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Is America's Competitive Advantage Worth More Than $2,000?

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With proxy season ending and shareholder proposals reaching the heart of corporate governance — the boardroom — it is time for the U.S. Securities and Exchange Commission to conduct a thoughtful and comprehensive review of its shareholder proposal rule. Currently, a shareholder owning only $2,000 in a company's stock for one year may include a proposal in the company's proxy statement to be voted on at the company's annual meeting. Many in the corporate community are deeply concerned that the rule, if left unchanged, could have an unintended and potentially disruptive impact on the long-term competitiveness of the U.S. economy. The rule is not only a significant financial drain on U.S. companies, but may also contribute over time to a short-term focus by corporate management. This short-termism could severely undermine our companies' long-term ability to thrive in the global market and consequently, destroy U.S. jobs.

The SEC enacted its shareholder proposal rule in 1942 under its authority to promulgate proxy rules "necessary or appropriate in the public interest or for the protection of investors." In 1998, when it last revised the rule, the SEC explained that the rule is meant both to strengthen disclosure — by requiring shareholder proposals expected to be presented at the annual meeting to be included in the company's proxy materials — and to "enhance[ ] investor confidence in the securities markets by providing a means for shareholders to communicate with management and among themselves on significant matters." It's time the SEC re-examined whether the rule is fulfilling its intended purpose.

In recent years, the rule has been hijacked by shareholders seeking to advance political or social agendas that are often inconsistent with, or unrelated to, protecting investors or increasing long-term shareholder value. According to the Conference Board, of the 752 shareholder proposals submitted to Russell 3000 companies with meetings in the first half of 2014, 77 percent were sponsored by labor unions, pension funds, individuals, or religious or activist groups. These groups generally aim to advance certain ideological goals — not necessarily the best interests of long-term investors. In fact, 288 proposals submitted to Russell 3000 companies with meetings in the first half of 2014 — or nearly 40 percent — pertained to social and environmental policy issues, up from 109 proposals during the same period in 1998.

This trend is not limited to the Russell 3000. According to a Manhattan Institute study of proposals submitted to Fortune 250 companies in 2014, institutional investors without a labor, religious, social or policy affiliation sponsored merely 1 percent of shareholder proposals. Moreover, of those proposals submitted by individuals, 70 percent were submitted by only three individuals and their respective families.

The SEC has never accurately assessed the costs associated with its shareholder proposal rule despite its responsibility to do so before promulgating or amending its rules. Seventeen years ago, when it last revisited the shareholder proposal rule, the SEC acknowledged that it had "no empirical information" regarding the attendant expense incurred by public companies. While an economist's review is in order, given the recent proliferation of shareholder proposals, there can be no question that these proposals cost companies a significant amount — not to mention the toll they take on the time and attention of management teams and boards.

Much more troubling, however, is a cost to the American economy that may be considerably greater than any presently quantifiable monetary sum. The shareholder proposal process may be helping to foster a structural bias toward management's short-term thinking — undercutting the widely held belief that to maximize shareholder returns, corporate strategy should be devised to achieve the long-term best interests of the corporation and its shareholders. The result may be the curtailment of capital investment, stunted innovation and ultimately, the destruction of American jobs.

Over the last decade or so, the shareholder proposal rule has been used not only to advance the agendas of special interest groups, but also to dismantle key corporate protections, paving the way for increased shareholder activism. By way of example, largely as a result of the shareholder proposal rule, the number of poison pills amongS&P 500 companies has decreased from 300 in 2002 to 29 in 2014, and the number of S&P 500 companies with classified boards has plummeted from 302 to 49 during this period. At the same time, the percentage of S&P 500 companies providing shareholders the right to call special meetings has risen from 41 percent in 2002 to 59 percent in 2014.

With poison pills and classified boards no longer available and with the ability to call a special meeting at any time, corporations and their management teams could not be more vulnerable; this structure enables any shareholder to accumulate a large stake in the company and, in a short time, threaten to take over the board and throw out management. Combined with the funds flowing to activists, estimated at $120 billion-$200 billion in assets under management (up from $12 billion just a decade ago), is it any wonder that activists have been taking advantage of these vulnerabilities and initiating more campaigns? Or that activists are targeting a record number of companies with market capitalizations of over $10 billion, such as Microsoft and Apple? Or that last year, S&P 500 companies returned a record $904 billion, or 95 percent of profits, to shareholders through dividends and share buybacks — two actions often sought by shareholder activists?

As Democratic SEC Commissioner Kara Stein observed recently, these payouts often mean that "companies have to cut back on capital expenditures, research and development, workforce training, and other investments that lead to new innovation, higher productivity, and future growth."

Shareholder activists can have an important role in ensuring management's accountability. But because they typically have a shorter-term horizon, their interests are not necessarily aligned with those of long-term shareholders, and corporate boards may be strongly influenced to focus on short-term performance. The question, therefore, is whether the current shareholder proposal rule strikes the right balance between giving shareholders the ability to exercise influence over the affairs of the company and allowing management to take a longer-term view and invest for the future.

The SEC's current shareholder proposal rule may have permitted the pendulum to swing too far toward short-termism. This could have serious adverse consequences on the U.S. economy, including the loss of America's competitive advantage and American jobs — all of which may not be perceptible until it is too late to reverse the trend. At the very least, this concern should propel the SEC to conduct a long-overdue holistic assessment, including a cost-benefit analysis, of its shareholder proposal rule and the corporate governance environment in which it operates — starting with the rule's $2,000 threshold, which was recently described as "absurdly low" by Republican SEC Commissioner Daniel Gallagher.

When asked in 1943 about the potential for the shareholder proposal rule to be usurped by "either the nuisance man or the man with a particular idea or even an 'ism' or something he wants to advance," then-SEC Commissioner Ganson Purcell told Congress that such a case would require the SEC to "make such appropriate changes as might seem necessary." Now is that time — our country's long-term competitive advantage may be at stake.

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