SEC staff issues guidance on Rule 14a-8 calling for board involvement in evaluating shareholder proposals

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Abstract

Purpose – *This paper examines a legal bulletin issued by the staff of the Securities and Exchange Commission (SEC) in November 2017 that provides significant new guidance to SEC-reporting companies on the application of the "ordinary business" and "economic relevance" exceptions in Rule 14a-8 under the Securities Exchange Act of 1934. Rule 14a-8 governs an SEC-reporting company's obligation to include shareholder proposals in its proxy materials for a shareholder meeting.*

Design/methodology/approach – *This paper provides in-depth analysis of the new interpretive guidance against the background of continuing controversy between companies and shareholder-proponents over the bases on which companies should be permitted to exclude from their proxy materials proposals that proponents believe raise social, ethical or other policy issues that are appropriate for shareholder action.*

Findings – *In acting on a company's request to exclude a proposal, the SEC staff must make difficult judgments regarding the connection between policy issues reflected in the proposal and the company's business operations, which the company's directors and officers seek to conduct free of inappropriate shareholder oversight. In the new guidance, the staff calls for assistance in making these judgments by soliciting greater board-level involvement in the exclusion determination and encouraging the company in its no-action submission to discuss the board's analysis and decision-making process. Greater board participation should encourage a more probing assessment of the considerations weighed in these determinations.*

Originality/value – *This paper provides expert guidance on a major new SEC disclosure requirement from experienced securities lawyers.*

Keywords *United States of America, US Securities and Exchange Commission (SEC), Securities regulation, Shareholder proposals, SEC proxy rules*

Paper type *Technical paper*

On November 1, 2017, the staff of the Division of Corporation Finance of the Securities and Exchange Commission (SEC or Commission) issued Staff Legal Bulletin No. 14I (CF) (SLB 14I)[1] to provide public companies with significant new guidance on the application of the "ordinary business" exception and the "economic relevance" exception in Rule 14a-8[2] under the Securities Exchange Act of 1934 (Exchange Act). Rule 14a-8 governs a company's obligation to include shareholder proposals in its proxy materials for a shareholder meeting. The new guidance will influence future staff action on requests by companies under Rule 14a-8 to exclude shareholder proposals from their proxy materials on the basis of the two exceptions.

In SLB 14I, the staff announced positions that:

> call on the company's board of directors, in appropriate cases, to determine in the first instance whether a shareholder proposal raises a "significant policy issue" for the

company that could preclude the company from excluding the proposal from its proxy materials in reliance on the "ordinary business" exception under Rule 14a-8(i)(7); and

signal the staff's intention in applying the "economic relevance" exception under Rule 14a-8(i)(5) to focus on whether a proposal that raises social or ethical issues is "significantly related" to the company's business, and, therefore, excludable from the company's proxy materials, and to consider the board's determination on this issue and the process the board followed in its evaluation.

The staff's new position on Rule 14a-8(i)(5) potentially extends the economic relevance exception to proposals reflecting important social or ethical issues that in the past would have been included in a company's proxy materials even though they were not significantly related to the company's business.

The new guidance also addresses eligibility requirements under Rule 14a-8 to be observed by shareholders who submit proposals "by proxy" through a representative, and clarifies the staff's view on the inclusion of graphics or images in proposals under the rule's procedural requirements.

Shareholder proposals under Rule 14a-8

Rule 14a-8 sets forth the requirements applicable to proposals submitted by shareholders for inclusion in their company's proxy materials for annual or special meetings[3]. Since its adoption in 1942, Rule 14a-8 has been a source of continuing controversy[4]. Many companies believe that the rule provides shareholders with excessively liberal access to their proxy materials, while numerous shareholders feel that the rule places too many restrictions on that access. The SEC has sought to steer a middle course in administering the rule.

Rule 14a-8(i) contains 13 separate grounds for a company to exclude a shareholder proposal from its proxy materials. In each instance, the ground for exclusion is based on the substance of the proposal, rather than on failure to comply with the rule's eligibility or procedural requirements.

The Division of Corporation Finance traditionally has acted as the arbiter of disputes between a company and a shareholder–proponent, as to whether the proponent's proposal may be excluded from the company's proxy materials on the basis of one or more of the 13 exceptions. The Division performs this function primarily through the issuance of no-action letters by its staff, advising both the company and the proponent whether the staff believes the company has provided a reasonable basis for omitting the proposal. The Division's staff considers the information furnished to it by the company in support of its intention to exclude the proposal from the company's proxy materials, as well as any information furnished by the proponent or the proponent's representative. In appropriate cases, the staff also will review statements to be made by the company in opposition to a proposal includable in its proxy materials to determine whether the statement violates statutes or other SEC rules.

If either of the parties is dissatisfied with the staff's position, the party may ask the full Commission to review the position, although such requests are rare and the granting of such a request is entirely within the discretion of the SEC Commissioners.

New guidance on substantive exceptions

Rule 14a-8(i)(7): "Ordinary business" exception may involve board analysis of policy issues

Ordinary business exception. Perhaps the most controversial provision of Rule 14a-8 is paragraph (i)(7), which permits a company to exclude from its proxy materials a

shareholder proposal that "deals with a matter relating to the company's ordinary business operations[5]". Rule 14a-8(i)(7) is based on the general principle of state corporation law that a corporation's directors and officers, rather than its shareholders, are responsible for conducting the corporation's day-to-day operations, and shareholders, therefore, should vote only on major corporate issues[6].

The "ordinary business" exception rests on two underlying considerations. First, as the SEC has observed, certain matters are "so fundamental to management's ability to run a company on a day-to-day basis that they would not, as a practical matter, be subject to direct shareholder oversight." Second, certain proposals that seek to "micromanage" the company's operations inappropriately probe into complex matters on which shareholders generally are unable to make an informed judgment[6].

Notwithstanding these considerations, the SEC staff typically has not deemed a proposal's application to a company's ordinary operations sufficient to warrant exclusion under Rule 14a-8(i)(7) where the proposal implicates a "significant policy issue." The staff considers some policy issues to be sufficiently important that they transcend the company's ordinary business or its day-to-day operations and render the proposal appropriate for a shareholder vote. The staff acknowledges in SLB 14I, however, that determining whether a proposal is subject to Rule 14a-8(i)(7) raises a significant policy issue often requires the staff to make difficult judgments regarding the connection between the policy issue and the company's business operations.

New guidance. SLB 14I is intended to assist the staff in making these judgments in certain cases by calling on the board of directors, "in the first instance," to determine whether a proposal raises a policy issue that is significant for the company. The staff has said that, if the board determines that a proposal does *not* raise a significant policy issue for the company, the company's no-action request should include a discussion of the board's analysis of the policy issue and its purported lack of significance to facilitate the staff's review of the request to exclude the proposal. The discussion should include a description of the "specific processes" the board followed "to ensure that its conclusions [were] well-informed and well-reasoned." The new guidance reflects the staff's belief that a company's board, charged with fiduciary duties in overseeing management and the company's strategic direction, is best able to determine whether or not a policy issue is significant enough for the company that it transcends ordinary business.

After it released the new guidance, the SEC staff informally clarified that not all no-action requests under Rule 14a-8(i)(7) will require a discussion of the board's analysis of a policy issue, particularly where there is a well-worn path to the company's exclusion determination in no-action precedent. However, where a company's proposal raises a policy issue that the staff in the past has found to be significant for *other companies*, the staff will now look for an explanation of the board's determination on behalf of the company seeking no-action relief that the policy issue is not significant for *that company*.

SLB 14I does not identify factors that might support a conclusion that a policy which is significant for some companies is not significant for others. The SEC staff indicated in an earlier legal bulletin that a company and its board should examine whether there is a connection between the shareholder proposal and the company's business sufficient to warrant inclusion of the proposal in the company's proxy materials[7]. If the policy is not important to the company or its shareholders, the staff has said, the policy may not be significant to the company. After the publication of SLB 14I, the staff indicated in a no-action letter issued to Apple Inc. (Dec 21, 2017)[8] that, if the company has acknowledged that the policy issue is "an integral component" of its business operations, the proposal may not be excluded under SLB 14I regardless of the extent to

which the company considers and addresses the issue as part of its day-to-day operations.

The staff has not provided any guidelines regarding the nature or extent of the analysis the board should undertake in its exclusion determination. In conducting its analysis, a board might make inquiries of management and the board's advisors regarding the policy issue raised by the proposal, its relevance to the company and the steps the company has taken to address the issue; evaluate the financial impact of the policy issue on the company; and review the results of any engagement by the board and management with shareholders and other constituents regarding the issue.

The staff also has not prescribed the documentation, if any, the staff would expect to see to support or evidence the board's analysis. It should not be necessary, however, to provide the staff with copies of minutes of board meetings or board materials, although a company may find it useful to provide certain written presentations that were considered by its board if the company carefully reviews the information to ensure that any confidential information has been redacted.

The staff has indicated that an appropriate committee of the board, such as the nominating and corporate governance committee, may undertake the analysis on behalf of the board, but that the analysis could carry more weight if the committee presented the analysis to the full board for approval.

Overall, the staff's guidance on the ordinary business exception is a clear request for assistance from issuers, as well as for board participation, in determining whether a policy issue is significant enough for the company that it transcends ordinary business. The introduction of board-level involvement in the analytical process will require attention as companies prepare their annual meeting calendars. In addition, companies and their boards should present their arguments carefully to avoid the appearance of declaring a significant policy to be unimportant rather than merely a matter of the company's ordinary business, particularly where the company has made public statements or published information on its website that highlight the issue's importance to it.

Rule 14a-8(i)(5): "Economic relevance" exception to require more focus on whether a proposal is significantly related to the company's business

Economic relevance exception. The "economic relevance" exception under Rule 14a-8(i)(5) permits a company to exclude from its proxy materials a proposal that:

> relates to operations accounting for less than 5 per cent of the company's total assets at the end of its most recent fiscal year, and for less than five per cent of its net earnings and gross sales for its most recent fiscal year; and
>
> is "not otherwise significantly related to the company's business." Because of the "significance" determination, the considerations that must be weighed in an exclusion analysis under Rule 14a-8(i)(5) are similar to those involved in evaluating a proposal under the ordinary business exception.

In recent years, notwithstanding the second part of this test, the SEC staff rarely has permitted exclusion of proposals on the basis that they are not significantly related to the company's business. Instead, the staff generally has required inclusion of a proposal that reflected broad ethical or social issues, rather than economic concerns, so long as *any* amount of the company's business was implicated by the issues, even where the affected operations fell below the five per cent thresholds specified in the rule. The staff's approach, as it recognized in SLB 14I, "simply considered whether a company conducted any amount of business related to the issue in the proposal and whether that issue was of broad social or ethical concern." The staff acknowledged in SLB 14I that this application of Rule 14a-8(i)(5) has

"unduly limited the exclusion's availability" by failing to consider fully whether, as Rule 14a-8(i)(5) directs, the proposal "deals with a matter that is not significantly related to the issuer's business" and is therefore excludable.

New guidance. The staff will now analyze the economic relevance exception in a manner it believes is more consistent with the language and purpose of Rule 14a-8(i)(5). If a proposal relates to operations that account for less than 5 per cent of the company's total assets, net earnings and gross sales, the staff will assess whether the proposal is "significantly related" to the company's business, regardless of whether the proposal raises important social or ethical concerns. If the proposal is not significantly related to the company's business, the company may exclude it. This guidance potentially extends the economic relevance exception to proposals that reflect important social or ethical issues and, therefore, would not have been excludable in the past despite their marginal financial relevance to the company.

The staff observes in SLB 14I that the analysis of any policy issue's significance to a company's business will depend on the circumstances of the individual company, rather than on the importance of the issue "in the abstract." Therefore, an issue might be significant to the business of one company but not to the business of another. The staff cautions, however, that it would generally view substantive governance matters to be significantly related to the business of almost all companies.

Where the significance of a proposal to the business is not apparent "on its face," the proponent will bear the burden of demonstrating that the proposal is otherwise significantly related to the company's business. For example, the proponent could provide information demonstrating that the proposal "may have a significant impact on other segments of the issuer's business or subject the issuer to significant contingent liabilities[9]". Under the new guidance, the proponent may continue to raise social or ethical issues in its arguments, but would need to tie those to a significant effect on the company's business. The staff notes in SLB 14I that the "mere possibility of reputational or economic harm" will not mean that the proposal must be included in the company's proxy materials, and that the staff will consider the proposal in light of the "total mix" of information available about the company.

The staff emphasizes that, as with an evaluation of the significance of a policy issue in the context of the ordinary business exception, determining whether a proposal is "otherwise significantly related to a company's business" under Rule 14a-8(i)(5) can involve difficult judgments. Accordingly, consistent with its guidance on the ordinary business exception, the staff indicates that a company's board is in a better position than the staff to make the significance determination in the first instance. Thus, the staff believes it will be helpful if a company's no-action request under Rule 14a-8(i)(5) discloses the board's analysis of the proposal's significance to the company's business and describes the process the board used to reach its conclusion. The explanation would be most helpful to the staff if it details the specific processes used by the board in its analysis.

The staff concludes its guidance on the economic relevance exception by observing that it will no longer look to its analysis of whether a proposal is "otherwise significantly related" for purposes of Rule 14a-8(i)(7), when evaluating arguments for the availability or unavailability of Rule 14a-8(i)(5). Instead, it will independently apply the analytical framework for each exception to "ensure that each basis for exclusion serves its intended purpose."

New guidance on proponent eligibility and compliance with procedural requirements

Rule 14a-8(b): "Proposals by proxy" will require additional documentation to demonstrate eligibility

There are two basic requirements under Rule 14a-8(b) that a proponent must satisfy to be eligible to submit a proposal under Rule 14a-8. First, at the time a proposal is submitted, the

proponent must have continuously held at least $2,000 in market value, or 1 per cent, of the company's outstanding voting securities for at least one year, and must continue to hold the securities through the date of the meeting. Second, the proponent must provide proof of compliance with the ownership standard. In all instances, the proponent must state in writing an intention to continue to hold the securities through the date of the meeting. Where the proponent is not the registered holder of the securities (such as where the securities are held in street name), the proponent must provide written verification of ownership from the broker, bank or other record holder, except where this is evident from a copy provided to the issuer of a filing (and any amendments) by the person under Section 13(d) or 16(a) of the Exchange Act.

Proposal by proxy. Although Rule 14a-8 does not address this procedure, shareholders frequently submit proposals through a representative in a practice known as "proposal by proxy." The staff considers the practice to be consistent with the proponent eligibility requirements of Rule 14a-8(b) and largely a function of state agency law. In recent years, however, some companies have expressed concern that representatives may be abusing the process by obtaining from eligible shareholders written appointments that do not make clear whether the shareholder is aware of the proposal being submitted or of the company receiving the submission.

New guidance. To address these concerns, the staff has outlined in SLB 14I several types of information that would more clearly allow companies to assess whether a shareholder's delegation of authority to a representative satisfies the eligibility requirements of Rule 14a-8(b). Generally, the staff would expect appropriate documentation to:

identify the shareholder–proponent and the representative selected as a proxy;

identify the company to which the proposal is directed;

identify the annual and special meeting for which the proposal is submitted;

identify the specific proposal to be submitted; and

be signed and dated by the shareholder.

The information identified by the staff will provide companies greater certainty in assessing whether an eligible shareholder actually authorized the submission of a proposal by a representative. If the information is not provided, there may be a basis to exclude the proposal under Rule 14a-8(b).

Rule 14a-8(d): SEC staff will continue to evaluate use of graphs or images in proposals using existing provisions of Rule 14a-8

Under its procedural provisions, Rule 14a-8(d) permits exclusion of a proposal that, when combined with any accompanying supporting statement, exceeds 500 words. The rule does not address whether words contained in graphs or images included in a proposal are considered in evaluating compliance with the 500-word limit. Further, because Rule 14a-8 does not provide for the use of graphs or images in proposals, some companies have objected to their inclusion. In recent years, the SEC staff has disagreed with company arguments that the inclusion of graphs or images is not contemplated by Rule 14a-8 and has permitted proponents to continue to include them in proposals.

New guidance. In SLB 14I, the staff confirms that the inclusion of graphs or images in a proposal will not, by itself, serve as a basis for excluding the proposal. The staff clarifies that any words that are contained in a graph or image that is part of a proposal will count toward the 500-word limit.

In its guidance, the staff recognizes the potential for abuse in proponents' use of graphs or images, but states that those concerns may be addressed by other provisions of Rule 14a-8.

The staff notes, for example, that exclusion of a proposal may be appropriate if the proposal contains graphs or images that:

> make the proposal materially false and 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.

Some companies might have favored an outright prohibition on inclusion of graphs or images in proposals. The staff's guidance in SLB 14I, however, is consistent with its position expressed in recent no-action letters[10].

Conclusion

SLB 14I is the most recent in a line of staff legal bulletins issued since 2001, in which the Division of Corporation Finance has provided guidance on the requirements of Rule 14a-8. A staff legal bulletin is not a rule, regulation or statement of the Commission, which neither approves nor disapproves a bulletin's content. Like its predecessors, however, SLB 14I represents the staff's evolving view of the requirements of Rule 14a-8 and deserves careful consideration by both shareholder–proponents and their companies. This latest guidance provides welcome clarification on the application of two important substantive exceptions under Rule 14a-8 and promises to revitalize the economic relevance exception by redirecting attention to a proposal's financial significance to the company's business.

Notes

1. Staff Legal Bulletin No. 14I (Nov 1, 2017), available at: www.sec.gov/interps/legal/cfslb14i.htm
2. 17 C.F.R. § 240.14a-8 (2018).
3. The term "proposal" is defined in Rule 14a-8(a) as a "recommendation or requirement that the company and/or its board of directors take action." The term is deemed under Rule 14a-8(a) to include both the actual proposal and any accompanying statement in support of it.
4. A former Director of the SEC's Division of Corporation Finance has stated that "[p]erhaps no SEC rule has provoked more debate and comment throughout its history than Rule 14a-8." See Quinn and Menaker, "Shareholder Proposal Reform Redux," *Insights* (Dec 1997) 19.
5. The ordinary business exception was intended to prevent shareholders from "assert[ing] the power to dictate the minutiae of daily business decisions." *Grimes* v. *Centerior Energy Corp.*, 909 F.2d 529, 532 (D.C. Cir. 1990), *cert. denied.* 111 S. Ct. 799 (1991). See also *Medical Committee for Human Rights* v. *SEC*, 432 F.2d 659, 677-80 (D.C. Cir. 1970), vacated as moot, 404 US 403, 92 S. Ct. 577 (1972); *New York City Employees' Retirement System* v. *Brunswick Corp.*, 789 F. Supp. at 147 (S.D.N.Y. 1992).
6. Release No. 34-40018 (May 21, 1998), 63 Fed. Reg. 29107 (1998).
7. Staff Legal Bulletin No. 14H (Oct 22, 2015), available at: www.sec.gov/interps/legal/cfslb14h.htm citing Staff Legal Bulletin No. 14E (Oct 27, 2009), available at: www.sec.gov/interps/legal/cfslb14e.htm (stating that a proposal generally will not be excludable under the ordinary business exception "as long as a sufficient nexus exists between the nature of the proposal and the company").

8. Available at: www.sec.gov/divisions/corpfin/cf-noaction/14a-8.shtml
9. Release No. 34-19135 (Oct 14, 1982), 47 Fed. Reg. 27420 (1982).
10. *General Electric Co.* (Feb 3, 2017, *recon. granted* Feb 23, 2017); *General Electric Co.* (Feb 23, 2016).

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