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SHAREHOLDER PROPOSALS

Staff Legal Bulletin 14I: What You Need to Know

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On November 1, 2017, the staff of the Division of Corporation Finance of the Securities and Exchange Commission (Staff) published Staff Legal Bulletin No. 14I (SLB 14I),[1] which includes important guidance regarding the Staff's administration of the Securities and Exchange Commission's (SEC's) shareholder proposal rule. The guidance relates to arguments under the "ordinary business" and "economic relevance" exclusions in Rule 14a-8(i)(7) and Rule 14a-8(i)(5), respectively, under the Securities Exchange Act of 1934.

SLB 14I also includes new procedural guidance under Rule 14a-8(b) for agents of shareholder proponents and under Rule 14a-8(d) for the use of graphics and images in shareholder proposals. This guidance has the potential to

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significantly shift how the shareholder proposal rule will be used and what topics will survive challenge at the SEC. In this article we address the key considerations that companies and shareholders need to know about the guidance.

Staff Invites Board Analysis of the 'Ordinary Business' Exclusion Under Rule 14a-8(i)(7)

Under Rule 14a-8(i)(7), a company may exclude from its proxy materials a shareholder proposal that "deals with a matter relating to the company's ordinary business operations." The Staff has historically allowed companies to rely on Rule 14a-8(i)(7) to exclude shareholder proposals that raise matters that are "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." The Staff has not allowed the exclusion, however, for proposals that focus on significant social policy issues that transcend ordinary business matters.

In SLB 14I, the Staff describes the difficult judgement calls it must make in determining whether a shareholder proposal relates to ordinary business matters or raises significant social policy issues. In this regard, however, the Staff notes that a board of directors of a company would be better suited than the Staff to make these judgements due to its "knowledge of the company's business and the implications for a particular proposal on [a] company's business."

Accordingly, SLB 14I indicates that the Staff expects a company's Rule 14a-8(i)(7) no-action request to include the board of directors' "analysis of a particular policy issue raised and its significance," including in such analysis "the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned." The Staff believes that such analysis will greatly assist its review of Rule 14a-8(i)(7) no-action requests.

Staff Revives 'Economic Relevance' Exclusion Under Rule 14a-8(i)(5)

The most significant aspect of SLB 14I is the Staff's revival of Rule 14a-8(i)(5). Under Rule 14a-8(i)(5), a company may exclude a shareholder proposal from its proxy materials if the proposal (a) "relates to operations which account for less than five percent of the company's total assets at the end of its most recent fiscal year, and for less than five percent of its net earnings and gross sales for its most recent fiscal year" and (b) "is not otherwise significantly related to the company's business."

Over the last few decades, the Staff has only granted a handful of no-action requests under this exception. The relatively infrequent number of no-action grants under this exclusion is largely due to a Staff position adopted in the 1980s following a decision of a federal district court severely narrowing the application of the economic relevance exclusion.[2] Following that decision, the Staff concluded that a company could not rely on the economic relevance exclusion if the shareholder proposal was of any ethical or social significance, even if the proposal was well below the economic thresholds for significance included in Rule 14a-8(i)(5).

SLB 14I indicates that the Staff believes that its historical position has unduly limited the application of Rule 14a-8(i)(5) because it has not fully considered whether the proposal "deals with a matter that is not significantly related to the [company's] business and is therefore excludable." Accordingly, in SLB 14I the Staff says its analysis of Rule 14a-8(i)(5) no-action requests will focus on a shareholder proposal's significance to the company's business when it otherwise relates to operations that account for less than five percent of total assets, net earnings, and gross sales.

This significance, according to SLB 14I, will depend on the "particular circumstances of the company to which the proposal is submitted," which means that a proposal that is significant to one company may not be significant to another company. One exception to this approach appears

to be substantive governance matters, which the Staff views to be significantly related to almost all companies. The Staff also says in SLB 14I that the proponent of the shareholder proposal will bear the burden of demonstrating that such proposal is "otherwise significantly related to the company's business" if the significance of a proposal is not apparent on its face.

Similar to questions under Rule 14a-8(i)(7) discussed previously, determinations of whether a proposal is "otherwise significantly related to the company's business" require difficult judgment calls that the Staff believes a company's board of directors is better positioned to make than the Staff in the first instance. Accordingly, the Staff will expect a company's Rule 14a-8(i)(5) no-action request to include the board of directors' analysis of the proposal's significance to the company, including in such analysis the specific processes employed by the board.

Lastly, SLB 14I notes that the Staff's analysis of whether a proposal is "otherwise significantly related to the company's business" has historically been informed by its analysis under the "ordinary business" exception in Rule 14a-8(i)(7). SLB 14I makes it clear that the Staff "will no longer look to its analysis under Rule 14a-8(i)(7) when evaluating arguments under Rule 14a- 8(i)(5)." This reflects the Staff's view that application of separate analytical frameworks for each exclusion will ensure that each basis for exclusion serves its intended purpose.

Proposals by Proxy and Rule 14a-8(b)

Over the last several decades, there have been steady increases in the number of shareholder proposals that are submitted by individuals on behalf of multiple shareholders for the same annual meeting. This practice, which the Staff refers to as "proposals by proxy," is not covered in Rule 14a-8.

In SLB 14I, however, the Staff notes that a proposal by proxy can in fact raise numerous questions under Rule 14a-8, including whether the proof of ownership requirements of Rule 14a-8(b) are satisfied and whether shareholders are aware that proposals are being submitted on their behalf. To address these issues and to help the Staff and companies better evaluate whether the eligibility requirements of Rule 14a-8(b) have been satisfied, the Staff will start looking to whether the shareholder submitting a proposal by proxy provides documentation describing the shareholder's delegation of authority to the proxy. This documentation should provide the following information:

- The name of the shareholder-proponent and the person or entity selected as proxy;
- The company to which the proposal has been submitted;
- The specific annual or special meeting for which the proposal has been submitted;
- The shareholder proposal that has been submitted (*e.g.*, a proposal to lower the threshold for calling a special meeting from 25 percent to 10 percent); and
- A dated signature by the shareholder-proponent.

SLB 14I provides that the absence of such documentation could be a basis for excluding a shareholder proposal under Rule 14a-8(b). A company that seeks to exclude a shareholder proposal based on the failure to provide some or all of this information must notify the shareholder of the specific defect within 14 calendar days of receiving the proposal so that the shareholder can cure the defect.

Graphics and Images in Shareholder Proposals and Rule 14a-8(d)

Rule 14a-8(d) imposes a 500-word limit on a shareholder proposal and any accompanying supporting statement. In recent years, companies have challenged the inclusion of graphics in shareholder proposals under Rule 14a-8(d). These arguments generally have been unsuccessful. SLB 14I indicates that the Staff, consistent with these no-action decisions, is of the view

that Rule 14a-8(d) does not preclude a shareholder from including graphics or images in a shareholder proposal.

In SLB 14I, the Staff recognizes that the inclusion of graphics or images in shareholder proposals could allow shareholders to abuse Rule 14a-8, but notes that these graphics or images may be excluded through other provisions of Rule 14a-8. Specifically, the Staff indicates that a company may exclude graphs or images included in a shareholder proposal under Rule 14a-8(i)(3) when they:

- Make the proposal materially false or misleading;
- Render the proposal so inherently vague or indefinite that neither the stockholders voting on the proposal, nor the company in implementing it, would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires;
- Directly or indirectly impugn character, integrity, or personal reputation, or directly or indirectly make charges concerning improper, illegal, or immoral conduct or association, without factual foundation; or
- Are irrelevant to a consideration of the subject matter of the proposal, such that there is a strong likelihood that a reasonable shareholder would be uncertain as to the matter on which the shareholder is being asked to vote.

In addition, SLB 14I provides that graphics or images may be excluded from a shareholder proposal under Rule 14a-8(d) "if the total number of words in [such] proposal, including words in the graphics, exceeds 500."

SLB 14I also notes that a company may not "minimize or otherwise diminish the appearance" of a graphic in a shareholder proposal and that it must give such graphic similar prominence to its own graphics in its proxy statement. SLB 14I clarifies that if a company's proxy statement is in black and white, the shareholder proposal and accompanying graphics may also appear in black and white.

Key Questions Raised by the New Guidance

SLB 14I leaves open important questions regarding how the new guidance will be applied. Following, we address some of the most significant questions raised.

Will Companies Have to Provide Board Analyses for All Arguments under Rule 14a-8(i)(7)?

No. Although SLB 14I could be clearer on this point, it encourages the submission of the board's analysis, but it does not indicate that such analysis is a prerequisite for getting no-action relief. This point has been made clearer in subsequent Staff statements. For example, in a Webinar on TheCorporateCounsel.net (TheCorporateCounsel Web cast), Matt McNair, who has led the shareholder proposal task force in the SEC's Division of Corporation Finance over the last few years, indicated that the board analysis would be helpful, but not necessary, noting:[3]

> …we don't expect to see this information included as part of every ordinary business argument…If something is clearly on the ordinary side, we wouldn't expect the board to include it. What we're looking for is when the proposal implicates significant issues that the Staff Legal Bulletin says raises difficult judgment calls for us, the company and proponents, that is where we think this analysis would be helpful, but again, it's not required.

Is the Staff Looking for Boards to Provide Their Analysis of Whether a Shareholder Proposal Concerns a Significant Social Policy in Support of Arguments under Rule 14a-8(i)(7)?

No. The Staff has indicated that it is looking for a board-level analysis of whether the issues

to be addressed by a shareholder proposal are significant to the company to which the proposal has been submitted. It is not, however, looking for companies to provide a board analysis of whether a shareholder proposal raises significant social policy issues.

In the TheCorporateCounsel Web cast, the Staff stated that "what we're asking for is information that is going to help us decide the nexus question, whether it is sufficiently significant to the company's business." The concept of a nexus is one that has existed for some time in Staff no-action letters. In those letters, the Staff has historically taken the position that a shareholder proposal that raises significant social policy issues may not be excluded under Rule 14a-8(i)(7) if the policy issue has a significant nexus to the company's business. It is this position that provides the basis for the distinction that the Staff has historically drawn between retailers and manufacturers of products that raise significant policy issues.[4]

Can a Company Rely on the New Guidance to Exclude a Shareholder Proposal that the Staff Has Previously Concluded Raises Significant Policy Considerations?

It appears so. The Staff has stated that a company could demonstrate that a particular shareholder proposal topic has an insufficient nexus to a company even if the Staff had previously taken the position that the proposal raised significant social policy considerations:[5]

> It's possible that in the past, we've made our own determination on that point, or that a company has conceded and not made the argument. They viewed it as a foregone conclusion that it would not be excludable and did not challenge it. I think something that is already recognized under this new framework as a significant policy issue, that proposal could be excluded depending on connection to the company.

Does a Company Need to Provide the Staff with Board Minutes or Presentations in Order to Take Advantage of the Guidance Included in SLB 14I?

No. There is no expectation that a company would submit board minutes or board presentations in order to support an argument for no-action relief. Instead, the Staff appears to be looking for a summary of the board process and its analysis of the relevant proposal and its significance to the company at issue. This summary should be designed to demonstrate that the board's analysis is well informed and supported by the facts.

At a minimum, the analysis should indicate what body of the board conducted the analysis, what factors the board considered, any information that was provided to the board by its advisors, any relevant financial analysis, and any other information that the board believes is relevant to the analysis. From a practical perspective, companies should keep in mind that shareholder proposal no-action requests are a matter of public record. Consequently, it would not be advisable to submit confidential or privileged board materials or communications solely to support a request for no-action relief.

What Factors Are Relevant to an Analysis of Whether a Shareholder Proposal Has a Significant Nexus to a Company's Business?

Much of the answer to this question remains to be seen. Staff no-action letters under Rule 14a-8(i)(7) have historically taken a number of considerations into account. One key consideration is whether the issues raised or topics addressed by a shareholder proposal relate to activities in which a company has engaged. For example, a company should be able to successfully argue that a shareholder proposal asking it to cease fracking activities relates to ordinary business if the company does not actually engage in fracking. Along similar lines, a company could try to demonstrate that a proposal topic is not significant to the company by providing information regarding the extent

to which the topic is something that its investors have shown a lack of interest in—either based on shareholder votes on the topic, communications with shareholders, or some other indicia.

Finally, companies should consider providing analysis of the financial impact of the proposal or the topics that are the subject of the proposal. Even though economics are a much more significant consideration in the context of the economic relevance exclusion, they could still demonstrate that a shareholder proposal does not have a significant nexus to a company.

Does a Board of Directors Have to Conduct the Analysis Described by SLB 14I, or Can It Delegate the Responsibility to a Board Committee?

This is a question that has come up frequently since the publication of SLB 14I. The Staff has indicated that it is up to a board of directors to decide what level of involvement they would want to have in the evaluation of a shareholder proposal. With that said, the Director of the Division of Corporation Finance has indicated in public statements that the analysis of a board of directors will carry more weight than an analysis prepared by a board committee.

Does the Staff's Guidance Regarding Rule 14a-8(i)(7) Extend to Arguments under Rule 14a-8(i)(5)?

Yes. Although SLB 14I makes clear that its analysis of Rule 14a-8(i)(5) will no longer be synonymous with its analysis under Rule 14a-8(i)(7), much of the guidance described previously applies in full measure to Rule 14a-8(i)(5). As is the case with the ordinary business exclusion, arguments under the economic relevance exclusion may be (but are not required to be) supported by relevant board analysis.

Although Rule 14a-8(i)(5) does not consider "nexus" in the same way as the Staff's analysis under Rule 14a-8(i)(7) , the "otherwise significantly related" aspect of Rule 14a-8(i)(5) is quite similar. As is the case with a nexus analysis, a company that intends to rely on Rule 14a-8(i)(5) must demonstrate why a shareholder proposal is not significantly related to the company's business.

We expect that companies making arguments under Rule 14a-8(i)(5) will want to make many of the same arguments that they would make under Rule 14a-8(i)(7). Specifically, a company should address issues such as whether the company engages in the activities that are the subject of the proposal and the financial impact of the proposal or the subjects addressed by the proposal.

This analysis could address the impact of the proposal on the company's business segments, overall financial performance, relationships with its customers, suppliers, investors, or other constituencies, any liabilities relating to the activity, and actual or potential reputational harm associated with the activity. To the extent that a proposal relates to issues that raise significant policy considerations or are the subject of significant media, legislative, or regulatory scrutiny, a company may wish to explain why that controversy has not impacted its operations or why the aspects of the proposal that relate to its business are not relevant to the scrutiny.

One particularly important difference between the Staff's guidance in SLB 14I regarding the ordinary business and economic relevance exclusions is the fact that the guidance regarding the economic relevance exclusion shifts the burden to a shareholder to demonstrate why a shareholder proposal is of significance to a company in order to preclude exclusion. Consequently, we would expect shareholders to focus on many of the same factors outlined in the prior paragraph in support of the inclusion of their shareholder proposals in a company proxy materials.

Conclusion

As highlighted by the foregoing discussion, SLB 14I will have significant implications for the future use of the shareholder proposal rule. At a minimum, it is likely to result in a greater

degree of board involvement in the shareholder proposal process, which may be a good thing in its own right. The most significant aspect of the guidance is clearly the revival of the economic relevance exclusion, which has been sparingly relied upon by companies for the last two decades. A great many questions are raised by the guidance, not the least of which are its implications for tried-and-true shareholder proposal topics that raise social policy issues.

It is likely that companies will rely on that guidance to challenge a range of proposals that companies and shareholders alike had assumed were exempt from exclusion due to the subjects that they address. Whether the Staff will allow the exclusion of such proposals, and the information that will be required to obtain such relief are significance open issues. No matter the outcome, SLB 14I is likely to significantly shift the landscape with respect to shareholder proposals.

Notes

1. Staff Legal Bulletin No. 14I can be found at *https://www.sec.gov/interps/legal/cfslb14i.htm,* last accessed Dec. 5, 2017.

2. *See Lovenheim v. Iroquois Brands, Ltd.*, 618 F. Supp. 554 (D.D.C. 1985).

3. *See* Transcript for Shareholder Proposals: Corp Fin Speaks, November 14, 2017, available on *TheCorporateCounsel.net* (TheCorporateCounsel Web cast).

4. *See e.g.*, Kimberly-Clark Corp., (Feb. 22, 1990) ("In the Division's view, the proposal, which would call on the Board to take actions leading to the eventual cessation of the manufacture of tobacco products, goes beyond the realm of the Company's ordinary business"); *compare* Wal-Mart Stores, Inc., (Mar. 12, 1996) (granting relief under Rule 14a-8(c)(7) with respect to a proposal that the company refrain from selling tobacco products).

5. *See* TheCorporateCounsel Web cast. Based on this guidance, it appears that a company can rely on the new guidance to challenge a shareholder proposal on ordinary business grounds that had previously been determined to raise significant policy issues.