Corporate Governance
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Chairman Jeb Hensarling
Financial Services Committee
2129 Rayburn HOB
Washington, DC 20515

Financial CHOICE Act – Oppose Unless Amended

April 23, 2017

Dear Chairman Huizenga:

This is to request amendments to the draft Financial CHOICE Act ("Act"). I agree with the stated intent of growing the economy from Main Street up, instead of Washington down. However, as currently written, several provisions will have the exact opposite impact. Freedom is tied to risk and responsibility. Maintaining it requires investment, hard work and the ability of investors to hold their agents accountable. Silencing their directives and recommendations will only lead to further dependency on government.

I am a shareholder advocate at many of the 100 companies where I own stock. As the publisher of Corporate Governance (CorpGov.net) for over twenty years, I have been an important contributor to the movement to facilitate a dialog between shareholders and their companies. As a result, CEOs typically no longer handpick their directors, the majority of whom are now independent. At most large corporations, uncontested directors now need to win a majority vote or resign. Free markets can play their crucial role because shareholders demanded bylaws that allow them to hold special meetings to remove directors or merge with another firm. Most of the largest firms now have proxy access, allowing groups of substantial long-term shareholders to better hold directors accountable. Such measures make companies more accountable and more profitable.

Corporations: Important Mediating Structures in our Commercial Republic

A health society depends on important mediating structures, such as family, schools, religious institutions, neighborhoods and businesses - especially corporations. Our founders established the United States as a commercial republic, with business forming a firmer foundation than military, aristocracy or religion.

Corporations are important mediating structures between the individual and the absolute power of the state. They depend on investments, respect for law and benefit from peaceful trade. Corporations teach cooperation, the value of diverse perspectives, prudence and attention to detail. They generate the vast majority of America's wealth. Congress should be strengthening the ability of corporations to act as mediating structures in fostering civic virtue, not attacking the very foundations of corporate governance by creating democratic-free zones.

Prior to the founding of out great nation, corporations were instruments of privilege through tightly controlled monopolistic charters issued by self-serving monarchs. The United States reinvented the corporation. No longer dependent on special privileges granted by the state, survival and growth depended on meeting the needs of customers through governing principles agreed upon by investors. By 1800 we already had more corporations than all of Europe.

In recent decades, fewer and fewer individuals own stock directly (around 30% of stock is still held by individuals). Retail shareholders are so alienated that 90% do not vote their proxies. They have been told over and over that if they don't like anything about how their companies operate, they should leave governance to the experts, remain silent, or should sell their shares. That is like telling a homeowner to move away from an otherwise desirable community because they want a stop sign at the end of their block.

Several provisions of the Financial CHOICE Act serve to reinforce this problematic state of disengagement by shareholders. Congress should be enacting measures that encourage share ownership and participation in corporate governance, instead taking rights from shareholders that allow them to hold their agents accountable.

Problematic Provisions

SEC. 844 of the Act would drastically alter the shareholder proposal rules. The Act would require shareholder proponents to hold one percent of the issuer's voting securities, instead of the current threshold of $2,000. The holding period would be increased from one year to three years. Additionally, the thresholds for resubmitting proposals would be raised and the common practice of having an agent submit proposals on behalf of a shareholder would be prohibited.

SEC. 845 of the Act would prohibit the SEC from requiring the use of a universal proxy, prohibiting the ability of shareholders to split their votes between the proxy sent by the current board and the proxy sent by a challenger as they can do if they attend the meeting in person.

Historical Perspective on Shareholder Proposals

Shareholder proposals have been allowed at annual meetings since colonel times. When the process was formalized by Securities and Exchange Commission (SEC) regulation in 1942 as Rule X-14A-7, there were no minimum share requirements, no limits on the number of proposals a shareholder could raise and no subject matter limits. When the SEC enforced the rule (*SEC v. Transamerica Corp*., 1947) the court concluded issuer-specific limitations interfered with the intent of Congress that shareholder voting rights operate as a check on the abuse of power by corporate management and that Rule X-14A-7 was consistent with that intention.

There has been a long history of proxy proposal usage by retail shareholders. Beginning in the 1930s John and Lewis Gilbert, for example, embarked on a lifelong crusade to make corporate governance more democratic and to encourage participation by shareholders. Over almost seventy years, they filed hundreds of proposals, responsible for over half of all proposals introduced by retail shareholders, on topics such as eliminating staggered boards, requiring directors to own stock and limiting executive pay.

My Own Proxy Proposals

During the last five years, 132 of my proposals have been voted on. Most received substantial support in the 30-50% range. Well over 20% received a majority vote. See Exhibit 1.

“Losing” a proposal does not mean having no impact. For example, my proposal at Reeds Inc. last year was defeated but negotiations resulted in four of five directors being named for replacement prior to the annual meeting in 2016. While the founder retained his position as the CEO, the new board appointed another director as chairman. Share price increased 69% during the period of our negotiations and the company is now addressing its challenges.

Most of my proposals are aimed at making the board more autonomous in its dealings with management. While many boards have served primarily to sound out management decisions, I seek a body of effective oversight and strategic deliberation – in touch with its shareholders, customers and the needs of society.

The democratization of corporate governance does not impose political constraints in opposition to economic performance; on the contrary, the need for democratization stems from increasing corporate complexity and contributes to corporate performance.

Impact of Proposed Changes in SEC. 844

Requiring shareholders to hold 1% of a company’s stock for three years would virtually eliminate shareholder proposals.

At most large and mid-sized companies, the only shareholders remaining eligible would be the largest, mostly indexed funds, such as Vanguard, BlackRock, Fidelity and State Street. None of these funds have ever filed a shareholder proposal. Three reasons for this inactivity come to mind:

1. These funds frequently run company retirement programs. Research indicates they vote against management less frequently when they have such contracts. (*Proxy Voting Conflicts: Asset Manager Conflicts of Interest in the Energy and Utility Industries*, 50/50 Climate Project, 4/16/2017 at https://5050climate.org/news/largest-fund-managers-face-conflicts-interest-voting-proxies/) Since conflicts of interest reduce voting against management for fear of losing contracts, we can assume filing proposals would have an even greater chance of reducing the likelihood of contract renewal.
2. Since they are primarily indexed, these funds compete largely based on cost. Although the cost is relatively small, filing proposals does require time and money. Any benefit derived goes equally to competitors holding a similar amount of stock, while all expenses are borne solely by proponents. Filing proposals would put such funds at a competitive disadvantage.
3. These funds hold such a relatively high percentage of stock in most companies that they might be able get the type of changes typically sought through shareholder proposals by simply expressing their desires to company management. Therefore, they have no need to file proposals.

Using mid-cap H&R Block, Inc. as an example, Exhibit 2 shows that only 22 institutional shareholders owned 1% or more of the company's shares at the end of 2016. Exhibit 3 shows that only 9 meet the draft requirement of holding those shares continuously for three years. None of those 9 institutional shareholders has ever filed a proxy proposal.

Corporate Governance and Equity Prices by Paul Gompers of Harvard and Andrew Metrick of the University of Pennsylvania's Wharton School found that "firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and fewer corporate acquisitions." Investors who bought firms with the strongest democratic rights and sold those with the weakest rights "would have earned abnormal returns of 8.5 percent per year during the sample period." (Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=278920)

Shareholder proposals have driven most of the rights evaluated by Gompers and Metrick. Since boards can adopt such rights without shareholder proposals but typically do not, we must conclude that boards typically prefer weak shareholder rights. The amendments suggested in SEC. 844 would likely lead to a substantial erosion of existing shareholder rights, lower returns, and a substantial drag on the entire economy.

Congress should be strengthening shareholder rights, not weakening them. Aside from serving to increase accountability, proposals often serve as an "early warning" system. Had companies listened, we might have avoided the 2008 financial collapse, since proposals concerning predatory subprime lending and the securitization of such subprime loans were introduced in 2000. Proposals beginning in 2003 asked securitizers to police their loan pools. See letter to the SEC from Paul M. Neuhauser dated 10/2/2007 available at https://www.sec.gov/comments/s7-16-07/s71607-476.pdf)

Had the board of Wells Fargo's not opposed such a proposal, they could have escaped both losses due to subprime loan practices but also their more recent scandal involving opening unwanted accounts.

> In 2004, Northstar Asset Management raised issues related to Wells' loan sales and asked the bank's board to "conduct a special executive compensation review" because, according to banking regulators at the time, Wells Fargo had "not adjusted compensation policies to discourage abusive sales practices" and did not have adequate audit procedures in place. The board dismissed the request, saying that Wells Fargo's "compensation and commission policies are designed to encourage appropriate sales practices" and that the bank had "comprehensive monitoring and audit procedures." (*Here's How Wells Fargo's Board Of Directors Just Failed Customers*, by Eleanor Bloxham, Fortune, 4/14/2017 at http://fortune.com/2017/04/14/wells-fargo-fake-accounts-2/)

With regard to raising resubmission requirements, changes in voting behavior do not come quickly. Proposals often require years of academic research, consideration, refinement and negotiation before they are widely accepted and proxy voting policies are changed. For example, support for shareholder proposals to declassify boards was regularly below 10% in the 1980s, but grew to over 80% in 2012. If resubmission thresholds of 15% and 30% had been in place, these proposals would have died long before they had the chance to be adopted. Declassified boards are now common practice, with 90% of S&P 500 companies holding annual votes, up from 40% 10 years ago.

With regard to the proposed prohibition against allowing shareholder proposals to be submitted by proxy, that is like denying the right to legal representation in court. Filing proposals is a complex legal process, requiring analysis, coordination and presentation. I typically delegate authority to an agent who helps ensure all legally required paperwork is properly filed and my proposals are properly presented, even if the meeting is held thousands of miles away in a remote location. Corporations frequently appoint outside legal counsel, filing no-action letters with the SEC in hopes of omitting my proposals. I see no reason why corporations should be able to appoint such agents, but shareholders should not.

Impact of Proposed Changes in SEC. 845

With regard to universal proxies, proponents of this amendment are driving the push to abandon the rule based on the misconception that activists will use it to drive more contests. However, the universal proxy is not being driven by activists, who will continue to solicit using their own proxy, but by investors who do not want to have to attend the annual meeting to be able to split their votes between two or more proxies.

As SEC Chairman Purcell explained to Congress in 1943, the intent of proxy rules is to replicate the rights that a shareholder would have if she/he actually attended the annual meeting, including the right “to make a proposal; to speak on that proposal at appropriate length; and to have his proposal voted upon.” (cited in previously mentioned Neuhauser letter)

This sentiment has been frequently repeated. For example, see the SEC’s briefing paper *Roundtable on the Federal Proxy Rules and State Corporations Law*, 5/7/2007 (available at https://www.sec.gov/spotlight/proxyprocess/proxy-briefing050707.htm):

> The proxy system that Congress authorized the SEC to devise was meant to replicate as nearly as possible the opportunity that shareholders would have to exercise their voting rights at a meeting of shareholders, if they were personally present.

Shareholders should be able to vote for the candidates of their own choosing by proxy, without incurring the expense of attending a meeting, which may be thousands of miles away. Instead, proposed amendments contained in SEC. 845 would prohibit the right of shareholders to choose their own representatives.

Conclusion

Corporations are among the most important mediating structures between the individual and society. Shareholder engagement in corporate governance has a long history of increasing management accountability and wealth generating capacity. Congress should strengthen the ability of corporations to act as mediating structures in fostering civic virtue, instead of attacking the very foundations of corporate governance by creating democratic-free zones.

Limiting the ability of owners to influence corporate behavior will simply lead to more government regulation, since corporations must be controlled and accountable to someone. I would rather see government regulation as a last resort. Strengthen the

ability of shareholders to govern corporations and we can largely hold them accountable with reduced government regulation. I urge you to oppose the proposed amendments contained in draft SEC. 844 and SEC. 845 of the Act and would be happy to discuss these issues with you or your staff at your convenience. Please do not hesitate to call me at 916-869-2402 or jm@corpgov.net.

Sincerely,

James McRitchie, Shareholder Advocate
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Elk Grove, CA 95758

Attached: Exhibits 1-3

cc: Randy Hultgren, Illinois, *Vice Chairman*
Peter T. King, New York
Patrick T. McHenry, North Carolina
Sean P. Duffy, Wisconsin
Steve Stivers, Ohio
Ann Wagner, Missouri
Luke Messer, Indiana
Bruce Poliquin, Maine
French Hill, Arkansas
Tom Emmer, Minnesota
Alexander X. Mooney, West Virginia
Thomas MacArthur, New Jersey
Warren Davidson, Ohio
Ted Budd, North Carolina
Trey Hollingsworth, Indiana
Jeb Hensarling, Texas, *ex officio*
Carolyn B. Maloney, New York, *Ranking Member*
Brad Sherman, California
Stephen F. Lynch, Massachusetts
David Scott, Georgia
James A. Himes, Connecticut
Keith Ellison, Minnesota
Bill Foster, Illinois
Gregory W. Meeks, New York
Kyrsten Sinema, Arizona
Juan Vargas, California
Josh Gottheimer, New Jersey
Vicente Gonzalez, Texas
Maxine Waters, California, *ex officio*
Ami Bera, California