HUNTON& WILLIAMS

Client Alert

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SEC Staff Issue New Staff Legal Bulletin on Shareholder Proposals

On October 22, 2015, staff in the Division of Corporation Finance (the "Division") at the Securities and Exchange Commission (the "Commission") issued Staff Legal Bulletin 14H (the "Bulletin"). The Bulletin is the latest in a series of Division interpretations under Rule 14a-8 governing shareholder proposals. The Bulletin focuses specifically on circumstances in which the Division will grant no-action relief to exclude a shareholder proposal under two hot-button issues from last year's proxy season: (1) Rule 14a-8(i)(7), for proposals dealing with a company's ordinary business operations, and (2) Rule 14a-8(i)(9), for a proposal that directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting. We discuss the Bulletin below.

Ordinary Business Exclusion: Background

The discussion in the Bulletin regarding Rule 14a-8(i)(7) is in response to a recent decision by the Third Circuit Court of Appeals in *Trinity Wall Street v. Wal-Mart Stores, Inc.*[1] There, the Third Circuit reversed a lower court and held that Trinity Wall Street's shareholder proposal was excludable from Wal-Mart Stores, Inc.'s proxy materials. The case was somewhat unusual in that it commenced after the Division granted no-action relief to Wal-Mart, permitting it to exclude the proposal from the company's 2014 proxy statement based on the ordinary business exclusion under Rule 14a-8(i)(7), and the proponent in effect sought judicial review of the staff's decision.[2]

In December 2014, the federal district court for the District of Delaware concluded that because Trinity's proposal (the "Trinity Proposal") concerned the company's board of directors (rather than its management) and focused principally on governance, it was outside Wal-Mart's ordinary business operations.[3] Following the district court's ruling, Trinity resubmitted the Trinity Proposal for inclusion in Wal-Mart's 2015 proxy statement. On appeal to the Third Circuit, Wal-Mart sought a ruling to exclude Trinity's Proposal from the 2015 proxy materials and to confirm that the company was correctly permitted to exclude the Proposal from its 2014 proxy materials.

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[1] No. 14-4764 (3d. Cir. July 6, 2015). Hunton & Williams LLP submitted an amicus brief to the Third Circuit on behalf of the National Association of Manufacturers in support of Wal-Mart Stores.

[2] A "no-action" letter is one in which the staff indicates that, on the basis of the facts presented to it, it will not recommend that the Commission institute enforcement proceedings against a party with respect to the matter discussed in the party's incoming correspondence.

[3] The Proposal requested that the Wal-Mart Board of Directors amend the Compensation, Nominating and Governance Committee charter (or add an equivalent provision to another Board committee charter) to add the following:

> 27. Providing oversight concerning the formulation and implementation of, and the public reporting of the formulation and implementation of, policies and standards that determine whether or not the Company should sell a product
> that:
> 1) especially endangers public safety and well-being;
> 2) has the substantial potential to impair the reputation of the Company; and/or
> 3) would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand.

The Third Circuit reversed the ruling of the district court, holding that the Trinity Proposal is properly excludable under the ordinary business exclusion and that the social policy intended by the proposal is no exception to that exclusion. The majority opinion explained that the Commission has consistently reaffirmed that when analyzing shareholder proposals, the emphasis should be on substance rather than the style of a proposal. Accordingly, the court asserted that the district court put undue weight on the distinction between a directive to management and a request for board action. The majority also stated that it rejected the notion that a proposal's call for board action rather than management action precludes the availability of the ordinary business exclusion.

The Third Circuit majority also placed a great deal of emphasis on whether the Trinity Proposal focused on a significant policy issue that "transcends" Wal-Mart's day-to-day business operations. Prior Commission guidance has indicated that notwithstanding the ordinary business exception, certain significant public policy issues (such as shareholder proposals involving employment discrimination) are not excludable under Rule 14a-8(i)(7) even if they otherwise involve a company's ordinary business affairs. The court explained that the Trinity Proposal raises a matter of sufficiently significant policy because of the importance of the social issue involved. Nevertheless, the majority held that because the policy issue impacts product selection, it does not in this instance transcend Wal-Mart's ordinary business operations.

Ordinary Business Exclusion: Treatment under the Bulletin

The Bulletin indicates that, while the Division agreed with the Third Circuit's analysis in *Trinity* in some respects, it believes the Court also deviated from prior Commission practice. On the one hand, the Division believes the Third Circuit correctly concluded that the analysis should focus on the underlying subject matter of a proposal's request for board or committee review regardless of how the proposal is framed. On the other hand, the Division believes that the Court erred in its part of its analysis.

According to the Division, the Third Circuit majority opinion employed a new two-part test, concluding that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business." The majority opinion found that to transcend a company's ordinary business, the significant policy issue must be "divorced from how a company approaches the nitty-gritty of its core business." The Division believes this two-part approach differs from the Commission's prior interpretations of the ordinary business exclusion and Division practice.

Instead, the Division favors the analysis expressed in a concurring opinion to the Third Circuit's decision in *Trinity*. The concurring judge analyzed Rule 14a-8(i)(7) in a fashion the Division believes is more consistent with the approach previously articulated by the Commission and applied by the Division, including in Wal-Mart's no-action request. In particular, the concurring judge noted that "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business. Rather, a proposal is sufficiently significant 'because' it transcends day-to-day business matters." The judge also explained that the Commission "treats the significance and transcendence concepts as interrelated, rather than independent."

The Division expressed its concern that the new analytical approach introduced by the Third Circuit majority goes beyond the Commission's prior interpretations and may lead to the unjustified exclusion of certain shareholder proposals. For example, the majority opinion viewed a proposal's focus as separate and distinct from whether a proposal transcends a company's ordinary business, but the Commission has not made a similar distinction. Instead, the Commission has stated that proposals focusing on a significant policy issue are not excludable under the ordinary business exception "because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote." Thus, under the Commission's prior formulation, a proposal may

transcend a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business." Therefore, the Division believes proposals that focus on a significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7). In sum, the Division intends to continue to apply Rule 14a-8(i)(7) as previously articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge, when considering no-action requests that raise Rule 14a-8(i)(7) as a basis for exclusion.

Conflicting Proposals: Background

The Bulletin's discussion of Rule 14a-8(i)(9) is linked to the controversial subject of "proxy access," which was a divisive issue in the 2015 proxy season. In December 2014, the Division granted no-action relief to Whole Foods Market, permitting Whole Foods to exclude a 3%, three-year proxy access proposal because the company intended to advance forward a management proposal for proxy access at a 9%, five-year threshold. The Division concluded there was a direct conflict between the two proposals. Whole Foods later reduced the ownership threshold in its management proposal from 9% to 5%.

The Division's grant of no-action relief to Whole Foods was largely consistent with the Division's prior interpretations of Rule 14a-8(i)(9), and in some respects was unremarkable. Based on the Division's position, several other companies began to make similar plans to counter shareholder proxy access proposals by putting forward their own management proxy access proposals with higher minimum thresholds. Following the grant of no-action relief, however, the shareholder proponent at Whole Foods appealed the grant to the full Commission, and a number of like-minded activist investors expressed their support for the proponent.

Commission Chair Mary Jo White in January 2015 directed the Division to undertake a thorough review of Rule 14a-8(i)(9). Consequently, in a highly unusual development, the Division announced that it would no longer grant no-action relief on the basis of Rule 14a-8(i)(9) for the remainder of the 2015 proxy season and rescinded the relief granted to Whole Foods.

Conflicting Proposals: Treatment under the Bulletin

The Bulletin's discussion of Rule 14a-8(i)(9) begins with an explanation of the public policy underlying the rule, which is to prevent shareholders from using Rule 14a-8 to circumvent the proxy rules governing solicitations. The Division expressed its view that the shareholder proposal process should not be used as a means to conduct a solicitation in opposition without complying with these requirements, which include various procedural and disclosure requirements that are not otherwise required by Rule 14a-8.

The Division also noted that for decades its prior letters granting no-action relief under the exclusion expressed the view that a shareholder proposal was excludable if including it, along with a management proposal, could present "alternative and conflicting decisions for the shareholders" and create the potential for "inconsistent and ambiguous results." The Division's historical approach therefore focused on the potential for shareholder confusion and inconsistent mandates, instead of more specifically on the nature of the conflict between a management and a shareholder proposal.

According to the Bulletin, the Division is abandoning its historical approach. Instead, the Division's new interpretation of Rule 14a-8(i)(9) will be based on an assessment of whether there is a "direct conflict" between the management and shareholder proposals. The Division explained that such a direct conflict would exist if a reasonable shareholder could not logically vote in favor of both proposals, i.e., "a vote for one proposal is tantamount to a vote against the other proposal." The Division acknowledged that this approach may be a higher burden for some companies seeking to exclude a proposal to meet than had been the case under its previous formulation.

In considering no-action requests under Rule 14a-8(i)(9) going forward, the Bulletin indicates that the Division will focus on whether a reasonable shareholder could logically vote for both proposals. The Bulletin provides a few illustrative examples:

- Where a company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger, the Division would agree that the proposals directly conflict.
- Similarly, the Division believes a shareholder proposal seeking the separation of the company's chairman and CEO would directly conflict with a management proposal seeking approval of a bylaw provision requiring the CEO to be the chair at all times.

Conversely, the Division will not view a shareholder proposal as directly conflicting with a management proposal if a reasonable shareholder, although possibly preferring one proposal over the other, could logically vote for both. Again, the Division provides some hypothetical examples:

- If a company does not allow shareholder nominees to be included in the company's proxy statement, a shareholder proposal that would permit a shareholder or group of shareholders holding at least 3% of the company's outstanding stock for at least three years to nominate up to 20% of the directors would not be excludable if a management proposal would allow shareholders holding at least 5% of the company's stock for at least five years to nominate for inclusion in the company's proxy statement 10% of the directors. The Division bases this outcome on the fact that in its view, both proposals generally seek a similar objective, i.e., to give shareholders the ability to include their nominees for director alongside management's nominees in the proxy statement. Moreover, the Division believes the proposals do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals.
- Similarly, a shareholder proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year annual vesting would not directly conflict with a management proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards. The Division believes this is the correct result because (in its view) a reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan.

The Bulletin also offers insight into additional related interpretive questions.

- The Division appears to reject the suggestion that it should take the view that precatory proposals do not directly conflict with management proposals because they are not binding. Accordingly, the Division announced its belief that a precatory shareholder proposal, while not binding, may nevertheless directly conflict with a management proposal on the same subject "if a vote in favor is tantamount to a vote against management's proposal."
- Other commenters have suggested that the Rule 14a-8(i)(9) exclusion should not apply when a shareholder submits his or her proposal before the company approves its proposal. The Division also seems to reject this view, reasoning that this approach would not necessarily prevent a shareholder from submitting a proposal opposing a management proposal, in contravention of the proxy rules governing solicitations.

Takeaways

The Bulletin resolves recent uncertainty under Rules 14a-8(i)(7) and 14a-8(i)(9) but, depending on the issue, has the potential to disappoint both issuers and shareholder proponents who may have preferred the status quo. Still, suspending no-action relief under all of Rule 14a-8(i)(9) was a harsh result, and resuming that process — even on a more limited basis — is better than the alternative.

As to the *Trinity* case, how can a federal agency pick and choose which parts of an appellate decision it will follow? Arguably, the Division is able to do so because the Bulletin technically does not express an official policy interpretation on the part of the Commission. Instead, it simply lays out the criteria the Division will follow as it weighs whether to grant no-action relief — that is, whether it will choose to make an enforcement recommendation (or not) based on a particular fact pattern. As both the district court and appellate court pointed out in *Trinity*, a no-action letter by agency staff is not binding on a court and as a legal matter has no precedential weight. Thus, the Division seems to be taking the position that it can elect to interpret the law in a manner different from a federal appellate court given the informal discretionary nature of a no-action letter.[4]

In light of the Division's new view on conflicting proposals under Rule 14a-8(i)(9), how will issuers facing two different proxy access proposals on the same ballot address this potentially confusing scenario to shareholders? The Bulletin addresses this scenario in a footnote:

> Where a shareholder proposal is not excluded and companies are concerned that including proposals on the same topic could potentially be confusing, we note that companies can, consistent with Rule 14a-9, explain in the proxy materials the differences between the two proposals and how they would expect to consider the voting results. As always, we expect companies and proponents to respect the Rule 14a-8 process and encourage them to find ways to constructively resolve their differences.

This situation may occur with a variety of proposals, including with respect to special meetings, the ability to act by written consent, and, of course, proxy access.

It remains to be seen whether the Bulletin will cause more issuers to avoid the Division's no-action process altogether in favor of seeking direct review by a federal district judge. An aggrieved party that does not like the Division's reinterpretation of Rule 14a-8(i)(7), as expressed in the Bulletin, may prefer to seek judicial review if the *Trinity* majority's holding is more favorable to it. This tactic may be compelling if venue for a challenge would be proper in the Third Circuit — which includes Delaware, a popular state of incorporation for many public companies. While the Division may choose to disregard portions of that opinion for purposes of no-action review, the Bulletin is not binding on any court and a court may likewise choose to ignore the Bulletin.

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[4] Although a no-action letter is technically not binding on a court or even the Commission, the Commission has never commenced enforcement action against a party who has received a no-action letter on the basis of the facts described in the letter when that party subsequently engages in the kind of conduct described to the staff in the request for no action. From time to time, of course, both the Commission and agency staff may rescind a prior no-action letter, as was the case with Whole Foods, or either may announce that on a go-forward basis they will no longer follow the holding of a prior no-action letter.