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CAPITAL MARKETS REFORM

The SEC Should Advance Materiality and Long-Term Investor Interests in Reforming U.S. Capital Markets for Consistency with the Core Principles

The Securities and Exchange Commission (SEC) has a three-part mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. In evaluating federal securities laws, the following Core Principles for Regulating the United States (U.S.) Financial System (the Core Principles) described in Executive Order 13772, issued on February 3, 2017 (the Executive Order), are particularly relevant as they are consistent with and promote this mission:

> "(a) empowering Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; and
>
> (f) making regulation efficient, effective and appropriately tailored."[1]

Business Roundtable believes that to ensure compliance with the SEC's mission and the Core Principles, federal securities laws and regulations must adhere to the SEC's bedrock principle of materiality when regulating disclosure and must focus on protecting the long-term interests of the ordinary investor. As a result, Business Roundtable believes it is imperative to repeal or reform federal securities laws and regulations that deviate from these principles. Our paper describes the principle of materiality for public company disclosures, the importance of protecting the long-term interests of the ordinary investor and identifies the revisions to laws and regulations that we believe are most necessary to provide for the efficient and effective regulation of the financial system the Executive Order seeks to achieve.

Adhering to the Materiality Standard and Protecting the Interests of Long-Term Investors are Necessary for Compliance with the Core Principles

For the better part of a century, materiality has been the fundamental guiding principle for public company disclosures under the federal securities laws. Materiality has been and remains the linchpin of public company disclosure because it sets an investor-focused standard for the appropriate information to be shared, is customized to the particular characteristics and circumstances of each registrant and naturally addresses current issues as they emerge.

As Congress, courts and the SEC have recognized, filtering out irrelevant information is critical to investors' ability to make informed investment and voting decisions. Without the filter materiality-based disclosure rules provide, investors can be subject to "information overload," "a phenomenon in which ever-increasing amounts of disclosure make it difficult for investors to focus on the information that is material and most relevant to their decision making as investors in our financial markets."[2]

[1] Exec. Order No. 13,772, 82 Fed. Reg. 9,965 (Feb. 3, 2017).
[2] Mary Jo White, Chair, Sec. and Exch. Comm'n, Speech at the 14th Annual A.A. Sommer, Jr. Lecture on Corporate Securities and Financial Law: The Importance of Independence (Oct. 3, 2013).

Despite the importance of adhering to the bedrock principle of materiality, the federal securities laws and regulations have increasingly been used as a vehicle to bring attention to specific special interest concerns, mandating disclosure of information regardless of its materiality or relevance to a company's strategic, operational or financial performance. As noted by SEC Chairman Jay Clayton during his remarks at the Economic Club of New York, "this disclosure-based regime has worked so well that we — not just the SEC, but lawmakers and other regulators — have slowly but significantly expanded the scope of required disclosures beyond the core concept of materiality."[3] As a result, Chairman Clayton observed that over the last two decades "studies show the median word-count for SEC filings has more than doubled, yet readability of those documents is at an all-time low."[4]

In addition to protecting investors' ability to make informed investing and voting decisions, a focus on materiality has the added benefit of eliminating unnecessary compliance costs. These costs can be a disincentive for companies to enter the public markets in the United States.[5] Further, these costs expend corporate resources otherwise available to all shareholders to support special interests not material to a company's operational or financial performance. As Chairman Clayton has questioned in his remarks on the current shareholder proposal process, "how much cost should the quiet shareholder, the ordinary shareholder, bear for the idiosyncratic interests of others?"[6]

For the reasons stated above, Business Roundtable believes that federal securities laws and regulations that deviate from the standard of materiality inhibit regulation of the financial system in a manner consistent with the Core Principles because they hinder investors' ability to make informed choices in the marketplace and allow for regulations that are not efficient, effective or appropriately tailored. Business Roundtable further believes that federal securities laws and regulations that require companies to expend significant resources to address the idiosyncratic interests of a small subset of shareholders and potentially reduce investment returns to all shareholders — the very constituency these laws should be designed to protect — need reexamination and modernization in order to align with the Core Principles.

Top Recommendations for Change

A focus on, and return to, the standard of materiality and the long-term interests of investors in federal securities laws is necessary to ensure alignment with the Core Principles and the long-term success of the U.S. financial system. To that end, Business Roundtable believes that the current laws and regulations described below are of immediate concern because they conflict with the Core Principles. In addition, Business Roundtable believes that to help ensure the accuracy and materiality of information provided to investors so that they may make informed

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[3] Jay Clayton, Chair, Sec. and Exch. Comm'n, Remarks at the Economic Club of New York (July 12, 2017).
[4] *Id*.
[5] *See* Geoff Colvin, *Going Private: Take This Market and Shove It*, FORTUNE (May 17, 2016), http://fortune.com/going-private/. Commission staff estimates that there has been a roughly 50 percent decline in the total number of U.S.-listed public companies over the last two decades. Clayton, *supra* note 3.
[6] Jay Clayton, Chair, Sec. and Exch. Comm'n, Speech at the Center for Capital Markets Competitiveness: A Discussion with SEC Chairman Jay Clayton (July 26, 2017).

decisions, there must be increased supervision of proxy advisory firms by the SEC. Our recommendations for change are designed to achieve the Core Principles.

Conflict Minerals Rule

The conflict minerals disclosure mandated by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the *Dodd-Frank Act*) requires companies to annually determine if their products contain "conflict minerals" originating in the Democratic Republic of the Congo (DRC) or adjoining nations.[7] The SEC has acknowledged that the purpose of the rule is "quite different from the economic or investor protection benefits that our rules ordinarily strive to achieve" and that the law was "not necessarily intended to generate measurable, direct economic benefits to investors or issuers specifically."[8] And, although the SEC adopted the rule in 2012, the final disclosure requirements of the rule remain uncertain.

In August 2015, the U.S. Court of Appeals for the D.C. Circuit struck down a critical disclosure requirement under the rule when it reaffirmed the holding that the requirement to state whether products have "not been found to be 'DRC conflict free'" violated the First Amendment, finding it was not adequately shown that the compelled speech would further the government's humanitarian goals.[9] On April 3, 2017, the U.S. District Court for the District of Columbia affirmed this decision in a final judgment and remanded to the SEC to determine whether this description was required by statute or was a product of the SEC's rulemaking.[10]

In response to court rulings, in April 2014 and again on April 7, 2017, the SEC released guidance modifying the aspects of the adopted rule with which companies must comply. In its April 2014 guidance, the SEC suspended the requirement for companies to state whether their products were conflict free and provided that it would not require companies to provide an independent private sector audit (IPSA) unless the company affirmatively described its products as "DRC conflict free."[11] The April 2017 guidance further updated the disclosure requirements with the SEC stating that "in light of the uncertainty regarding how the SEC will resolve" the issues, it would not recommend enforcement action if a company did not file the detailed supply chain due diligence disclosure or, unless products are described as being conflict free, an IPSA otherwise required by the rule.[12] However, as a result of a number of factors, including the proximity of the SEC's updated guidance to the May 31 required filing deadline and the general uncertainty regarding future disclosure requirements with respect to the rule, companies generally continued to provide a conflict minerals report including the due diligence disclosure.[13]

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[7] 17 C.F.R. § 240.13p-1 (2012).
[8] 77 Fed. Reg. at 56,350.
[9] *Nat'l Ass'n of Mfrs., et al. v. SEC*, 800 F.3d 518 (D.C. Cir. 2015).
[10] *Nat'l Ass'n of Mfrs., et al. v. SEC*, No. 13-CF-000635 (D.D.C. Apr. 3, 2017).
[11] Keith F. Higgins, Director, SEC Division of Corporate Finance, "*Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule*" (Apr. 29, 2014).
[12] SEC Division of Corporate Finance, "*Updated Statement on the Effect of the Court of Appeals Decision on the Conflict Minerals Rule*" (Apr. 7, 2017).
[13] *See* Chris N. Bayer & Jesse H. Hudson, *Dodd-Frank Section 1502 – RY2016 Filing Evaluation*, Development International (July 25, 2017) noting that out of 1,153 total filings in 2016, 24 companies that filed a conflict minerals report in 2015 only filed a Form SD in 2016.

This compliance comes with a high price tag. At the time of adoption, the SEC estimated the cost of compliance at $3 billion to $4 billion initially and $207 million to $609 annually thereafter.[14] In practice, many Business Roundtable members have found that compliance with this rule costs hundreds of thousands (and in the case of larger companies, millions) of dollars each year in addition to the cost associated with the numerous hours that management and other employees have not devoted to other matters as their attention has been required for compliance with this rule.

These costs have led to unclear results. Of companies that filed a Form SD in 2015 and performed the related costly due diligence, approximately 67 percent reported they were unable to even confirm the source of the conflict minerals in their products.[15] Further, while there are some reports of beneficial effects of the rule on the region, other reports suggest that the rule is actually exacerbating the humanitarian problems in the DRC, including indications that the rule has increased the probability of civilian looting by at least 143 percent and that it increased the probability of battles in territories containing unregulated gold.[16]

Business Roundtable supports the underlying objective of addressing atrocities occurring in the DRC and surrounding areas as a social issue; however, we respectfully submit that Congress should repeal the conflict minerals disclosure rule as proposed in the Financial CHOICE Act of 2017, passed by the House of Representatives on June 8, 2017 (the CHOICE Act). We do not believe that compliance with any form of the rule has resulted in investors receiving information that is material to making informed voting or investment decisions or that the federal securities laws are a proper, efficient or effective vehicle for pursuing these policy objectives. Other policy mechanisms, such as regional and international diplomatic initiatives and strengthening and refining the mandate of the existing peacekeeping mission in the region, are much better suited to achieve the policy goals underlying the rule.

Until the rule is repealed, in light of the changes to the rule required by the courts and new evidence regarding consequences of adoption of the rule, we would reiterate our request set forth in our March 17, 2017 letter to Acting Chairman Michael Piwowar that the SEC engage in rulemaking, including robust economic analysis, to permanently more narrowly tailor the required disclosure.[17] Most critically, we believe the rule should be revised to permanently suspend any requirement for an IPSA for filers who do not choose to voluntarily assert in their reports that one or more of their products are "DRC conflict free." We further believe a better approach would be to amend the rule to make the disclosure requirement only applicable when it is material to a company's operational and financial performance.

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[14] 77 Fed. Reg. 56,334.

[15] U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-805, SEC CONFLICT MINERALS RULE: COMPANIES FACE CONTINUING CHALLENGES IN DETERMINING WHETHER THEIR CONFLICT MINERALS BENEFIT ARMED GROUPS (2016).

[16] Dominic P. Parker & Bryan Badheim, *Resource Cursed or Policy Cursed? US Regulation of Conflict Minerals and Violence in the Congo*, 4 J. ASS'N ENVTL. & RESOURCE ECONOMISTS 1, 3 (2017); Sudarsan Raghavan, *How a Well-Intentioned U.S. Law Left Congolese Miners Jobless*, WASH. POST (Nov. 30, 2014); David Aronson, *How Congress Devastated Congo*, N.Y. TIMES (Aug. 7, 2011).

[17] Letter from John Hayes, Corporate Governance Comm. Chair, Business Roundtable, to Michael S. Piwowar, Acting Chairman, SEC (Mar. 17, 2017), *available at* https://www.sec.gov/comments/statement-013117/cll2-1646348-148444.pdf.

CEO Pay Ratio Rule

The *Dodd-Frank Act* directed the SEC to promulgate rules that would require public companies to calculate and disclose CEO pay as a ratio to median employee pay.[18] These pay ratio rules provide no material information to shareholders or investors, and may actually be misleading as the ratio for companies with compensation packages that are heavily performance-based (an approach viewed as a "best practice" for public companies) will likely increase when a company is performing well and will likely decrease when a company is performing poorly.

Differences across companies, including business models, staffing strategy and regional, national or local employment markets, can distort the ratio, resulting in an arbitrary and often meaningless number. In addition, reliable information is costly and difficult to gather for global companies and, as a result of international data privacy laws, obtaining information for employees outside the United States may actually be prohibited and could change from one year to the next. All of these factors contribute to making the ratio more confusing to the Main Street investor.

Also concerning is the effect the rule will likely have on employee morale — not as it relates to employees comparing their compensation to the CEO's compensation — but as it relates to employees being provided a tool by which they can compare their compensation to that of their colleagues and the rest of the employee population.

The pay ratio disclosure rules serve no material, valid or helpful purpose for investors to make informed investment decisions. Their only use would be to serve as a means for certain special interest groups to force companies to devote resources to collect and analyze data in service of their own particular agenda. Business Roundtable believes the rules should be repealed by Congress as is contemplated in the CHOICE Act; pending repeal the rules should be re-examined and reformulated in a more constructive, less burdensome manner. Our recommended amendments to the rules are more fully described in our March 23, 2017 letter to Acting Chairman Piwowar and our August 2, 2017 letter to Chairman Clayton, and include excluding employees located outside of the United States and non-full time employees from the requirements of the rule to, among other things, create a more constant denominator, allowing the pay ratio information be "furnished" rather than "filed," and extending the compliance date to no earlier than the first fiscal year beginning on or after January 1, 2018.[19]

Shareholder Proposal Rules

Business Roundtable believes that constructive shareholder engagement is vital to the successful operation of public companies. The importance of this relationship drives the need for a shareholder proposal process that is robust, productive and oriented toward long-term value creation for all shareholders. That is not the case today.

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[18] 15 U.S.C. 78l; 17 C.F.R. § 229.402(u).
[19] Letter from John Hayes, Corporate Governance Comm. Chair, Business Roundtable, to Michael S. Piwowar, Acting Chairman, SEC (Mar. 23, 2017), *available at* https://www.sec.gov/comments/pay-ratio-statement/cll3-1664780-148922.pdf; Letter from John Hayes, Corporate Governance Comm. Chair, Business Roundtable, to Jay Clayton, Chairman, SEC (Aug. 2, 2017), *available at* https://www.sec.gov/comments/pay-ratio-statement/cll3-2166097-157803.pdf.

The shareholder proposal process has been increasingly dominated by a limited number of individuals who own only nominal amounts of shares in the companies they target and file common proposals across a wide range of companies. In fact, in 2016, one-third of all shareholder proposals at Fortune 250 companies were sponsored by 6 individual investors and their family members, while 38 percent of proposals were sponsored by institutional investors with an express social, religious or policy purpose.[20] These investors tend to pursue idiosyncratic interests, many of which have no rational relationship to the creation of shareholder value and are not material to what a rational investor would consider when making an investment decision.

Business Roundtable believes the shareholder proposal process has transformed to its current state for two primary reasons (i) the threshold for submitting a proposal is too low and (ii) excluding proposals relating to general social issues is difficult for companies. Under current rules, shareholders must only own $2,000 or 1 percent — whichever is less — of a company's stock for at least one year to submit a proposal. The ownership threshold was implemented in 1983 and has only been updated once in the past thirty-four years when the SEC adjusted it for inflation in 1998. This is no longer a reasonable standard for ownership and is considerably out of step with the 3 percent ownership threshold that has been established through private ordering with respect to proxy access.

Despite the low hurdle for submitting a proposal, it is difficult for companies to exclude even unsuccessful proposals. Shareholder proponents have had limited success with their campaigns with shareholder proposals receiving just 29 percent support on average over the past 10 years.[21] However, under current rules, proposals getting a mere 3 percent of the votes cast qualify for resubmission at least once, and for as long as the proposal obtains 10 percent of the votes cast, it may be submitted indefinitely allowing a small subset of shareholders to override the expressed will of a majority of shareholders indefinitely.

This process is also costing companies real money, estimated to be tens of millions of dollars annually and countless hours of management and board time through the cost of negotiating with proponents, seeking SEC no-action relief to exclude proposals from proxy statements, preparing opposition statements and other activities that are diverting from creating long-term shareholder value.[22] As a result, the current process is often used to promote the self-interest of a minority of shareholders, frequently at a significant cost to the company, which is borne by the entire stockholder base of a company, not just those making the proposal. We do not believe all shareholders should be forced to bear the cost to promote the "idiosyncratic interests" of a small subset, especially when a proposal has failed to garner any meaningful level of support.

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[20] James Copland & Margaret O'Keefe, *An Annual Report on Corporate Governance and Shareholder Activism,* PROXY MONITOR (Sept. 2016).
[21] David Larcker & Brian Tayan, *Gadflies at the Gate: Why Do Individual Investors Sponsor Shareholder Resolutions?*, CORPORATE GOVERNANCE RESEARCH INITIATIVE (Aug. 11, 2016).
[22] Joao Dos Santos & Chen Song, *Analysis of the Wealth Effects of Shareholder Proposals – Volume II*, U.S. CHAMBER OF COMMERCE (May 18, 2009).

As a result of the issues identified above, Business Roundtable believes the shareholder proposal process is in need of reform and modernization and has put forth ten pragmatic solutions, which we believe are in accordance with the Core Principles. The proposals aim to tighten eligibility and enable more rational exclusions of proposals and repeat submissions, such as requiring proposals to achieve at least 6 percent support before they can be resubmitted within a 3 year period and modernizing the current $2,000 ownership threshold for submitting proposals.

Proxy Advisory Firms

Institutional investors, such as pension funds, which own the majority of outstanding shares traded on U.S. public markets, rely on proxy advisory firms to help guide their proxy voting decisions.[23] As a result, proxy advisory firms have come to wield enormous influence over shareholder voting at public companies. Institutional Shareholder Services (ISS) and Glass Lewis & Co. (Glass Lewis) dominate this business, together accounting for 97 percent of the proxy advisory business market share. It is estimated that ISS clients directly influence 20 to 30 percent of the votes at a typical mid- to large-cap public company, while Glass Lewis clients typically influence 5 to 10 percent of the votes.[24]

Despite the heavily concentrated market in which they operate and the enormous influence they have, proxy advisory firms are currently subject to little regulatory oversight. Business Roundtable members are concerned that proxy advisory firms fail to avoid conflicts of interest and are neither transparent in their business dealings nor publicly accountable for the recommendations they provide. Business Roundtable members are also concerned that the proxy advisory firms' reports frequently include factually inaccurate information.

Business Roundtable believes it is imperative that proxy advisory firms be both transparent and accountable, so that information provided to shareholders and investors is accurate and material and supports reforms to improve this transparency and accountability. Specifically, Business Roundtable believes that the investing public would benefit from reforms requiring:

- Proxy advisory firms to register under the Investment Advisers Act of 1940, under a tailored regulatory framework that reflects the unique role they play in the proxy voting process;

- Conflict of interest disclosure by proxy advisory firms that describe specific conflicts of interest and avoid relying on generalized statements about conflicts of interest;

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[23] Steven Davidoff Solomon, *Rise of Institutional Investors Raises Questions of Collusion*, N.Y. TIMES (Apr. 12, 2016); Marshall E. Blume and Donald B. Keim, Working Paper, *Institutional Investors and Stock Market Liquidity: Trends and Relationships,* The Wharton School, University of Pennsylvania (Aug. 21, 2012), *available at* http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf, at p.4; *See, also,* The Conference Board, 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition (November 2010).
[24] Written Testimony of Timothy J. Bartl, President, Center on Executive Compensation, "Examining the Market Power and Impact of Proxy Advisory Firms" Hearing, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Committee on Financial Services (June 5, 2013) , *available at* https://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-tbartl-20130605.pdf.

- Proxy advisory firms to provide more transparency involving their internal controls, policies, procedures, guidelines and methodologies;

- Proxy advisory firms to provide public companies with copies of their draft reports sufficiently in advance of dissemination to their clients, to permit correction of inaccurate information;

- Proxy advisory firms to publicly disclose the final report about a public company 90 days after a shareholder meeting has occurred; and

- That new SEC rules emphasize the responsibility of each registered investment adviser to exercise appropriate oversight over its proxy voting process, to ensure that its voting decisions with respect to client securities are in the best interests of its clients.