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SEC Staff Publishes Staff Legal Bulletin 14H: New SEC Guidance Significantly Narrows the Shareholder Proposal Rule

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Securities

On October 22, 2015, the staff of the Division of Corporation Finance of the Securities and Exchange Commission (the "Staff") published Staff Legal Bulletin 14H ("SLB 14H"), which includes important guidance regarding how the Staff will approach arguments under the "conflicting proposals" and "ordinary business" exclusions under Rule 14a-8(i)(9) and Rule 14a-8(i)(7), respectively, of the Securities Exchange Act of 1934 (the "Exchange Act"). In this advisory we provide a high-level summary of what these new interpretations will mean for the 2016 proxy season and beyond.

Rule 14a-8(i)(9)

Under Rule 14a-8(i)(9) of the Exchange Act, a company may exclude a shareholder proposal from its proxy materials "if the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." The Staff has historically allowed companies to rely on Rule 14a-8(i)(9) to exclude shareholder proposals where inclusion of a management proposal and a shareholder proposal in the same proxy statement could "present alternative and conflicting decisions for shareholders and … submitting both proposals to a vote could provide inconsistent and ambiguous results." This included permitting omission of a shareholder proposal if the company demonstrated that the subject matter of the shareholder proposal directly conflicted with all or part of one of management's proposals.

In the beginning of the 2015 proxy season, many companies expected to rely on Rule 14a-8(i)(9) to exclude "proxy access" and other shareholder proposals from their proxy materials. Specifically, many companies that received shareholder proposals considered whether to submit management proposals concerning the same topics for shareholder approval and then subsequently seek no-action relief from the Staff under Rule 14a-8(i)(9). Beginning in January 2015, however, the Staff ruled this possibility out when, following a directive from SEC Chair Mary Jo White to review the proper scope and application of Rule 14a-8(i)(9), the Staff announced that it would express no view with respect to arguments under Rule 14a-8(i)(9) for the remainder of the proxy season.

This decision had significant consequences in 2015. For example, many companies that planned to rely on Rule 14a-8(i)(9) to exclude proxy access shareholder proposals chose instead to include proxy access shareholder proposals in their proxy materials. In total, 87 companies included proxy access shareholder proposals in their proxy materials during the 2015 proxy season. These proposals received significant levels of shareholder support, with 51 of these proposals receiving a majority of votes cast.

The SEC's New Approach to Rule 14a-8(i)(9) under SLB 14H

On October 22, 2015, the Staff announced the results of its review of Rule 14a-8(i)(9) in SLB 14H, which stakes out new territory for Rule 14a-8(i)(9). In SLB 14H, the Staff indicates that a company may only rely on Rule 14a-8(i)(9) to exclude a shareholder proposal if a shareholder proposal and management proposal are "in essence, mutually exclusive." Specifically, SLB 14H notes:

> After reviewing the history of Rule 14a-8(i)(9) and based on our understanding of the rule's intended purpose, we believe that any assessment of whether a proposal is excludable under this basis should focus on whether there is a direct conflict between the management and shareholder proposals. For this purpose, we believe that 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 Staff provided helpful examples of how the new approach would work in practice:

Examples of Proposals That Directly Conflict

- a company could rely on the exclusion to exclude a shareholder proposal directing shareholders to vote against a merger proposal where the company was recommending that shareholders vote in favor of the merger proposal;
- a company could rely on the exclusion to exclude a shareholder proposal seeking the separation of the roles of CEO and Chairman where the company was submitting a bylaw amendment that would require that the CEO be Chairman;

Examples of Proposals That Do Not Directly Conflict

- a company could NOT rely on the exclusion to exclude a shareholder proposal that would permit a shareholder holding at least three percent of the company's outstanding stock for at least three years to nominate up to 20% of the directors where the company was submitting a management proposal would allow shareholders holding at least five percent of the company's stock for at least five years to nominate for inclusion in the company's proxy statement ten percent of the directors; and
- a company could NOT rely on the exclusion to exclude a shareholder proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year annual vesting where the company was also submitting a management proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards.

As evidenced by these examples, the Staff's new approach to conflicting proposals will make it considerably more difficult for companies to rely on Rule 14a-8(i)(9) to exclude shareholder proposals that differ from, but are not mutually exclusive with, management proposals. This will likely result in the inclusion by companies of significantly more shareholder proposals than would have been the case without the change in Staff position articulated in SLB 14H.

Although the new approach significantly narrows the application of Rule 14a-8(i)(9), the Staff declined to adopt approaches favored by some shareholder groups. For example, the Staff decided not to adopt an approach pursuant to which precatory proposals could not be excluded in reliance on Rule 14a-8(i)(9) simply because they were non-binding. SLB No. 14H makes clear that a non-binding shareholder proposal may, despite its precatory nature, directly conflict

with a management proposal if a vote in favor of the shareholder proposal is tantamount to a vote against management's proposal. The Staff also declined to adopt an approach pursuant to which the exclusion would not apply if the company had not already approved its own proposal to be included in the proxy statement by the time that the shareholder submitted the conflicting shareholder proposal.

Finally, the Staff reminded companies that they should include complete copies of management proposals in no-action requests to enable the Staff to evaluate whether a company has met its burden of demonstrating that a shareholder proposal is excludable under Rules 14a-9(i)(9) or 14a-9(i)(10) (which allows the exclusion of proposals that have been "substantially implemented"). The Staff also reminded companies that, to minimize concerns about shareholder confusion, any company that includes shareholder and management proposals on the same topic in its proxy statement may also include disclosure explaining the differences between the two proposals and how they expect to treat the voting results.

Rule 14a-8(i)(7)

In 2015, Trinity Wall Street ("Trinity") submitted a shareholder proposal for inclusion in the proxy statement of Wal-Mart Stores Inc. ("Wal-Mart").[1] The proposal at issue requested that the charter of Wal-Mart's Compensation, Nominating and Governance Committee be amended to include the following among the Committee's duties:

> 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 [i.e., Wal-Mart] 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.

Wal-Mart submitted a no-action request to the Staff, seeking to exclude the proposal under the "ordinary business exclusion" set forth in Rule 14a-8(i)(7). This exception allows a company to exclude a shareholder proposal if such proposal "deals with a matter relating to the company's ordinary business operations." Based on language in Trinity's supporting statement and other statements in the proposal that suggested that the object of the proposal was to have Wal-Mart change its policy with respect to the sale of guns, Wal-Mart successfully persuaded the Staff that it was entitled to exclude the proposal on the basis that it related to Wal-Mart's ordinary business matters, i.e., the sale of a particular product.[2]

Following the Staff's grant of no-action relief, Trinity challenged Wal-Mart's omission of the proposal from its proxy materials in federal district court. In *Trinity Wall Street v. Wal-Mart Stores, Inc.*, the U.S. District Court for the District of Delaware granted a summary judgment motion in favor of Trinity, which had sought a declaratory judgment that it was entitled to have its shareholder proposal included in Wal-Mart's proxy materials.

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[1] *See* Trinity Wall Street v. Wal-Mart Stores, Inc., 2014 U.S. Dist. LEXIS 165431 (D. Del. 2014).
[2] Wal-Mart Stores, Inc., SEC No-Action Letter (Mar. 20, 2014).

The district court ultimately ruled in favor of Trinity, holding that the proposal related to oversight, not day-to-day implementation, of Wal-Mart's policy with respect to guns, and therefore transcended ordinary business matters.[3] On appeal, the Third Circuit disagreed, ruling that "because the proposal relates to a policy issue that targets the retailer-consumer interaction, it doesn't raise an issue that transcends in this instance Wal-Mart's ordinary business operations, as product selection is the foundation of retail management."[4] In so ruling, the Court stated that:

> the essence of a retailer's business is deciding what products to put on its shelves—decisions made daily that involve a careful balancing of financial, marketing, reputational, competitive and other factors. The emphasis management places on safety to the consumer or the community is fundamental to its role in managing the company in the best interests of its shareholders and cannot, "as a practical matter, be subject to direct shareholder oversight."[5]

The SEC's Response to Trinity v. Wal-Mart's Interpretation of 14a-8(i)(7)

In SLB 14H, the Staff noted that although the Staff agreed with the outcome in the *Wal-Mart* decision, the Third Circuit had articulated the analysis of the significant policy considerations exception in a way that differed from how the Staff has historically applied the exception. Specifically, the Staff questioned the Third Circuit majority opinion's new two-part test under which a company would examine first whether a proposal focuses on a significant policy issue and *then* whether the significant policy issue is "divorced from how a company approaches the nitty-gritty of its core business."

In order to avoid confusion regarding the Staff's approach to the issue, the Staff made clear in SLB 14H that the ordinary business exclusion employs a one-part, rather than a two-part test. Specifically, a company need only examine whether a proposal focuses on a significant policy issue. Under the test to be applied by the Staff, a shareholder proposal that raises a significant policy issue is not excludable *because* it transcends a company's ordinary business operations - even if the significant policy issue relates to the "nitty-gritty of its core business."

Conclusion

The Staff's new interpretation of Rule 14a-8(i)(9) meaningfully limits a company's ability to rely on the exclusion unless a shareholder could not logically vote in favor of both the company proposal and the shareholder proposal. In practice we think that means that companies will likely come to the table earlier in response to the submission of shareholder proposals that they might have otherwise contested in reliance on Rule 14a-8(i)(9). In light of the number of proxy access shareholder proposals that are expected to be submitted in the 2016 proxy season, this will likely have an extraordinary impact on corporate governance practices going forward: it could significantly accelerate the number of companies that adopt proxy access bylaws. In the 2015 proxy season we saw more than 87 shareholder proposals on the subject ultimately lead to the adoption of nearly 60 proxy access bylaws as of the date of this alert, with more expected

[3] *Id.* at *27.
[4] Trinity Wall St. v. Wal-Mart Stores, 792 F. 3d 323 (3d Cir. 2015).
[5] Trinity Wall St. v. Wal-Mart Stores, 792 F. 3d 323 (3d Cir. 2015).

in the remainder of the year. If that trend persists, proxy access may become a common fixture in corporate governance within the next few years.

With respect to Rule 14a-8(i)(7), notwithstanding the Third Circuit's decision in the *Wal-Mart* case, the Staff indicated it will continue to apply Rule 14a-8(i)(7) as articulated by the SEC and consistent with the Staff's prior application of the exclusion. As a result, shareholders and companies alike can approach Rule 14a-8(i)(7) in the 2016 proxy season as they did in prior seasons.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Securities practice group:

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