad” proposals.

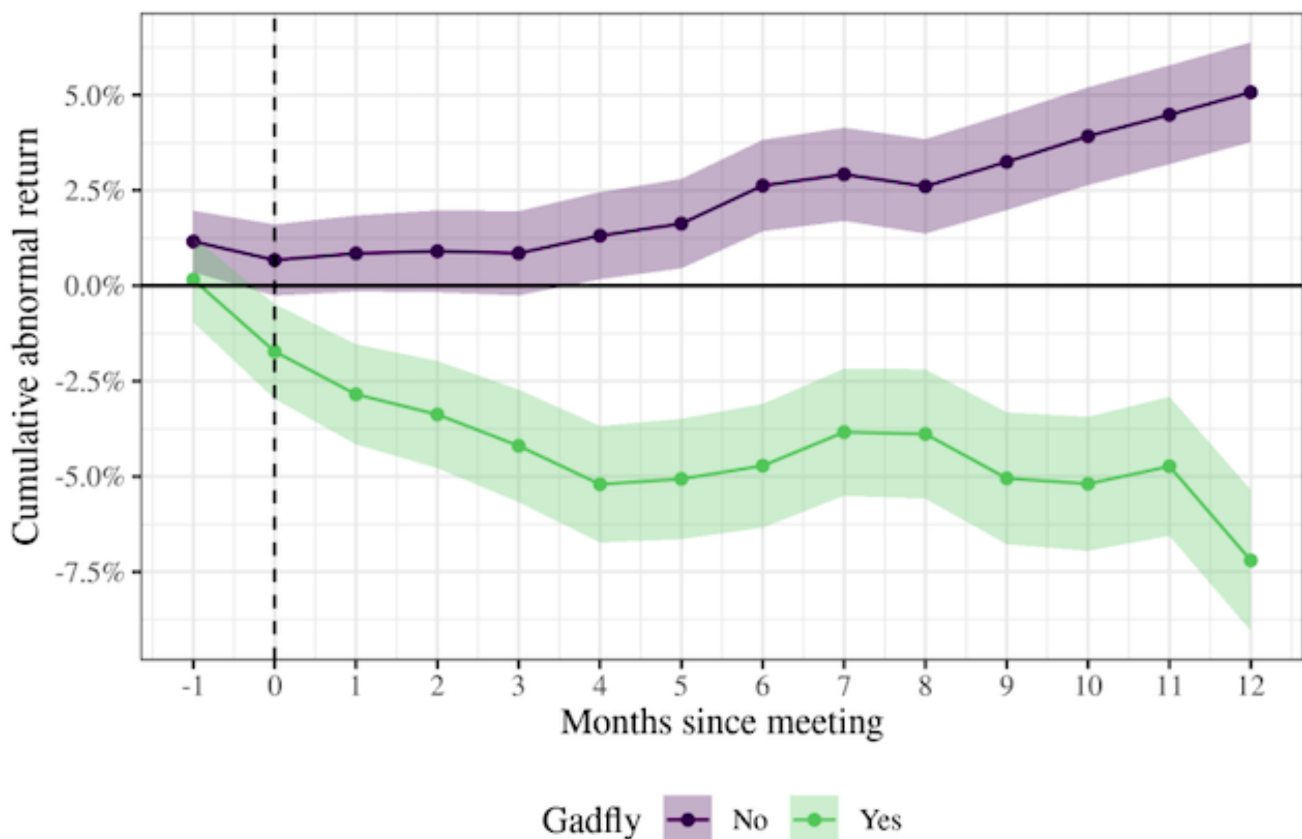
Commissioner Jackson's Data Appendix on Proposals to Restrict Shareholder Voting

Commissioner Robert J. Jackson, Jr. used the same data as Nickolay Gantchev & Mariassunta Giannetti to evaluate the impact that "proposed revisions to the resubmission thresholds" and to analyze the impact of "gadfly" investors on firm value. Unfortunately, Jackson "drank from the same Kool-Aid" with respect removing close votes that fall within ±20% of passing and not accounting for proposals successfully withdrawn.
Despite those potential biases, he finds:

> The proposed rules would also exclude up to 35% of independent Chair shareholder proposals, 40% of proxy access proposals, 50% of board diversity proposals, and nearly 65% of report on climate change proposals, and 40% of political spending disclosure proposal

More problematic are his findings with respect to activist individual investors, so-called gadflies:

> The results are striking. On average, we show, inclusion of shareholder proposals from individual investors by an American public company tends to be associated with long-term value increases. But so-called gadfly proposals—those brought by the ten most frequent individual submitters each year—appear to have the opposite effect, leading to long-run value decreases for ordinary investors:

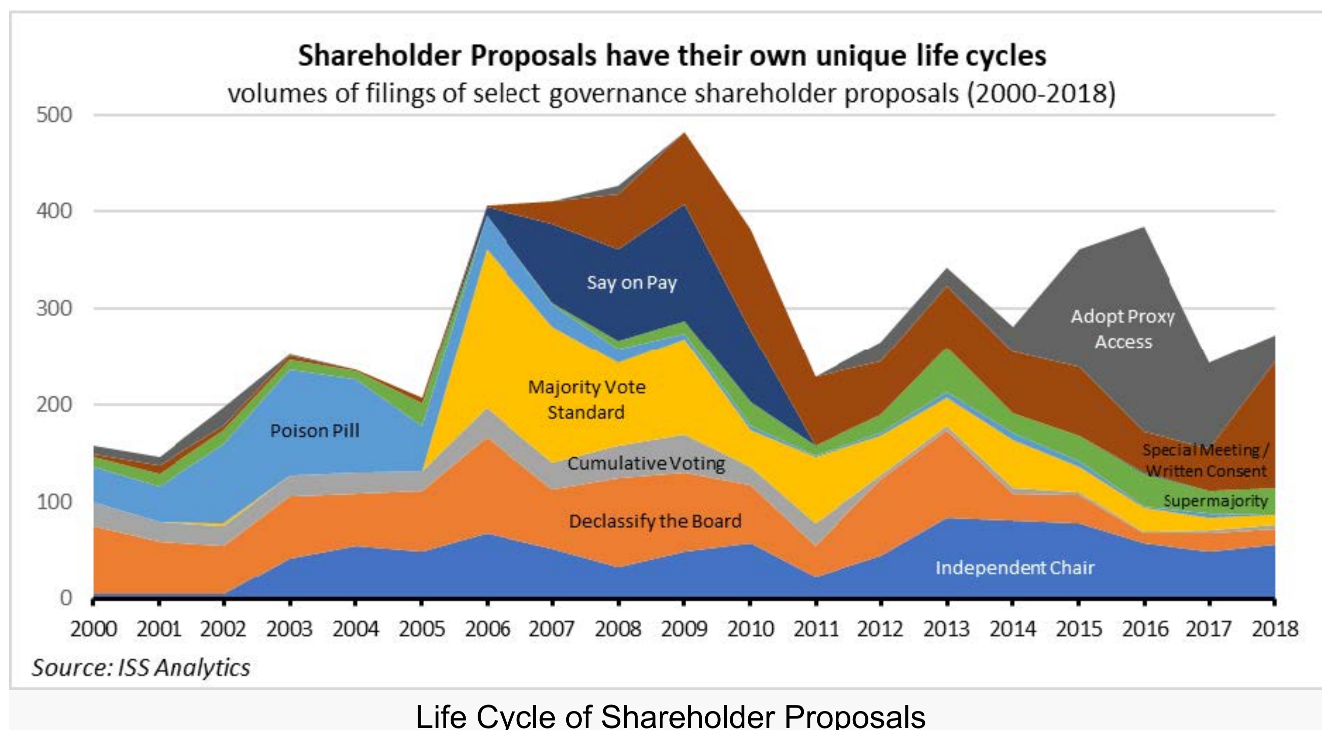


That sounds damning. However, in an important footnote, he notes:

> Notwithstanding the rigorous methodological choices in Gantchev & Giannetti, supra note 10, I need not and do not draw the causal inference that proposal inclusion

causes the value effects depicted in Figure 1. The evidence may instead pick up a selection effect: that certain proponents are more likely to target poorly performing companies, for example, or that those companies have other corporate governance features linked to long-term value effects. For present purposes, I note only that inclusion of certain proposals can be clearly associated with long-run value implications that matter for investors. In my view, evidence of this kind is critical in making policy choices like those we are proposing today.

Jackson observes, "certain proponents are more likely to target poorly performing companies." I would guess that "gadflies," especially during the study period (2004-2014) filed disproportionately at companies with governance practices that deny shareholder rights. As seen from the chart below, some "best" practices are adopted fairly rapidly, like "say on pay," while others take decades to be widely adopted, like removing super majority standards, declassifying boards and requiring an independent chair. Gadflies frequently persist in filing the same governance proposals year after year with companies lagging in best practices. It would not be surprising if such companies also lag in stock performance.



Life Cycle of Shareholder Proposals

Jackson is probably correct in hypothesizing that gadflies targeted disproportionately poorly governed and performing companies. As noted above in the discussion of the report by Gantchev and Giannetti, I ran a SharkRepellant report for proposals submitted by John Chevedden and his family members. Chevedden filed and won a proposal at Delphi Corporation aimed at revoking their poison pill for four years running. Instead of redeeming their poison pill, they went bankrupt. It was a poorly governed and poorly performing company, like many of his other targets.

Out of 241 of Chevedden's majority vote proposals, 91 or 38% won more than 70% of the vote, so would not be considered using Jackson's methodology. There were undoubtedly other proposals adopted by companies without going to the proxy after negotiating with Chevedden. What impact would including such proposals have on an analysis of abnormal

returns? Even if he disproportionately targeted poor performers, such as Delphi, it would be more informative to have all proposals counted and potentially assessed.

Although I am skeptical of event studies, especially events that largely go unnoticed by the market, including all submitted proposals would more likely show a positive correlation between share value and “gadfly” proposals. For example, 13 of my 22 majority votes out of 46 proposals won over 70%. However, even such a modified study accounting for the entire spectrum of votes, would leave out proposals that never went to the proxy due to successful negotiations. As mentioned above, 10 out 46 (22%) of my own proposals this year were negotiated wins, so never appeared on proxies. A study meant to measure the impact of “gadflies” should not leave out of consideration half of their proposals.

Conclusion

I urge Commissioner Jackson to rerun his study’s numbers to include all proposals, not just those that fall within ±20% of passing. Additionally, Commissioners who voted in favor of revising shareholder submission and resubmission thresholds, based on the findings of Nickolay Gantchev and Mariassunta Giannetti’s *The Costs and Benefits of Shareholder Democracy,* should reexamine their votes because of the many flaws in research methodology discussed above.

Sincerely,

James McRitchie, Shareholder Advocate/Publisher
Corporate Governance (CorpGov.net)