<u>The Financial CHOICE Act</u>
H.R. 10

By John C. Harrington

SEC Rule 14a-8: Better than Nothing

The Republican-dominated House Financial Services Committee recently adopted legislation, The Financial CHOICE (Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs) Act, at the request of the U.S. Chamber of Commerce and the Business Roundtable, which repeals important parts of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, including eliminating the capacity of common stock shareholders[1] to have the ability to introduce shareholder resolutions pursuant to SEC Rule 14a-8 created over 70 years ago to protect the rights of owners to communicate with corporate management.

The current Rule 14a-8 system is already rigged against owners in many ways as discussed below, but the current legislative effort will eliminate any legal input available for stakeholders to communicate with or have legal oversight of corporate self-nominated and self-compensated boards of directors and executive officers.

[1] Shareholders are also referred to as "shareowners," "legal owners," and/or "stakeholders." Generally, shareholders are considered as one form of stakeholder; other stakeholders include: vendors, contractors, customers, holders of corporate debt, and other classes of investors, as all have a "stake" in the corporation.

1001 2nd STREET, SUITE 325 NAPA, CALIFORNIA 94559 707-252-6166 800-788-0154 FAX 707-257-7923
WWW.HARRINGTONINVESTMENTS.COM

Self Nominated "Elections" of Directors

Currently, many publicly traded corporations still do not have "majority voting," but "plurality voting" for directors (also including no ability for shareholders to nominate directors), which means that one vote for the entire slate of directors, elects the entire board. Publicly-traded corporations that have plurality voting, means that shareowners cannot vote "against" director nominees, only vote "yes," "abstain," or "withhold." A "withhold" vote is not a vote "against" the nominee, it is only "withholding" the proxy from being voted.

Many corporations also require "classified voting," which means shareholders can only vote for a few self-nominated board members every three years; so, if a majority of shares are purchased to take over the company, it will still take at least two years for a majority of shareholders to elect a majority of the board to gain control.

Even if shareholders are allowed to "elect" nominees by majority voting, because there is only one slate of nominees standing for election, the rest of the "elected" board can fill the vacancy with a director nominee of their choice, including the one that was "defeated" pursuant to the "Business Judgment Rule" [2], which pretty much allows a board to take action in the "best interest of the corporation." It is an entirely rigged system to permit managers to maximize their wealth and power at the expense of stakeholders, including owners.

[2] The Business Judgment Rule is a legal presumption in Delaware State Law, that in making a business decision, the directors of the corporation act on an informed basis, in good faith, and in the honest belief that the action taken is in the best interest of the company. Most large corporations are chartered in the State of Delaware as it is the most liberal benefitting corporate management to the detriment of owners.

In 2016, the 37,000 corporate directors that faced "elections" (all self-nominated with no opposition, and running as a slate) in a majority vote election, only 57 failed to gain a majority, according to Institutional Shareholder Services (ISS), a proxy voting advisory service. Of those 57 (0.0015%) directors that failed to receive a majority vote, we don't know how many of them actually lost their positions on the board, or for how long.

There is no such thing as "corporate democracy." Corporations are authoritarian, public dissention among directors is not allowed, directors nominate themselves unopposed as a slate (similar to the old Soviet Electoral System) and almost all corporate directors come from the same socio-economic group, race, ethnicity, education, and gender. Not surprisingly, most are wealthy, some extremely so. In other words, most corporate directors are white, wealthy, heterosexual older men, primarily vetted by the CEO and generally recruited within the corporate community. Many are corporate executives, or former or retired corporate executives, some sitting on many other corporate boards, paid lots of money, representing the 1%. In no way do corporate boards represent the diversity of stakeholders.

Confused or concerned yet; we're just getting started. Owners, and other stakeholders are also confused and, if you've ever decided to communicate with corporate management as an owner of stock, you may have tried writing a letter or e-mail and, if you never received a response, you're not alone. Most shareholders, at best, will receive a form letter, mostly full of propaganda and marketing information, most likely not responding to any of your questions or concerns. Read an annual shareholders report and you'll immediately get the idea.

SEC Rule 14a-8

Rule 14a-8 is important to corporate owners or shareholders mostly because it's the only game in town, and the only "legal" method we have to elicit a formal response from corporate management, which is a property right that goes all the way back to the time of Adam Smith. When Adam Smith authored The Wealth of Nations in 1776, however, ownership and control of business enterprises were the same. It was John Maynard Keynes, and Adolf A. Berle and Gardiner C. Means who were the first to explain the evolution of the separation of ownership from control in 1926 and 1932, respectively, which created "separate autonomies" widely dispersing ownership[3] and a change in property relations, "which split the property atom," or where "management is more or less permanent, directing the physical property which remains intact while the participation privileges of ownership are split into innumerable parts – "shares of stock" – which glide from hand to hand, irresponsible and impersonable."[4]

In essence, the Republicans in the U.S. House of Representatives, representing corporate management, are attempting to eliminate property rights for thousands of shareholders, who already have an extremely limited ability to oversee managers that control vast amounts of wealth with no responsibility or accountability to owners or to the American public. After all, these shares are property held for millions of Americans in their personal brokerage accounts, retirement and pension plans, foundations, trusts, churches, unions, and in other accounts and ownership throughout this country and the world.

---

[3] John Maynard Keynes, Essays in Persuasion (New York: Harcourt, Brace and Company, 1932), 314-315.

[4] Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, (New York: Macmillan Company, 1939), 285.

The Revolving Door

Currently, SEC Rule 14a-8 is a very modest means of allowing shareholders to communicate with corporate management, although complex, convoluted, expensive, and confusing for owners, as stakeholders, to navigate. Almost all the cards, as well as corporate wealth, are in the hands of corporate management, while the Securities and Exchange Commission (SEC) and its staff, the federal regulatory agency responsible for corporate oversight, is comprised mainly of former employees of lawyer/lobbyist firms that represent corporations ("the regulated"). Many of these SEC employees are also hired by "regulated" corporations at higher salaries because they have intimate knowledge and expertise as regulators ("the revolving door"). What better path to higher salaries and upward mobility than working at the SEC and then being hired by lawyer/lobbyist firms working for "regulated" corporations? Don't you think the possibility of working for the private sector at a much higher salary influences their work at the SEC when it comes to making a decision on whether or not a shareholder resolution should be on a corporate ballot? They then turn around, after being hired, representing the "regulated" to lobby and influence their former employer against the interests of stakeholders, including owners. For example, the two former chairs of the SEC now work for lawyer/lobbyist firms working for "regulated" corporations.

The SEC vs. Shareholder "Rights"

Pursuant to SEC Rule 14a-8, shareholders have the right to attempt to introduce a resolution or proposal at a corporation's annual shareholder meeting. I use the word "attempt," because often, those lawyer/lobbyist firms working for corporations, challenge the resolution utilizing

13 possible exclusions or hurdles that shareholders have to get through to be permitted to place a proposal on the ballot. Lawyer/lobbyist firms, representing corporate management, not shareholders (using shareholder funds, no less), present arguments (complex and mostly technical in nature) to convince their future colleagues and former friends and colleagues at the SEC, to allow the company to omit the proposal from the proxy material.

The most commonly used challenge by corporate management is the broadly SEC defined "ordinary business," or challenging a shareholder resolution on the basis that the proposal deals with a matter relating to the company's ordinary business operations, or the company's day-to-day business and affairs of the board of directors. You see, directors do not want any input from their owners, much less other stakeholders. The exception to the SEC rule on ordinary business are those issues raised by shareholders that focus on "sufficiently significant social policy issues. . .(which) would not be considered to be excludable because the proposals would transcend the day-to-day business matters." [5] Most shareholder resolutions, however, already specifically address very "significant social policy issues," such as climate change, human rights, privacy, excessive CEO compensation, bribery, governance and corporate ethics, among other issues.

When challenging shareholder proposals, corporate attorneys will use multiple challenges, including that, "the company has already substantially implemented the proposal," a proposal conflicts with the Corporation's own proposal, the company lacks the power to implement the proposal, the proposal substantially duplicates another proposal, and so on. You would be

[5] Division of Corporate Finance, Staff Legal Bulletin No. 14A (July 12, 2002)

amazed at the inverted logic and convoluted reasoning that lawyers come up with to keep corporate owners' resolutions off the proxy ballot, never to see the light of day at shareholder meetings. That's why corporate lawyers get very big bucks.

Here's the Joke: Almost all of these resolutions are precatory or advisory! They are all "requests," the next best thing to begging. The reality is that owners of the corporation are begging those directors that legally run the corporation, that nominate themselves and set their own pay, and use shareholder funds to hire attorneys to fight them; and those directors can simply thumb their collective noses at the owners and say "get lost, shareholders"; and other than going to court for an extremely expensive and time consuming process, which no ordinary shareholder can do, there is not one thing any of us can do about it.

Here's the other Joke: The Republican dominated House of Representatives is attempting to destroy even the ability of most shareholders to beg corporate management, to take an action which doesn't even require them to respond. Republicans and corporate management want absolutely no voices of dissent or different opinions. They want to silence any possible opposition. They demean shareholders as well as themselves for such a bill.

The attempt by the Republican-controlled Congress to eviscerate or disembowel SEC Rule 14a-8 is only part of what is called the Financial CHOICE Act. Most of the bill is to eliminate the major provisions of the Dodd-Frank Act, a law that was in response to the deregulation of the financial services industry, which created the great recession. The deregulation of financial services adopted by both Democrats and Republicans almost brought down the entire economy in 2008 and now the Republicans representing corporations want to deregulate again with possibly

more catastrophic consequences. Like SEC Rule 14a-8, Dodd-Frank is better than nothing, but the 2300-page bill was convoluted, confusing, full of loopholes, incomplete, and the product of fearful politicians, passing the buck to compromised and weak-kneed regulators. It included 243 new rules, as well as laws, mandating 67 new studies and reports from federal regulatory agencies and government departments. Thanks again, mostly to Republicans and corporate management, much of the legislative deadlines were never met, regulations were defeated or vacated by the courts, exempted, amended, or deleted by regulators, never implemented, or enforced or simply forgotten. Now, like SEC Rule 14a-8, which is little better than nothing, and the Dodd-Frank Act are targeted for elimination.

Mandated by the enactment of Dodd-Frank, the SEC adopted Rule 14a-11 to provide universal proxy access; the ability of shareholders who own collectively at least 3% of the outstanding shares of stock in a corporation for at least 3 years, to have the ability to nominate a small number of director candidates. This regulation was challenged in federal court by the Business Roundtable and the Chamber of Commerce, and was overturned, although the courts permitted the SEC to allow shareholders to attempt to enact proxy access by shareholders on a company-by-company basis.

Financial CHOICE Act: SEC Rule 14a-8

Basically, instead of allowing a shareholder who currently holds at least $2,000 in stock for one year to introduce one shareholder resolution, it would require one shareholder to hold 1% of the company stock for three years to introduce a resolution. It would also increase the

percentage of the vote for a shareholder to be able to re-introduce the resolution for successive years.

At the larger publicly held corporations, it would take literally billions of dollars in stock to introduce a resolution, which would mean only a handful of the largest institutional investors could file a resolution. For example, to file a resolution at Wells Fargo, an investor would have to own about $2.7 billion of stock to submit a proposal. At Apple, it would take $7 billion in stock to file a resolution, or on the institutional shareholder side, it would take the $36 billion Harvard Endowment to put 20% of its assets in Apple ($767 billion market capitalization) in order to file a resolution. This would disenfranchise all but a few of the largest institutional investors. The only shareholders eligible to introduce a shareholder resolution at Apple would be BlackRock, Vanguard, State Street, FMR, Northern Trust, Bank of New York, Mellon, Berkshire Hathaway, and T. Rowe Price. These institutional investors have never presented a shareholder resolution at an annual meeting.[6]

Similarly, the $200 billion California State Teachers Retirement System (CALSTRS) could not file a shareholder resolution, because it does not hold 1% of any publicly traded corporation. CALSTRS which has filed more than 300 proposals over the last five years would be shut out of the process.[7]

---

[6] Council of Institutional Investors letter to Chairman and Ranking Member of the U.S. House of Representatives Committee on Financial Services, April 24, 2017, p.3.

[7] The author worked with California Governor Edmund G. Brown and his State Department of Finance Director, Sid McCausland, as early as 1975-76 in developing a proxy voting process for CALSTRS and the California Public Employees Retirement System (CALPERS), which is still in place today.

Although almost totally hamstrung or powerless, SEC Rule 14a-8 has allowed some light into a rigged system thanks to many small and large shareholders determined enough to use the prevailing system to challenge corporate dominance, abuse, crime, and continuing social injury. Overall, we have collectively been able to force:

- Changes in corporate governance, including many corporate annual majority vote "elections" of directors, and access to limited proxy shareholder nominations.
- Almost 100 corporations to publish sustainability reports.
- Some corporations to increase board diversity.
- Over 150 corporations to disclose more data on political spending.
- Almost 90% of Fortune 500 companies prohibit discrimination based on sexual orientation, and two-thirds prohibit discrimination based on gender identity.

According to Harvard Business Review that reviewed outcomes from 2,665 shareholder proposals found the following, "even though such proposals rarely receive the majority support necessary in the event of a vote, they still have had an effect on corporate management, with managers investing resources and improving performance on diversity, energy efficiency, water consumption and product safety."[8]

[8] https://hbr.org/2016/07/the-fastest-growing-cause-for-shareholders-is-sustainability

HII Advocacy

I started introducing shareholder resolutions as an individual in the early 1970s, mostly attempting to disclose corporate involvement in the South African apartheid state and how U.S. capital was strategic to the economy and fundamental to the survival of racism in Southern Africa. I attended a Bank of America (BAC) shareholders meeting in San Francisco challenging BAC's lending program to the South African government. I also introduced resolutions at both Del Monte and Chevron questioning the company's investment in South Africa.

Harrington Investments (HII) was registered as a Registered Investment Advisor (RIA) in 1982, and we continue to introduce resolutions challenging egregious corporate conduct and socially and environmentally injurious practices. Some years, we introduce two or three resolutions, but most years we introduce many more. Below, I've outlined a few of the recent HII resolutions that have been successful, or created an opportunity for improved corporate social performance.

Company	Year	Issue/Resolution	Results	HII Shares
Bank of America	2015	Proxy Access	Negotiated approval*	100
Anthem	2015	Proxy Access	66.52% approved	100
Monsanto	2015	Proxy Access	53% approved	300
Starbucks	2016	Proxy Access	57.4% approved	500
Coca-Cola	2017	Sustainability Committee	Adopted Governance Language for Sustainability *	100
Pepsico	2015, 16, 17	Sustainability	Company Created	100

		Committee	Committee*	
Monsanto	2010	Sustainability Committee	Company created Committee* Provided legal opinion	300
Starbucks	2005	Classified Voting	Adopted by Company*	500
Starbucks	2007	Majority Voting	Adopted by Company*	500
Bank of Nova Scotia	2017	Human Rights Committee	Company Adopted Policy Change*	200
INTEL	2008	Sustainability Committee	Company Adopted Governance Language for Sustainability* Provided Legal Opinion	500

* HII Resolution withdrawn

Over the course of HII advocacy history, most of the resolutions we have introduced have been defeated, if not challenged successfully at the SEC by corporate management and omitted from the proxy ballot. While that was unfortunate, just the fact that they were introduced raised very important social and environmental policy issues, identifying the lack of corporate transparency or injurious corporate conduct, or identified a policy issue that was also picked up and advocated by larger institutional and individual investors and other stakeholders. These resolutions were even more successful when they made it to the ballot and received important recognition and publicity. All of the introduced resolutions are important also, because they create a public record of responding to corporate abuses and call for action.

<u>Conclusion</u>

Without SEC Rule 14a-8, although little better than nothing, shareholders will not be able to legally communicate with corporate management and receive a response. Already, many states have allowed corporations to hold virtual meetings on-line, where directors and executives don't even have to meet face-to-face with shareholders. These meetings allow directors to privately travel to exotic locations, and avoid facing owner "riffraff." Without the ability to introduce a resolution, there would be no legal requirement for corporate management to respond at all to shareholders, as stakeholders.

Not only are an increasing number of corporations lobbying state legislatures to permit them to exclusively hold virtual meetings online, many corporations, in the race to the bottom, since 1984, have created other classes of stock to give company founders and certain executives outsized voting power. Often corporations create more than two classes of stocks for investors, including occasionally issuing non-voting stock.

Many media and technology companies have issued dual or multiple classes of shares, including the New York Times, CS, Viacom, Google, and Facebook, while others in going public (IPO) have offered investors stock with no voting rights at all.[9]

The CHOICE Act, if enacted into law, would silence shareholders from having any relationship to corporations in which they invest. Heidi Welsh, the founding executive director of the

[9] https://corpgov.law.harvard.edu/2017/05/17/dual-class-the-consequences-of-depriving-institutional-investors-of-corporate-voting-rights/

Sustainable Investment Institute (SI2), a corporate responsible research firm, was quoted as saying the CHOICE Act was ". . . not only anti-democratic, it's also anti-capitalist."[10]

Ms. Welsh is correct. Corporations and their board members and executives are "anti-democratic and anti-capitalist." The corporate structure is elitist and by its very nature, anti-capitalist, anti-competitive; corporations strive to dominate markets, coalescing into oligopolies, and not competing in a freely competitive open market. Corporate directors also nominate themselves in a Soviet-style one-party state system and thanks to the "revolving door" at the SEC, control access to the proxy ballot.

Corporate management's primary goal is to maximize personal materialistic self-interest, power, and influence, by using the assets of the corporation (other people's money) to accomplish their goal. Adam Smith maintained that businesses, while having more knowledge about their own self-interest, would often engage in activities to advance their own materialistic self-interest, while ignoring, overriding, or harming the public interest,[11] knowing that, "men, whose interest is never the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.[12]

Another supporter of capitalism, economist Milton Friedman, based his theory of political freedom upon the separation of economic and political power by arguing: "The kind of economic organization that provides economic freedom directly, namely competitive

---

[10] https://www.responsible-investor.com/home/article/hodgson_on_CHOIC_act/

[11] Adam Smith, The Wealth of Nations, (New York: Batam Dell, 1776), 338.
[12] Ibid., 339.

capitalism, also promotes political freedom because it separates economic power from political power and in this way enables the one to offset the other."[13]

Corporate executives that comprise the Business Roundtable and the Chamber of Commerce lead large corporations that have consolidated wealth and power to dominate not only economic power, but now political power. Economic power is no longer separate from political power; they are one and the same. The sole purpose or goal of the corporation is to enrich the managers and exert political control over the sovereign state to further the self-interest of the corporation. The CHOICE Act will further that goal.

Future Battles

There is no doubt that the House of Representatives controlled by Republicans will adopt H.R. 10 and we will have another fight in the U.S. Senate. The Republicans will soon also have a majority of members appointed by the President to the SEC. We expect that there will be a concerted effort by the SEC staff and directors to eviscerate SEC Rule 14a-8, thanks to continued pressure by the Business Roundtable and the Chamber of Commerce. While HII plans to continue to socially screen our portfolios and vote our stock proxies to maximize financial and social performance, we retain our right to use other means to accomplish our fiduciary duty representing our clients if SEC Rule 14a-8 is effectively eliminated.

[13] Milton Friedman, Capitalism and Freedom, (Chicago: University of Chicago Press, 1962), 9.