

INSIDE THE SEC

SEC Staff Guidance on Shareholder Proposals

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On October 23, the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14J (SLB 14J) to provide new guidance on the application of the "ordinary business" and "economic relevance" exceptions to a public company's obligation under Exchange Act Rule 14a-8 to include shareholder proposals in its proxy materials. The guidance will govern SEC staff action during the 2019 proxy season on company no-action requests seeking exclusion of shareholder proposals on the basis of these exceptions.

The Division's new statement in part supplements guidance it issued in November 2017 in Staff Legal Bulletin No. 14I (SLB 14I), in which it solicited greater board-level involvement in a company's exclusion determination under the ordinary business and economic relevance exceptions and encouraged companies in appropriate circumstances to discuss the board's analysis in their no-action requests. The Division also provides insight in the new bulletin into how it approaches particular issues raised in exclusion determinations under the ordinary business exception.

Ordinary Business and Economic Relevance Exceptions

In SLB 14J, the Division revisits significant features of the ordinary business and economic relevance exceptions on which it issued significant guidance last year in SLB 14I.

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Ordinary Business Exception

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 corporate 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.

The "ordinary business" exception rests on two underlying considerations. First, as the Commission 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. 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 acknowledged in SLB 14I, however, that determining whether a proposal 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.

SLB 14I called for companies to assist the staff in making these judgments in appropriate cases by

involving 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 said in this bulletin that, if the board determines that a proposal does *not* raise a significant policy issue for the company, the company should consider including in its no-action request 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. 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 guidance in SLB 14I 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.

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 (1) relates to operations accounting 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* (2) 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 whether a proposal raises a "significant policy issue" that would preclude exclusion of a proposal under the ordinary business exception.

In recent years, notwithstanding the second part of the economic relevance test, and until it issued SLB 14I, the SEC staff rarely permitted exclusion of proposals on the basis that they are not significantly related to the company's business. Instead, the staff generally 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 percent 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) "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 therefore is excludable.

The staff announced in SLB 14I that it would 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 five percent 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 address 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 observed 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 cautioned, however, that it generally will view substantive governance matters to be significantly related to the business of almost all companies. The Division has reiterated this position in SLB 14J.

The staff emphasized 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 indicated 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 often 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. The staff said in SLB 14I that a description of the board’s analysis would be most helpful to the staff if it details the specific processes employed by the board in its analysis.

The staff concluded its guidance in SLB 14I on the economic relevance exception by observing that it no longer will look to its analysis of whether a proposal raises a policy issue that is sufficiently significant in relation to the company, for purposes of the ordinary business exception, when evaluating arguments for the availability of the economic relevance exception based on whether the policy issue is otherwise significantly related to the company’s business. Instead, the staff will independently apply the analytical framework for each exception to “ensure that each basis for exclusion serves its intended purpose.”

Inclusion of Board’s Analysis in No-action Request

The 2018 proxy season afforded the staff its first opportunity to evaluate the usefulness of inclusion of the board’s analysis in no-action requests under the ordinary business and economic relevance exceptions. The staff reports in SLB 14J that its experience confirmed that a “well-developed discussion of the board’s analysis” can assist the staff’s evaluation, even if, as in the case of some no-action requests submitted during the last proxy season, the staff is unable to concur with the company’s exclusion determination.

The staff offers the following observations from its experience during the 2018 proxy season:

- The discussion of a board’s analysis should address whether a particular policy issue raised by a proposal is (1) sufficiently significant in relation to the company, in a no-action request based on the ordinary business exception, or (2) otherwise significantly related to the company’s business, in a no-action request based on the economic relevance exception.
- The inclusion of a board’s analysis will be particularly helpful to the staff “where the significance of a particular issue to a particular company and its shareholders may depend on factors that are not self-evident and that the board may be well-positioned to consider and evaluate.”
- During the 2018 proxy season, the staff found most helpful discussions that focused on (1) the board’s analysis and (2) the specific substantive factors the board considered in its exclusion determination. The staff found less helpful discussions that described the board’s conclusions or process without addressing the specific substantive factors the board considered.

The Division indicates that “submission of a board analysis is voluntary and the inclusion or absence of an analysis will not be dispositive in the staff’s evaluation of a company’s request” for no-action relief. The absence of a board analysis therefore will not create a presumption against exclusion of a proposal. The staff qualifies this assurance with the observation that it might be unable to concur with an exclusion determination if the company does not share with it the board’s views on policy issues that are not “self-evident.” This admonition appears consistent with informal staff statements since the issuance of SLB 14I suggesting that inclusion of a board’s analysis might be of less value to the staff if there is a well-worn path to the company’s exclusion determination in no-action precedent. Companies, however, should consider this suggestion in light of the staff’s reminder in SLB 14J that exclusion determinations are made “on a case-by-case basis” and, accordingly, that

“a proposal that the staff agrees is excludable for one company may not be excludable for another” and “conversely, a proposal that is not excludable by one company would not be dispositive as to whether it is excludable by another.” In instances where prior no-action submissions under the ordinary business or economic relevance exception do not clearly support excluding a proposal on the basis that it fails to present a significant policy issue, companies may wish to consider engaging their boards to perform a substantive analysis of the issue to support a no-action request on the exclusion determination.

Substantive Factors for Board’s Analysis

The staff did not provide any guidelines in SLB 14I regarding the nature of the analysis the board should undertake in its exclusion determination. In SLB 14J, the Division offers guidance as to the types of “specific substantive factors” a board might consider and what a “well-developed discussion” of the board’s analysis should describe to assist the staff in its evaluation of an exclusion determination. The staff’s non-exhaustive list of such factors encompasses the following:

- the extent to which the proposal relates to the company’s core business activities;
- quantitative data, including financial statement impact, related to the matter that illustrate whether or not a matter is significant to the company;
- whether the company has already addressed in some manner the issue raised by the proposal, including the differences—or the “delta”—between the proposal’s specific request and the actions the company already has taken with respect to the matter, and an of whether the delta presents a significant policy issue for the company;
- the extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement;

- whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- whether the company’s shareholders have voted previously on the matter and the board’s views as to the related voting results.

The Division indicates that a board is not required to address each of the foregoing factors, nor need it limit its analysis to these factors. The lesson of the guidance is that a board’s analysis should be informed by a consideration of specific substantive factors and that these factors should be discussed in sufficient detail to permit the staff to evaluate the board’s views on the policy issues raised by the proposal.

The last substantive factor listed by the staff is whether the company’s shareholders have voted previously on the matter raised by the proposal and the board’s views as to the related voting results. The inclusion of this factor suggests that a particular level of prior shareholder support for a proposal could elevate the significance of the policy issue raised by the proposal. The staff indicates that the weight it will give to this factor “will depend on the specific facts and circumstances.” The facts and circumstances the staff says it might consider include the amount of shareholder support received by the previously voted-on matter, the length of time that has passed since the matter was last voted on by shareholders, and whether any subsequent company actions or intervening events might have mitigated the issue’s significance to the company (if the matter received significant shareholder support) or increased the issue’s significance to the company (if the matter did not receive significant shareholder support).

Application of the Ordinary Business Exception

In the balance of SLB 14J, the Division clarifies how it applies the ordinary business exception to specific types of proposals in light of the two considerations underlying the exception:

- *Subject matter of the proposal:* The subject matter of a proposal may require the proposal's exclusion if, in the Commission's formulation, the matter is one that is "so fundamental to management's ability to run a company on a day-to-day basis" that the matter "would not, as a practical matter, be subject to direct shareholder oversight."
- *Manner in which proposal addresses an issue:* Even if the subject matter of the proposal is appropriate for a shareholder vote, the proposal may be excludable if its manner of implementation seeks to "micromanage" the company.

Micromanagement of Company as Basis for Exclusion

In its new guidance, the staff clarifies the basis on which it evaluates claims that a proposal seeks to "micromanage" a company and therefore is excludable, even if the subject matter of the proposal is not an improper one for shareholder oversight. The staff 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 company to which the proposal is addressed.

Proposals That Implicate Senior Executive or Director Compensation

The Division also provides guidance on the analysis it employs to determine whether proposals that address senior executive or director compensation may be excluded under the ordinary business exception as involving matters that are inappropriate for shareholder oversight. The staff performs its evaluation against a pattern of no-action determinations in which proposals that address "general employee compensation and benefits" are considered to relate to ordinary business matters and therefore generally are excludable, while proposals

that focus on significant aspects of senior executive or director compensation generally are considered to raise significant policy issues and therefore are not excludable.

The staff clarifies its views on the excludability under Rule 14a-8(i)(7) of two types of proposals that implicate senior executive or director compensation:

- In evaluating a proposal that raises both ordinary business and senior executive or director compensation matters, the staff will consider the proposal to be excludable if its "focus" or "underlying concern" is an ordinary business matter (such as employee benefits). The fact that such a proposal "is connected to or touches upon" senior executive or director compensation will not protect it from exclusion.
- In evaluating a proposal that addresses aspects of senior executive or director compensation, the staff will consider whether those aspects of compensation also are available or applicable to the general workforce. A proposal relating to broadly available aspects of compensation may be excludable under Rule 14a-8(i)(7) because such forms of compensation are considered to relate to a company's ordinary operations and therefore generally do not raise significant compensation issues that transcend ordinary business matters. To illustrate this approach, the staff states that a proposal which focuses on the ability of senior executives or directors to receive golden parachute compensation may be excludable under the ordinary business exception if the company can demonstrate that the golden parachute compensation broadly applies to a "significant portion" of the workforce.

Finally, the Division announces a change to its historic position of denying exclusion of proposals addressing senior executive or director compensation on the basis of micromanagement arguments. The staff now will be guided by the view that there is no basis for treating executive compensation proposals differently from proposals on other topics. Accordingly, consistent with the framework it uses to assess micromanagement issues, the staff indicates

that it may concur with the exclusion of senior executive or director compensation proposals on the basis of micromanagement when the proposal “involves intricate detail” or seeks “to impose specific timeframes or methods for implementing complex policies.” As an example, the staff indicates that it might exclude on this basis a proposal detailing the eligible expenses that should be covered by a company’s relocation expense policy as well as the scope of eligible participants and amounts covered.

Conclusion

SLB 14J presents helpful new guidance to companies and proponents for assessing the excludability of proposals under the ordinary business and economic relevance exceptions and for addressing exclusion determinations in no-action letter requests. The new guidance is particularly welcome in answering questions about including a discussion of a board’s analysis that were raised but not answered last year in SLB 14I.