

Client Alert

November 2017

Shareholder Proposals: New SEC Staff Guidance Involves Boards

On November 1, 2017, the staff of the Securities and Exchange Commission issued Staff Legal Bulletin No. 14I (“SLB 14I”), which layers on additional requirements for companies seeking to exclude certain shareholder proposals from their proxy materials. In particular, no-action requests seeking to exclude shareholder proposals related to “ordinary business” or that are not “economically relevant” to the company will be expected to include a discussion of how the board of directors reached its determination. The guidance suggests, however, that the SEC staff may give greater deference to analysis performed by the board of directors.

This client alert provides a brief summary of SLB 14I and explains how it is likely to affect shareholder proposals and the involvement of boards moving forward. It also briefly highlights certain additional guidance in SLB 14I.

Highlights

- The Securities and Exchange Commission (“SEC”) staff now expects boards of directors to analyze shareholder proposals before companies make no-action requests to exclude such proposals from proxy materials under Rule 14a-8(i)(7) (the ordinary business exception) or Rule 14a-8(i)(5) (the economic relevance exception).
- Those no-action requests should include a discussion reflecting the board’s analysis and the specific processes it employed to reach a well-informed and well-reasoned conclusion.
- New documentation is required for submissions of shareholder proposals by proxy.
- Guidance has been issued on the use of images and graphs in shareholder proposals.

Ordinary Business Exception

The ordinary business exception under Rule 14a-8(i)(7) allows a company to exclude a shareholder proposal that deals with a matter that is “so fundamental to management’s ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight.” Proposals that focus on “sufficiently significant” policy issues that transcend ordinary business, however, may not be excluded under this exception. In the past, the SEC staff has conducted its own analysis to determine whether it believes a shareholder proposal is “sufficiently significant.” SLB 14I puts more responsibility on boards, stating that “the board of directors is generally in a better position to determine” these “difficult judgment calls.”

Traditionally, management often directed legal counsel to prepare a no-action request when the company believed there was a basis to exclude a proposal. The board often did not discuss the merits of the proposal unless and until the SEC staff denied the request. But under SLB 14I, the SEC staff will now expect no-action requests under this exception to include a discussion that reflects the board’s analysis of the policy issue raised in the proposal and its significance to the company. SLB 14I further advises that

an explanation of the board's analysis "would be most helpful if it detailed the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned."

SLB 14I does not specify what actions boards should take to satisfy the new guidance, but it certainly places a greater burden on boards seeking exclusion. Some issues to consider include:

- the process to be undertaken by the board in reaching its decision, including the information considered and whether outside advisors were involved;
- whether a board can or should rely on SEC staff responses to previous no-action letters in making its determination; for example, in situations where it has long been held that a certain issue is not a "sufficiently significant" policy issue, it is unclear whether the board can or should consider this as part of its analysis (although arguably it will be a relevant factor in many instances);
- whether the board needs to meet after receiving the proposal if it has already given significant consideration to the substance of the proposal; and
- how much detail should be included in a no-action request explaining the board's rationale and decision-making process.

Based on our discussions with SEC staff, we believe the staff does not have any preconceived notion as to what the appropriate level of board analysis will be. Instead, the staff seems to understand that the board discussion and analysis may vary based on the facts. For example, a given proposal that has long been excludable under prior staff guidance need not receive the same level of board consideration as an issue that is novel or unprecedented. The staff anticipates that a committee of the board such as the nomination and governance committee may do the preliminary analysis of a particular proposal, and the staff believes it would be acceptable for the full board to consider the recommendation of the committee as it would with any other issue. The staff is also cautiously optimistic that a greater level of board involvement with shareholder proposals will lead to additional shareholder engagement that may reduce the need for the staff to mediate disagreements between issuers and investors.

Although SLB 14I does not create a presumption in favor of companies, it does seem to signal an intent by the SEC staff to defer to boards on the analysis. Boards will be able to make a more tailored argument in favor of exclusion. For example, a board might conclude that while long-standing SEC precedent suggests a proposal is a significant policy issue, the proposal is not appropriate to include for their particular company. Likewise, based on our discussions with the SEC staff, a board might conclude that a shareholder proposal that has been resubmitted after a vote at the prior year's shareholder meeting might not be appropriate for a particular company if the earlier vote was relatively low, even if it did not meet the exclusion criteria of Rule 14a-8(i)(12). It is thus possible that these new requirements will lead to an overall increase in the number of shareholder proposals excluded pursuant to Rule 14a-8(i)(7) and a decrease in shareholder proposals in proxy materials. In some cases, however, the new guidance may cause companies not to seek no-action relief because the board prefers to avoid disclosing its formal view on the issue. Submitting a no-action request regarding a controversial policy issue now requires the board to take a public position that it may prefer not to address.

Economic Relevance Exception

The economic relevance exception, Rule 14a-8(i)(5), permits companies to exclude shareholder proposals relating to company operations which account for less than five percent of a company's total assets and of its net earnings and gross sales and that are not "otherwise significantly related to the company's business." Companies have rarely relied on this exception, as few proposals have ever been excluded on this basis due to its narrow interpretation by the SEC staff.

Moving forward, this exception is poised to become more helpful to issuers seeking to exclude shareholder proposals. As with the ordinary business exception, companies relying on this exception must include a discussion in their no-action requests that reflects the board's analysis of the proposal's significance to the company. As noted above, we believe this may signal the SEC staff's intent to give

increased deference to boards. The SEC staff has also stated that its analysis under Rule 14a-8(i)(5) will give greater weight to whether the proposal is economically significant to the business, rather than on whether the proposal is “otherwise” significantly related to the company’s business. In addition, the new framework places the burden to establish the proposal’s significance to the company on the shareholder proponent when it is not otherwise clear. This shift makes the exception clearer and therefore it may be more useful for companies in the future.

Proposals by Proxy

SLB 14I also lists new procedural requirements for shareholders submitting proposals by proxy. This practice is popular among individual retail activists, who introduced 35 percent of all shareholder proposals submitted among Fortune 250 companies in 2016.¹ The new requirements imposed by SLB 14I require shareholders who submit a proposal by proxy to provide signed and dated documentation identifying the shareholder-proponent, proxy holder, the company, the meeting for which the proposal is submitted and the specific proposal to be submitted. Companies should monitor proposals for compliance with this new guidance and provide notice of deficiency to the shareholder-proponent within 14 days after receiving the proposal. A shareholder’s failure to correct this deficiency warrants no-action relief from the SEC staff.

Use of Images in Shareholder Proposals

Shareholder proposals are limited to 500 words under Rule 14a-8(d) but are permitted to include graphs and images. SLB 14I clarifies that only words in the graphics count against the 500-word limit. SLB 14I also provides guidance as to when graphs and images in shareholder proposals may be excluded from proxy materials. Companies can submit a no-action request for exclusion of graphs or images when they make the proposal false or misleading; render it inherently vague or indefinite; impugn reputation or make charges of improper, illegal or immoral conduct without a factual basis; or are irrelevant to the subject matter of the proposal.

Conclusion

SLB 14I places greater responsibility on boards by requiring them to consider shareholder proposals. It remains to be seen how much time and consideration boards must give to these proposals and what processes should be put in place to satisfy the new guidance. At the same time, SLB 14I’s new requirements may give boards a greater opportunity to exclude proposals under the ordinary business and economic relevance exceptions. Boards will be able to give company-specific reasoning for excluding particular shareholder proposals, and the SEC staff may be more likely to defer to their management expertise.

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¹ James R. Copland & Margaret M. O’Keefe, *Proxy Monitor 2016: An Annual Report on Corporate Governance and Shareholder Activism*, *The Manhattan Institute* 7 (2016), http://www.proxymonitor.org/Forms/pmr_13.aspx.