SULLIVAN & CROMWELL LLP

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# SEC Staff Begins Taking Steps to Reform Shareholder Proposals

## Guidance Contemplates New Board of Director Involvement in the "Ordinary Business" and "Economic Relevance" Exclusions and Suggests the Staff Would Give the Board's Conclusion a Degree of Deference; Also Establishes Procedural Requirements for Proponents to Designate Representatives and Allows Shareholders and Issuers to Use Images in Proposals

### SUMMARY

On Wednesday, the staff of the Division of Corporation Finance of the Securities and Exchange Commission issued new guidance on the shareholder proposal process:

- For the Rule 14a-8(i)(7) "ordinary business" exclusion, the guidance states that the SEC staff will expect no-action requests to include a discussion of the company board's conclusion that the underlying issue is not sufficiently significant to the company's business to transcend ordinary business matters and suggests that the staff will give a degree of deference to a conclusion that is "well-informed and well-reasoned."
- For the Rule 14a-8(i)(5) "economic relevance" exclusion, the guidance expands the availability of the exclusion, clarifies that the burden is on the proponent to show that the proposal is significantly related to the company's business, states that the SEC staff will expect a similar discussion of the company board's analysis of the proposal's significance and also suggests that the staff will give a degree of deference to the board's conclusion.
- The guidance confirms that shareholders may submit proposals through a representative but states that the SEC staff will now expect the proponent to identify its representative by name and confirm the representative's authority to act at a specified shareholder meeting and on a specified proposal.
- The guidance clarifies that shareholders and issuers may use graphics in their proposals, so long as the graphics otherwise comply with Rule 14a-8. The size of the graphics appears to be unlimited so long as the issuer's graphics and proponent's graphics are given equal prominence.

## BACKGROUND

Exchange Act Rule 14a-8 addresses when a company must include a shareholder's proposal and supporting statement in its proxy statement. The Rule provides certain procedural and substantive bases for exclusion of a shareholder proposal. Among other potential procedural bases for exclusion, the Rule provides that a proposal may be excluded if the proponent does not demonstrate that it is eligible to submit a proposal or if the proposal exceeds 500 words. The Rule also provides 13 substantive bases for exclusion, including that the proposal deals with the company's ordinary business operations or relates to operations of the company that account for less than 5% of the company's total assets as of the end of the company's most recent fiscal year and less than 5% of the company's net earnings and gross sales for the most recent fiscal year and, in each case, is not otherwise significantly related to the company's business.

## HIGHLIGHTS FROM THE SHAREHOLDER PROPOSAL GUIDANCE

### Rule 14a-8(i)(7): The Ordinary Business Operations Exclusion

Rule 14a-8(i)(7) permits the exclusion of a shareholder proposal if it "deals with a matter relating to the company's ordinary business operations." This exclusion is based on two central considerations:

- certain matters are so fundamental to management's ability to run the company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight; and
- the shareholder proposal may not seek to "micromanage" the company.

In applying the Rule, however, the SEC has developed an exception to this basis for exclusion when the proposal also presents a significant social policy issue for consideration that transcends ordinary business. The guidance indicates that the line between ordinary business operations and policy issues has often been difficult to define and often requires a judgment call by the SEC staff.

The new guidance explains that the company's board of directors, acting with fiduciary duties to the company's shareholders and with a unique knowledge of the company's business, is often in the best position to determine whether a particular issue transcends ordinary business matters because the policy issue is sufficiently significant. Accordingly, the new guidance states that, in future no-action requests seeking to invoke this ordinary course of business exclusion, the SEC staff will expect the company to include a discussion of the board's analysis of the policy issue and its significance to the company. The guidance states that it would be helpful if the explanation detailed the specific processes employed by the board to ensure that its conclusions were well-informed and well-reasoned. The guidance implies that, so long as the no-action request adequately demonstrates that the board's conclusions were well-informed and well-reasoned, the staff would give the board's recommendation a degree of deference. However, the guidance does not affirmatively state this or provide an indication as to the degree of deference the staff will provide. We expect that there will be more clarity as no-action practices develop in this area.

This level of board involvement in the Rule 14a-8 no-action process is new and may present some challenges for companies this season. For example, until no-action practices develop in this area, it is unclear the extent to which a well-informed and well-reasoned process will require the board to become familiar with the staff's historical practices in this area and how they apply to the company's particular situation or whether the process would benefit from multiple meetings. For companies that receive multiple shareholder proposals to which the ordinary course of business exclusion may be applicable, the staff's new position may well present challenges in terms of timing, although delegating shareholder proposals to a committee may facilitate compliance with the new guidance and the company's ability to stay within the Rule 14a-8 timing requirements.

### Rule 14a-8(i)(5): The Economic Relevance Exclusion

Rule 14a-8(i)(5) is another substantive exclusion that permits the exclusion of a shareholder proposal that "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business." The specific economic tests included in the current form of the exclusion were adopted in 1983 to expand the potential availability of the exclusion in response to the SEC staff's initial practice of only allowing exclusion of proposals that reflected social or ethical issues when they had no economic relationship to the company's business whatsoever. However, in 1985, the District Court for the District of Columbia in *Lovenheim* v. *Iroquois Brands, Ltd.*[1] preliminarily enjoined a company from excluding a proposal that fell well below the quantitative tests provided in the exclusion due to the proposal's "ethical and social significance" and because it implicated a "significant level of sales." Since then, the SEC staff has continued to generally not allow exclusion where the company conducts business related to the issue raised in the proposal, even when the proposal is well below the quantitative tests.

The new guidance states that the application of the exclusion is unduly limited and as such, going forward, the analysis will focus on the proposal's significance to the company's business when it otherwise does not exceed the quantitative tests, with a focus on the particular circumstances of the company. A proponent will have the burden to show that the proposal is significantly related to the company's business and would need to tie social or ethical issues it raises to a "significant effect" on the company's business.

The guidance indicates that, while governance matters will generally be viewed as significantly related to almost all companies, the mere possibility of reputational or economic harm by itself would not preclude exclusion. The staff will consider the proposal in light of the "total mix" of information about the issuer.

[1] 618 F. Supp. 544 (D.D.C. 1985).

As with the ordinary course of business exclusion, the guidance states that the company's board of directors is generally in a better position to determine whether a proposal is otherwise significantly related to the company's business under Rule 14a-8(i)(5). Therefore, in the future no-action requests seeking to invoke this exclusion, the staff will expect a discussion of the board's analysis. This presents the same opportunities and issues described above in connection the ordinary course of business exclusion.

### Proposal Submitted on Behalf of Shareholders

Rule 14a-8 does not specifically address the ability to submit shareholder proposals through a representative, or "proxy." The new guidance confirms that the practice of proposal by proxy is consistent with Rule 14a-8. However, the guidance acknowledges that proposals by proxy raise concerns with respect to satisfying the eligibility requirements of Rule 14a-8 and shareholder consent. Accordingly, going forward, a proposal by proxy will generally need to include documentation that:

- identifies the shareholder-proponent and the person or entity that will act as proxy;
- identifies the company and annual or special meeting for which the proposal is directed;
- identifies the specific proposal to be submitted; and
- is signed and dated by the shareholder.

The guidance notes that, when this information is not provided, the company may have a basis to exclude the proposal, subject to providing the proponent the required 14-day notice period to cure the defect.

### Rule 14a-8(d): Use of Images

Rule 14a-8(d) provides a procedural basis for exclusion of a shareholder proposal if the proposal, including any supporting statement, exceeds 500 words. The SEC staff has recently expressed the view that the 500-word limit does not preclude the inclusion of images or graphics in a proposal, and the new guidance confirms that view. However, the guidance notes that images will still be subject to the other requirements of Rule 14a-8. In particular, the guidance notes that images may be subject to exclusion under Rule 14a-8(i)(3) where they:

- make the proposal materially false or misleading;
- render the proposal inherently vague or indefinite;
- impugn character, integrity or personal reputation without factual support;
- make charges concerning improper, illegal or immoral conduct without factual support; or
- are irrelevant to the consideration of the proposal.

The guidance specifically provides that any words in the graphics will be counted toward the 500-word limit under the Rule, but does not specifically provide any limits to the size of the graphics.

The new guidance acknowledges that companies can likewise include graphics in their responses, but must give similar prominence to the shareholder's graphics and cannot seek to minimize or otherwise diminish the shareholder's graphics.

## IMPLICATIONS

We expect that the SEC Staff's new guidance will increase the availability of the ordinary business and economic relevance exclusions. In addition, by directly involving the company's board of directors in analyzing the appropriateness of Rule 14a-8 proposals, the guidance will raise the review of shareholder proposals by companies, along with the visibility of such proposals and their responses, to a new level. This is, of course, in the context of a corporate governance environment where boards are already deeply involved in a variety of corporate governance matters. Moreover, in order to meet the well-informed and well-reasoned standards in the guidance and the Rule 14a-8 timing requirements, especially for companies that receive multiple shareholder proposals where the ordinary course of business and relevance exclusions may be applicable, boards of directors should consider delegating to a committee of the board at least the initial review of any such shareholder proposals. In addition, management should consider accelerating its internal review schedule to permit board and/or committee consideration. The ordinary course of business exclusion has been a popular ground for exclusion. In the last proxy season, the ordinary course of business exclusion was the most common basis for exclusion of shareholder proposals, but was also the most common basis for denial of a company's no-action request.

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## CONTACTING SULLIVAN & CROMWELL LLP

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## CONTACTS


| | | |
|---|---|---|
| **New York** | | |
| Robert E. Buckholz | +1-212-558-3876 | buckholzr@sullcrom.com |
| Catherine M. Clarkin | +1-212-558-4175 | clarkinc@sullcrom.com |
| Heather L. Coleman | +1-212-558-4600 | colemanh@sullcrom.com |
| Robert W. Downes | +1-212-558-4312 | downesr@sullcrom.com |
| John E. Estes | +1-212-558-4349 | estesj@sullcrom.com |
| William G. Farrar | +1-212-558-4940 | farrarw@sullcrom.com |
| Matthew M. Friestedt | +1-212-558-3370 | friestedtm@sullcrom.com |
| John P. Mead | +1-212-558-3764 | meadj@sullcrom.com |
| Scott D. Miller | +1-212-558-3109 | millersc@sullcrom.com |
| Robert W. Reeder III | +1-212-558-3755 | reederr@sullcrom.com |
| Melissa Sawyer | +1-212-558-4243 | sawyerm@sullcrom.com |
| Glen T. Schleyer | +1-212-558-7284 | schleyerg@sullcrom.com |
| William D. Torchiana | +1-212-558-4056 | torchianaw@sullcrom.com |
| Marc Trevino | +1-212-558-4239 | trevinom@sullcrom.com |
| **Washington, D.C.** | | |
| Eric J. Kadel, Jr. | +1-202-956-7640 | kadelej@sullcrom.com |
| Robert S. Risoleo | +1-202-956-7510 | risoleor@sullcrom.com |
| **Los Angeles** | | |
| Patrick S. Brown | +1-310-712-6603 | brownp@sullcrom.com |
| Eric M. Krautheimer | +1-310-712-6678 | krautheimere@sullcrom.com |
| Alison S. Ressler | +1-310-712-6630 | resslera@sullcrom.com |

| | | |
|---|---|---|
| **Palo Alto** | | |
| Scott D. Miller | +1-650-461-5620 | millersc@sullcrom.com |
| Sarah P. Payne | +1-650-461-5669 | paynesa@sullcrom.com |
| John L. Savva | +1-650-461-5610 | savvaj@sullcrom.com |
| **London** | | |
| Nikolaos G. Andronikos | +44-20-7959-8470 | andronikosn@sullcrom.com |
| Kathryn A. Campbell | +44-20-7959-8580 | campbellk@sullcrom.com |
| John O'Connor | +44-20-7959-8515 | oconnorj@sullcrom.com |
| David Rockwell | +44-20-7959-8575 | rockwelld@sullcrom.com |
| **Paris** | | |
| William D. Torchiana | +33-1-7304-5890 | torchianaw@sullcrom.com |
| **Frankfurt** | | |
| Krystian Czerniecki | +49-69-4272-5525 | czernieckik@sullcrom.com |
| **Melbourne** | | |
| Robert Chu | +61-3-9635-1506 | chur@sullcrom.com |
| **Sydney** | | |
| Waldo D. Jones Jr. | +61-2-8227-6702 | jonesw@sullcrom.com |
| **Tokyo** | | |
| Izumi Akai | +81-3-3213-6145 | akaii@sullcrom.com |
| Keiji Hatano | +81-3-3213-6171 | hatanok@sullcrom.com |
| **Hong Kong** | | |
| Garth W. Bray | +862-2826-8691 | brayg@sullcrom.com |
| Michael G. DeSombre | +852-2826-8696 | desombrem@sullcrom.com |
| Chun Wei | +852-2826-8666 | weic@sullcrom.com |