Harvard Law School
Cambridge, MA 02138

Lucian Arye Bebchuk
James Barr Ames Professor of
Law, Economics, and Finance
Director, Corporate Governance Program

Tel (617) 495-3138
Fax (617) 812-0554
bebchuk@law.harvard.edu
http://www.law.harvard.edu/facutly/bebchuk

February 3, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
By email to rule-comments@sec.gov

RE: File No. S7-23-19; Release No. 34-87458

Dear Ms. Countryman:

This comment letter provides comments with respect to the above rule proposal.[1] The comments focus on the economic analysis described in the Release ("the Economic Analysis").

*   *   *   *

As I explain below, the Economic Analysis does not provide an acceptable basis for SEC rulemaking in this area. The Economic Analysis fails to adequately analyze the costs and benefits of the proposed rule, as well as its effects on efficiency, competition and capital formation; overlooks significant effects and issues; and does not use evidence that is available or could be obtained.

---

[1] I act in my individual capacity. My institutional affiliation is noted for identification purposes only.

Below I do not attempt to identify and discuss all the significant shortcomings of the economic analysis described in the Release. I only note several significant problems that by themselves indicate the necessity of redoing the economic analysis before proceeding to decision-making. However, I will be happy to assist the Commission or the Staff with identifying all the shortcomings that need to be addressed and carrying out the necessary economic analysis of the subject.

The Basic Economics of Shareholder Proposals

1. The Economic Analysis fails to give adequate weight to the Commission's long-standing interest in facilitating private ordering and the key role that shareholder proposals play in such private ordering. Shareholder proposals provide a key instrument for shareholder-driven private ordering intended to bring about value-enhancing governance changes that are disfavored by directors and executives.

In this connection, because the Economic Analysis does not analyze the subjects of proposals could be expected to be excluded under the proposed rule, the Economic Analysis does not engage with the data indicating that shareholder proposals by retail investors have played a key role in the adoption by numerous companies of changes widely viewed as consistent with best governance practices.

To illustrate, annual elections are supported by the ISG Corporate Governance Principles and the proxy voting guidelines of the vast majority of institutional investors. Had the Economic Analysis examined the data on the subject, it would have found that retail investors have been responsible for a majority of the precatory proposals that led a large number of companies to adopt annual elections.

2. The Economic Analysis fails to give adequate weight to the evidence that significant institutional investors tend to avoid the submission of shareholder proposals though they regularly vote for certain types of shareholder proposals. Scott Hirst and I document in a recent article that the Big Three index fund managers have generally avoided the submission of any shareholder proposal – not even proposals advocating the changes favored by their own governance.[2] In other

[2] See Lucian A. Bebchuk and Scott Hirst, "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy," *Columbia Law Review*, Vol. 119, 2019, Section II.B.3.

research, we have found that managers of actively managed mutual funds also tend to largely avoid the submission of shareholder proposals. This evidence highlights the costs that would result from discouraging the submission of proposals by those retail investors and organizations with relatively small stakes that play an important role in private ordering.

Relatedly, the Economic Analysis fails to give adequate weight to the benefits that shareholders that do not submit proposals themselves derive from the proposal submission. The Economic Analysis notes that the submission of proposals imposes costs on non-submitting shareholders by requiring them to bear the costs of assessing the proposals. However, as the corporate governance system currently operates, many institutional investors currently benefit significantly (and some even rely on) the submission of proposals that they regularly vote for to bring about changes that are favored by the institutional investors' own governance principles.

3. In discussing the need to "update" the submission and resubmission requirements, the Economic Analysis claims that shareholders now have alternative ways, such as through social media, to communicate their preferences and effect change. However, shareholder proposals have certain advantages in bringing about change compared with the use of other ways such as social media. The use of social media cannot be expected to be able to substitute for the ability of shareholder proposals to bring about governance changes in a very large number of companies. The Economic Analysis does not attempt to analyze available evidence that could shed light on how shareholder proposals compare with the use of social media in effecting change in many companies.

Cost-Benefit Analysis of the Proposed Rule

4. The Economic Analysis substantially does not present empirical evidence on the subjects and outcome of proposals submitted by retail investors, and does not provide estimates of the type and scale of governance changes that would have been precluded had the proposed amendments been in place. My own analysis indicates that the proposed amendments would have likely led to the exclusion of many

proposals that went on to pass and bring about changes that are widely viewed as consistent with best governance practices.

The Economic Analysis does not attempt to provide any empirical analysis of the expected economic effects of changes brought about by shareholder proposals in general, and the types of shareholder proposals that would have been excluded had the proposed rule been in place. Such an analysis would be valuable for any assessment of the proposed rule. For example, the well-known (and cited by the Release) study by Cunat et al. (2012)[3] provides estimates of the increases in market capitalization produced by the passage of certain shareholder proposals that have often been submitted by retail investors. One could combine these estimates with the estimates produced by the Economic Analysis regarding the expected reduction in proposal submission by retail investors to produce a quantitative assessment of the costs that the proposed rule would impose by eliminating some proposals submitted by retail investors that could obtain majority support.

My preliminary examination of this issue indicates that such an analysis could well produce estimated of costs that would far exceed the proposed rule's estimated benefits in terms of reducing the costs to companies and investors of dealing with proposals. To be sure, one could attempt to study the economic costs of excluding certain proposals in a different way than building on the Cunat et al. study, but conducting such an empirical analysis should be a significant component of the necessary economic analysis.

5. The Economic Analysis focusses on the benefits produced by proposals that go to a vote. However, this focus leads to a significant underestimation of the benefits from the ability to submit a proposal -- and thus also the costs from tightening the requirements for proposal submission.

In particular, changes are often made (a) as a result of proposals that are submitted but withdrawn before reaching a vote due to the issuer agreeing to make a change after communications with the proponent, and (b) as a result of engagement between shareholders and an issuer that is conducted without any

[3] See Cunat et al., The Vote is Cast: The Effect of Corporate Governance on Shareholder Value, *Journal of Finance*, Vol. 67, 2012.

proposal being formally submitted but against the background of the issuer's expectation that a proposal might be submitted if the issuer does not agree to make satisfactory changes. The basic point is that the prospect of submitting a proposal, and thus the ability to submit a proposal, play a role and produce benefits in shareholder-issuer engagements.

Therefore, an adequate economic analysis should take into account these "indirect" benefits of the ability to submit shareholder proposals and thus the "indirect" costs resulting from a significant tightening of the submission and re-submission rules. To this end, the analysis should consider the literature and available evidence on engagements and changes that are produced without a shareholder proposal going to a vote. For example, the analysis should examine empirically the incidence of companies adopting annual elections without the passage of a shareholder proposal to make such a change but following the passage of such proposals in many other companies.

6. Throughout, the premise of the Economic Analysis is that proposals that get substantial support falling short of a majority ("substantial minority support") do not provide benefits but rather impose costs. Due to this premise of the Economic Analysis, the Analysis assumes that excluding proposals that would be expected to obtain substantial minority support would produce benefits rather than costs. This premise leads the Economic Analysis to yet another underestimation of the costs of the proposed rule.

Whereas the Economic Analysis indicates that majority-passed proposals are likely to bring about subsequent changes, it overlooks that proposals that obtain significant minority support also often bring about changes. Furthermore, the mere prospect that shareholders will submit a proposal expected to get significant minority support, or insist on bringing such a proposal to a vote, often enables shareholders to get companies to agree to make changes. In particular, there is evidence, which the Economic Analysis could but did not examine, that proposals receiving significant minority support have brought many companies to change their practices with respect to disclosure of political spending and disclosure of environmental and climate change effects.[4]

Furthermore, it is a mistake to assume that the implementation of any proposal that receives only significant minority support must be opposed by a majority of the shareholders. There are several reasons, some grounded in recent empirical evidence, to question this assumption, and a detailed discussion of them can be found in a recent article I co-authored.[5]

Finally, a proposal that receives significant minority support provides useful information to the company at which the vote takes place. And proposals advocating a certain type of change that receive significant support in a number of companies provide useful information to other companies, as well as to policymakers, regarding the level of support such changes enjoy among shareholders. Indeed, the Commission itself used such information in its past adoption of rules regarding disclosure of executive pay.[6]

Effect on Efficiency, Competition, and Capital Formation

7. The Economic Analysis contains just two pages with a discussion of the effects of the rule proposal on efficiency, competition and capital formation, and this discussion does not identify any negative effects. As should be clear from the above comments, and as I note briefly below, the proposed amendments would have significant negative effects on efficiency and capital formation that deserve serious consideration.

In particular, by weakening shareholder ability to bring about value-enhancing changes through private ordering, including moves to what are widely viewed as best governance practices, the proposed rule would reduce the

---

[4] For a discussion of evidence on such changes, see Lucian A. Bebchuk, Robert J. Jackson, Jr., James David Nelson, and Roberto Tallarita, "The Untenable Case for Keeping Investors in the Dark," *Harvard Business Law Review*, Vol. 10, 2019, Section III.A.

[5] For a discussion of these reasons and relevant evidence, see Bebchuk, Jackson, Cohen, and Tallarita, *supra*, Section II.D.2.

[6] For discussion of the Commission's reliance on the expression of shareholder views in proposals receiving substantial minority support, see Bebchuk, Jackson, Cohen, and Tallarita, *supra*, Section II.D.1.

effectiveness of shareholder oversight, the efficiency of corporate governance arrangements, and the extent to which such governance arrangements conform with best governance principles that are widely accepted.

As to capital formation, when companies go public, investors not only care about the quality of the corporate governance arrangements in place at the time, but also care about the prospects that value-enhancing amendments to such arrangements will be made down the road if and when circumstances or changes make such changes worthwhile. By significantly impeding opportunities to bring about such changes in public companies during their long post-IPO life, the proposed rule would have an adverse effect on capital formation.

* * * *

For the above reasons, I urge the Commission to have the economic analysis described in its Release redone, and I will be happy to assist the Commission or the Staff in developing the necessary economic analysis. I can be reached at (617) 495-3138 or via electronic mail at bebchuk@law.harvard.edu.

Sincerely,

Lucian Bebchuk

Lucian Bebchuk