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SEC Chair Addresses Activism and Shareholder Engagement

At today's *SEC-NYU Dialogue on Securities Market Regulation* held at NYU's Stern School of Business, SEC Chairman Jay Clayton provided opening remarks focusing on the interplay between shareholder activism and shareholder engagement. Chairman Clayton framed the concern:

> The governance structure of public companies reflects the reality of capital allocation in a well-functioning free market economy: capital is allocated predominantly on a collective but widely distributed basis; in practice, companies have many shareholders who have no connection to one another. Various factors drive this approach to collective capital allocation, including that, first, in a global economy, firms have necessarily become large (and therefore very few can be funded by a single investor or small group of investors). Second, from an investor's perspective, diversification across investment opportunities has proven to be a prudent and attractive strategy. As a result, firm ownership is diffused and ever-changing. This is fertile ground for the age old problems of collective action. How do we address collective action problems? There are several proven approaches but, for companies, we have long settled on the approach of selecting dedicated individuals to oversee the company's affairs and imposing on them a fiduciary duty.

Chairman Clayton noted that in response to principal/agent concerns, the SEC has "mandated or suggested rule sets — including disclosure requirements and incentive driving requirements and prohibitions — that have reduced the opportunities for misalignment between shareholders and managers." Recognizing that markets constantly change, Chairman Clayton comments that the SEC needs to continually reexamine its rules, noting that in recent years there has been an even larger separation between companies and their true beneficial owners:

> [I]ncreasingly, a second layer of separation between ownership and control has opened between the ultimate owners of capital and corporate management. Shareholders invest in investment vehicles — mutual funds, ETFs, etc. — which in turn own the shares of operating companies. In theory, a daisy chain of fiduciary duties keeps these interactions focused on the interests of the ultimate beneficial owner, but it also means that the principal-agent issues are multi-layered. . . . Shareholders can have vastly different investment time horizons. As a well-known specific example, we have seen many cases where

> some shareholders believe capital should be reinvested while others believe it should be returned to shareholders through buy backs or dividends. . . . Should index funds seek guidance from investors in the fund, or clearly disclose their engagement policies such that potential investors could self-select into their desired category?

Acknowledging that shareholder engagement can be valuable, Chairman Clayton observes that there are real costs to engage that make it uneconomic for many investment funds. Since funds often compete on fees, many have outsourced their voting decisions to proxy advisory firms. Importantly, Chairman Clayton makes the point that the director-centric model addresses this issue: “Let’s not forget that the director-officer fiduciary duty model itself was designed to, and does effectively, if not perfectly, address the fundamental problem of fair and efficient collective action.”

Since very few public companies are actually immune to activism and activism is not disappearing, Chairman Clayton notes: “So it is more important than ever for shareholders to understand and evaluate activists’ long-term impact on companies and shareholder value. In particular, to what extent do shareholder campaigns launched by activist investors create value for all shareholders? What is the effect of these campaigns on long-term value?”

In conclusion, Chairman Clayton harkens back to the fundamental problem that exists in today’s proxy voting model, the fund investor who is focused on long-term value creation for his or her retirement is absent from the equation:

> The engine of economic growth in this country depends significantly on the willingness of Main Street investors to put their hard-earned capital at risk in our markets over the long term. If our system of corporate governance is not ensuring that the views and fundamental interests of these long-term retail investors are being protected, then we have a lot of work to do to make it so.

Unfortunately, the Chairman is correct – we have a lot of work to do to turn away from the short-term focused incentive structure that drives our markets and many activist investors, to one that creates real value over the long-term.

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