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INSIDE THE SEC

SEC Provides Guidance on Excluding Shareholder Proposals

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Rule 14a-8 under the Securities Exchange Act of 1934 permits shareholders who have owned either at least $2,000 in market value or one percent of the voting stock of a company for at least one year to submit a proposal that a company must include in its proxy statement, unless the proposal has specified procedural deficiencies or can be excluded based on one of the substantive grounds that are set forth in the rule. For example, Rule 14a-8(i)(9) permits exclusion of a shareholder proposal if "the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." In the past, the staff of the US Securities and Exchange Commission's Division of Corporation Finance (the Staff) has granted no-action relief on this basis—even where the management proposal was on the same topic but with more restrictive terms—including in situations when the management proposal was developed only after the shareholder proposal was received.

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Background

In December 2014, the Staff took a no-action position pursuant to Rule 14a-8(i)(9) with respect to excluding a proxy access shareholder proposal received by Whole Foods Market Inc. that conflicted with a management proxy access proposal that had different terms than the shareholder proxy access proposal.[1] Following the controversy generated by certain shareholders and shareholder groups as a result of this no-action letter, SEC Chair Mary Jo White directed the Staff to review and report on the scope and application of Rule 14a-8(i)(9) as grounds for excluding shareholder proposals. Pending completion of the review, the Staff suspended giving no-action relief on this basis for any type of shareholder proposal, not just for proxy access proposals.

Another substantive basis for a company to exclude a shareholder proposal from its proxy statement is provided by Rule 14a-8(i)(7), which applies "[i]f the proposal deals with a matter relating to the company's ordinary business operations." In *Trinity Wall Street v. Wal-Mart Stores, Inc.*,[2] a three-judge panel of the US Court of Appeals for the Third Circuit held that a shareholder proposal submitted to Wal-Mart Stores, Inc., was excludable under Rule 14a-8(i)(7). In applying the Rule 14a-8(i)(7) test, the court employed a new two-part test that went beyond

the Staff's past interpretations of this ground for excluding a shareholder proposal. The court concluded that, for the significant policy exception to the ordinary business exclusion under Rule 14a-8(i)(7) to apply, "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."

On October 22, 2015, the Staff issued Staff Legal Bulletin No. 14H[3] (SLB 14H) addressing the scope and application of the grounds for exclusion of shareholder proposals from company proxy statements provided by Rule 14a-8(i)(9) and Rule 14a-8(i)(7).

Rule 14a-8(i)(9)

As described in SLB 14H, when reviewing a no-action request made under Rule 14a-8(i)(9), the Staff now will focus on whether a reasonable shareholder could logically vote for both the shareholder proposal and the management proposal. Under this new Staff analysis, a shareholder proposal would directly conflict with a management proposal, and thereby be excludable under Rule 14a-8(i)(9), only if a reasonable shareholder could not logically vote in favor of both proposals (i.e., where a vote for one proposal would be tantamount to a vote against the other proposal). The Staff indicated that it 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.

SLB 14H provides the following examples of situations where shareholder proposals *cannot* be excluded on the grounds of conflicting with management proposals:

- A shareholder proposal that would permit a shareholder or group of shareholders holding at least 3 percent of the company's outstanding stock for at least three years to nominate up to 20 percent of the directors would not directly conflict with a management proposal that would allow shareholders holding at least 5 percent of the company's stock for at least five years to nominate for inclusion in the company's proxy statement 10 percent of the directors; and
- 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.

Under SLB 14H, it is possible for a precatory shareholder proposal to directly conflict with a management proposal on the same subject, even though the shareholder proposal is not binding. SLB 14H also recognizes that a shareholder proposal may be in direct conflict with a management proposal even if the management proposal is approved by the company's board of directors after the shareholder proposal was received by the company.

Rule 14a-8(i)(7)

While the Staff granted a no-action letter to Wal-Mart under Rule 14a-8(i)(7), agreeing that Wal-Mart could exclude a shareholder proposal regarding the sale of products potentially raising public safety issues,[4] it disagreed with the court's analysis in *Trinity*, even though the court reached a similar conclusion. In SLB 14H, the Staff expressed concern that the new analytical approach introduced by the Third Circuit may lead to the unwarranted exclusion of shareholder proposals.

According to SLB 14H, the majority opinion in *Trinity* viewed a proposal's focus as separate and distinct from whether a proposal transcends a company's ordinary business, while the SEC 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." The Staff makes clear in SLB 14H that it will not permit the exclusion of a shareholder proposal on a significant policy that transcends a company's ordinary business operations, even if the significant policy issue relates to the "nitty-gritty" of the company's core business.

Practical Considerations

While the Staff review of its prior application of direct conflict exclusions was prompted by a proxy access no-action letter, the SLB 14H guidance impacts use of Rule 14a-8(i)(9) for any type of shareholder proposal, including proposals permitting shareholders to call a special meeting which, in the past, have been excluded as a result of management proposals with differing thresholds. In any event, it is important that companies carefully consider all of the options available to them when deciding how to respond to a shareholder proposal.

Because of the Staff's new position, it will be more difficult for companies to exclude shareholder proposals from their proxy statements pursuant to Rule 14a-8(i)(9) based on a management proposal on the same topic. A company likely will not be able to obtain a no-action letter from the Staff by developing a variation of the shareholder proposal with terms that it believes are more appropriate.

If the board of directors decides to implement the subject matter of a shareholder proposal, but believes that different terms would be better for the company, management can still create its own competing proposal to submit to shareholders. Following the suspension of the availability of Rule 14a-8(i)(9) as a basis for exclusion during the 2015 proxy season, there were a number of companies that included both shareholder and management proxy access or special meeting proposals in their proxy statements, with shareholders voting on both proposals. This trend is likely to continue, providing a concrete way for management to demonstrate its support for the subject matter of a shareholder proposal while explaining why it believes its variation is in the best interests of the company.

If a company decides to include a management proposal in its proxy statement on the same subject as a non-binding, precatory shareholder proposal, it needs to decide what action it plans to take if both the management proposal and the shareholder proposal are approved, or if only the shareholder proposal is approved. Companies considering a management proposal on the same topic as a shareholder proposal may find it possible to negotiate with the proponent, seeking withdrawal of the shareholder proposal based on management's commitment to adopt or submit to shareholders a mutually agreed upon version of the proposal.

Some companies may adopt their preferred version of proxy access or other proposal in anticipation of a shareholder proposal on the topic in the hope of averting a shareholder proposal, or excluding one under Rule 14a-8(i)(10). Thereafter, if a company receives a shareholder proposal with terms that differ from the provision on the same topic that the company already adopted, the company might be able to exclude that shareholder proposal under Rule 14a-8(i)(10) on the ground that the company already *substantially implemented* the shareholder proposal. Although Rule 14a-8(i)(10) does not require that a proposal be *fully* implemented, companies seeking to rely on this basis for exclusion must demonstrate that the proposal has already been substantially implemented. While SLB 14H does not address the "substantially implemented" ground for exclusion, the new guidance may reflect that the Staff's current views tend toward narrowly interpreting the scope of exclusions. In this regard, the next big test for Rule 14a-8 no-action letters may be over the interpretation of what it means for a proposal to have been "substantially implemented."

Although SLB 14H challenged a recent court formulation of the significant policy exception to the ordinary business exclusion pursuant to Rule14a-8(i)(7), the Staff affirmed its existing position on the issue. Therefore, existing no-action precedent construing whether a shareholder proposal raises a significant policy issue remains applicable.

As a reminder, companies receiving shareholder proposals for their proxy statements should promptly evaluate whether the technical and procedural requirements of Rule 14a-8 are met because deficiencies that are timely identified may provide a basis of exclusion for a shareholder proposal that is not otherwise excludable on substantive grounds.

Finally, as evidenced by the *Trinity* case discussed in SLB 14H, the Staff's no-action process is not the only method for determining whether a shareholder proposal may be excluded from a company's proxy statement. Although the no-action procedure is the most prevalent, parties sometimes turn to the courts to resolve the question of whether a shareholder proposal must be included in a company's proxy statement. In particular, one new factor for companies to consider if they can bring an action in the Third Circuit and are looking at the Rule 14a-8(i)(7) exclusion is whether they are likely to have a more favorable outcome dealing with the SEC's no-action letter process under Rule 14a-8 or with the Third Circuit and its current interpretation of the exclusion.

Notes

1. Available at *http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2014/jamesmcritchie120114.pdf*.
2. 792 F.3d 323 (3d Cir. 2015).
3. Available at *http://www.sec.gov/interps/legal/cfslb14h.htm*.
4. Available at *http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2014/trinitychurch032014-14a8.pdf*.