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SEC Update

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SEC staff issues important guidance on shareholder proposals for the 2020 proxy season

On October 16 the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14K (CF) (SLB 14K) to provide updated guidance on the application of the "ordinary business" exception to a company's obligation under Exchange Act Rule 14a-8 to include shareholder proposals in its annual proxy materials. The guidance will govern SEC staff action during the 2020 proxy season on company requests for no-action letters allowing exclusion of shareholder proposals based on the exception.

SLB 14K supplements earlier staff legal bulletins in which the Division solicited greater board-level involvement in a company's exclusion determination under the ordinary business exception and encouraged companies to discuss the board's analysis in their no-action requests. The new guidance clarifies and expands the prior guidance by suggesting ways companies might more effectively address certain substantive factors considered by the board, and also explains how the staff evaluates claims that a proposal should be excluded because it seeks to "micromanage" the company.

In other guidance presented in SLB 14K, the Division cautions companies not to apply an "overly technical reading" of the proof of ownership letter submitted by a proponent under Rule 14a-8(b)(2) in determining whether the letter adequately establishes the proponent's eligibility to submit a proposal.

SLB 14K can be found here.

Ordinary business exception

Background. In setting the context for its updated guidance, the Division summarizes the analytical framework of the ordinary business exception and explains how a well-developed discussion of the board's analysis supporting an exclusion determination can assist the staff's evaluation of the company's no-action request. Much of this discussion covers the same ground as the guidance presented in Staff Legal Bulletin No. 14I (CF) (SLB 14I) and Staff Legal Bulletin No. 14J (CF) (SLB 14J), which we discussed in *SEC Updates* we published on November 16, 2017 and November 7, 2018.

Rule 14a-8(i)(7) 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." This exception 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 not have a vote on matters relating to the company's ordinary business.

Notwithstanding these considerations, the staff typically has not deemed a proposal that otherwise relates to a company's ordinary business operations to be excludable where the proposal implicates a "significant policy issue." The staff considers some policy issues to be sufficiently important that they transcend the company's day-to-day operations and render the proposal appropriate for a shareholder vote.

The Division acknowledged in SLB 14I that determining whether a proposal 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. The staff has called for companies to assist it in making these judgments in appropriate cases by involving the board of directors to determine whether a proposal raises a policy issue that is significant for the company. The staff said in SLB 14I that if the board determines that a proposal does not raise a significant policy issue, the company's no-action request to exclude the proposal should include a discussion of the board's analysis of the policy issue and its lack of significance to the company.

New guidance. Based on its review of no-action requests submitted in the most recent proxy season, the Division encourages companies to enhance their discussion of the board's analysis under the ordinary business exception by including in their submission:

- a "delta analysis" that describes the differences (or the "delta") between the proposal's specific request and any actions already taken by the company to address the policy issue raised by the proposal, and that explains why, as a result of those actions, the policy issue is not significant for the company; and
- if the company's shareholders previously have voted on the subject matter of the pending proposal, a "robust discussion" of how any subsequent shareholder engagement or other event has shaped the board's view of the significance to the company of the policy issue implicated by the proposal.

Delta analysis. In SLB 14K the staff explains that it considers a delta analysis conducted by a board to help it evaluate whether a proposal raises a significant policy issue for the company.

The staff indicates that a properly presented delta analysis will:

- "clearly" identify the differences between the specific action a proposal requests the company to undertake and any actions the company already has taken to address the policy issue raised by the proposal; and
- explain "in detail" why, as a result of those actions, the policy is not significant for the company.

The matter the staff will consider – and the matter it believes the company should address in its discussion of the board's analysis – is whether the company's prior actions have "diminished the significance of the policy issue to such an extent that the proposal does not present a policy issue that is significant to the company."

The Division presents as an example a proposal that seeks greater disclosure of a company's customer information privacy policy. If the company's existing cybersecurity policy addresses customer information privacy, the presentation of the board's analysis, in the staff's view, could explain how the existing policy addresses the issues raised by the proposal and how the difference between the two approaches would not implicate a significant policy issue for the company. The staff will consider "less helpful" any "conclusory" statements about the difference that fail to explain why the board believes the policy issue is no longer significant.

Prior voting results. As it did in its prior guidance, the Division addresses in SLB 14K the manner in which a no-action request should address the board's consideration of a prior shareholder vote on the proposal's subject matter in assessing the significance to the company of the policy issue raised by the pending proposal.

In SLB 14J the staff listed "specific substantive factors" that a board might consider in assessing a proposal's significance and suggested that the company's no-action request should provide a "well-developed discussion" of the board's analysis to assist the staff in its evaluation of the request. The staff included in its non-exhaustive list of such factors whether the company's shareholders previously have voted on the matter and the board's views concerning the related voting results. The staff suggested that a particular level of prior shareholder support for a proposal could elevate the significance of the policy issue raised by the new proposal.

The staff said in SLB 14J that the weight it will give to prior voting results "will depend on the specific facts and circumstances." The facts and circumstances considered by the staff might include the amount of shareholder support received by in the earlier vote, the length of time that has passed since the most recent shareholder vote, and whether any subsequent company actions or intervening events might have mitigated the policy issue's significance to the company (if the matter received significant shareholder support) or increased the policy issue's significance to the company (if the matter did not receive significant shareholder support).

The Division indicates in its new bulletin that some of the no-action requests in the last proxy season did not adequately address those facts and circumstances. The staff said it found unpersuasive arguments that:

- the voting results were not significant given that a majority of shareholders voted against the prior proposal;
- the significance of the prior voting results was mitigated by the impact of recommendations from proxy advisory firms; and
- the voting results were not significant based on the number of "for" votes as a percentage of the shares outstanding, instead of votes cast.

The staff emphasizes that it looks for a "robust discussion" of how the "company's subsequent actions, intervening events or other objective indicia of shareholder engagement" on the policy issue raised by the new proposal "bear on the significance of the underlying issue to the company." The summary of the board's analysis should discuss how the board's views on the significance issue have been influenced by any shareholder engagement and any other actions the company has taken to address the concerns expressed in the new proposal.

Micromanagement. Even if the subject matter of a proposal is appropriate for shareholder consideration, the proposal may be excludable as relating to the company's ordinary business operations if it seeks to "micromanage" the company. The Division in SLB 14K augments its prior guidance to explain how the staff evaluates exclusion requests based on micromanagement concerns.

In SLB 14J the staff clarified that it uses as its framework the Commission's statement that a proposal entails micromanagement if it "involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies." In applying this framework, the staff focuses on the manner in which the proposal seeks to address an issue, and looks both at the nature of the proposal and the circumstances of the particular company.

The staff amplifies this guidance by explaining in SLB 14K that it evaluates micromanagement claims in light of the "level of prescriptiveness" with which a proposal approaches its subject matter. An overly prescriptive proposal could unduly limit the flexibility of management and the board to manage complex matters. The staff may concur with an exclusion determination if the proposal "seeks intricate detail or imposes a specific strategy, method, action, outcome or timeline for addressing an issue." On the other hand, the staff generally will not view as micromanagement a proposal "framed as a request that the company consider, discuss the feasibility of, or evaluate the potential for a particular issue."

The staff illustrates this distinction by contrasting the fates of two no-action requests submitted in the last proxy season.

- The staff concurred with a company's decision to exclude a proposal seeking annual reporting on "short-, medium- and long-term greenhouse gas targets aligned with" specified greenhouse gas reduction goals established by an international agreement, because the staff concluded that the proposal prescribed the method for reducing greenhouse gas emissions by effectively requiring the adoption of time-based targets.
- In contrast, the staff did not agree that a company could exclude a proposal seeking a report "describing if, and how, [the company] plans to reduce its total contribution to climate change and align its operations and investments" with the goal of the same international agreement, because the proposal deferred to management's discretion in deciding whether and how to address the subject matter of the proposal.

The staff says it observes these additional guidelines in acting on micromanagement claims:

- the staff follows the same analysis for precatory proposals as for mandatory proposals;
- the staff does not base its determination on whether it considers the proposal as presenting issues that are too complex for shareholders to understand; and
- the staff considers a proposal's supporting statement as well as its "resolved clause" in determining the proposal's underlying concern or central purpose.

Proof of ownership letters

The staff also uses SLB 14K to address recent company practice in contesting the sufficiency of shareholders' proof of stock ownership for purposes of Rule 14a-8(b). The rule provides that a proponent must prove eligibility to submit a proposal by offering proof that the proponent "continuously held" the required amount of the company's securities "for at least one year by the date" the proposal is submitted. The staff provided detailed guidance on satisfying this eligibility requirement in Staff Legal Bulletin No. 14F (CF) (SLB 14F), which we discussed in the *SEC Update* we published on November 8, 2011.

The staff directs companies not to apply "an overly technical reading" of letters submitted by proponents to establish their eligibility under Rule 14a-8(b). In the staff's view, a company should not seek to exclude a proposal simply because the proponent's proof of ownership letter deviates from the suggested form published by the staff in SLB 14F. In that guidance, the Division suggested the following formulation: "As of

[date the proposal is submitted], [name of shareholder] held, and has held continuously for at least one year, [number of securities] shares of [company name] [class of securities]." The Division says that companies, like the staff, should take "a plain meaning approach" to interpreting the text of the proof of ownership letter. The staff indicates that it will consider eligibility to be established if the language used in the letter "is clear and sufficiently evidences the requisite minimum ownership requirements," and will not concur in an exclusion determination that substitutes mere "drafting variances" as the test for non-compliance.

Impact of SLB 14K

Although it does not announce any fundamental changes to the staff's consideration of exclusion determinations under the ordinary business exception, SLB 14K presents helpful guidance for companies to consider in determining how best to present their bases for seeking to exclude proposals under the exception. The new guidance is particularly welcome in providing additional insight into what the staff thinks works or does not work in a discussion of the board's analysis and in arguments for exclusion based on micromanagement.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the following page of this update.

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