Client Alert | Capital Markets

SEC Issues New Guidance On Exclusions Under Rule 14a-8

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New SEC guidance limits the ability of companies to exclude shareholder proposals under the "conflicting proposal" and "ordinary business" exclusions of Rule 14a-8.

On October 22, 2015, the staff of the Division of Corporation Finance at the Securities and Exchange Commission (the "SEC") issued Staff Legal Bulletin No. 14H ("SLB 14H"), which effectively limits exclusions of shareholder proposals, including those for proxy access. The Bulletin provides guidance on the scope and application of Rule 14a-8(i)(9) and Rule 14a-8(i)(7) under the Securities Exchange Act of 1934, as amended. First, the new guidance articulates a stricter standard for Rule 14a-8(i)(9), requiring similar shareholder and management proposals to be in direct conflict before a company can exclude the shareholder proposal from the company's proxy statement. Second, the guidance explores the impact of the Third Circuit's decision in *Trinity Wall Street v. Wal-Mart Stores, Inc.* on the "ordinary business" exclusion of Rule 14a-8(i)(7). The staff differentiates the two-part test in the majority opinion from the staff's application of the significant policy exception to the "ordinary business" exclusion rule, which does not exclude shareholder proposals that transcend core business matters and raise significant policy issues. This Client Alert summarizes the views of the SEC's Division of Corporation Finance published in SLB 14H and the key considerations for public companies to which the new guidance would apply.

Directly Conflicting Proposals – Rule 14a-8(i)(9) Exclusion

Rule 14a-8(i)(9) allows a company to exclude a shareholder proposal from its proxy statement "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." Previously, the staff held the position that this exclusion applied when the subject matter of both the shareholder's and company's proposals presented "alternative and conflicting decisions for the shareholders" and created the potential for "inconsistent and ambiguous results."

While the previous view focused on shareholder confusion, the new interpretation presented in SLB 14H focuses on "whether there is a direct conflict between the management and shareholder proposals." A direct conflict exists "if a reasonable shareholder could not logically vote in favor of both proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal." SLB 14H provides examples to illustrate when the Rule 14a-8(i)(9) exclusion would and would not be available:

- Direct conflict and excludable under Rule 14a-8(i)(9):
    - A company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger.
    - A company seeks shareholder approval of a bylaw provision requiring the chief executive officer (the "CEO") to be the chairperson of the board of directors, and a shareholder proposal seeks separation of the CEO and chairperson positions.
- Not directly conflicting and therefore not excludable under Rule 14a-8(i)(9):

- A shareholder proposal to permit shareholders holding at least 3% of the company's outstanding stock for at least 3 years to nominate up to 20% of the directors, and company proposal allowing shareholders holding at least 5% of the company's stock for at least 5 years to nominate up to 10% of the directors.
- A shareholder proposal asking the compensation committee to implement a policy imposing a minimum four-year annual vesting of all equity awards and a company proposal to approve an incentive plan vesting the compensation committee with discretion to set the vesting provision for equity awards.

The stricter standard articulated in SLB 14H places a higher burden on a company wishing to exclude a shareholder proposal and will make it more difficult for companies to exclude a proposal in reliance on the Rule 14a-8(i)(9) "direct conflicts" substantive ground going forward. Companies may be faced with the effects of shareholders approving two similar proposals, as well as shareholder confusion when presented with such proposals in the same proxy statement. It is unclear how companies are expected to handle these ambiguities, but the staff does not view them as the kind of conflict the rule was designed to address.

Impact of *Trinity Wall Street* on Rule 14a-8(i)(7)

SLB 14H also addresses the Third Circuit's decision in *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015). Wal-Mart argued that the proposal was excludable under Rule 14a-8(i)(7), which allows the company to exclude a shareholder proposal relating to "the company's ordinary business operations," and obtained a no-action letter from SEC staff supporting its position. The federal district court in Delaware disagreed. Reversing the lower court's decision, the Third Circuit held on appeal that a Wal-Mart Stores, Inc. shareholder's proposal was excludable under Rule 14a-8(i)(7). The shareholder proposal in question called for increased board oversight of the sale of firearms. The Third Circuit applies a two-part analysis when evaluating whether the significant policy exception to the ordinary business exclusion rule applied, concluding that: (1) a shareholder "must do more than focus its proposal on a significant policy issue," and (2) the proposal's subject matter "must 'transcend' the company's ordinary business." This analysis requires that the policy issue be "divorced from how a company approaches the nitty-gritty of its core business," or it would not pass the two-part test and the proposal would be excludable by the company. Under this analysis, the Wal-Mart shareholder's proposal was excludable because it went to the core of Wal-Mart's business, *i.e.,* what it chose to sell in its stores.

While the staff agreed that the analysis should focus on the underlying subject matter of the proposal rather than how the issue is framed (and agreed with the outcome in the case), the staff noted that this two-part test differs from previous SEC statements concerning the "ordinary business" exclusion and the Division of Corporation Finance practice in applying Rule 14a-8(i)(7). In SLB 14H, the staff reaffirmed its view that shareholder proposals focusing on a significant policy issue are not excludable under Rule 14a-8(i)(7) "because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote . . . even if the significant policy issue relates to the 'nitty-gritty of [the company's] core business.'" The staff reiterated that it would continue to apply the SEC's prior interpretation of Rule 14a-8(i)(7) when considering no-action relief requests in the future.

Practical Considerations

SLB 14H will make it significantly more difficult for companies to rely on the conflicting proposals exclusion of Rule 14a-8(i)(9) and may potentially result in the inclusion by companies of a greater number of shareholder proposals than would have been the case prior to SLB 14H. If faced with two potentially conflicting proposals, a company may wish to consider whether to work jointly with a shareholder who submits a proposal that the company might have otherwise contested in reliance on Rule 14a-8(i)(9). Some commenters have already speculated that, in light of the number of proxy access shareholder proposals that are expected to be submitted in the 2016 proxy season, this could impact corporate governance practices going forward by accelerating the adoption of proxy access bylaws. If a company chooses to include similar board and shareholder proposals in its proxy statement, it may also have to include additional disclosure explaining the differences between the two proposals and how it expects to treat the voting results. The staff has not provided guidance on how a company should respond if shareholders vote for both proposals and it is unclear whether proxy advisory firms will automatically recommend in favor of the shareholder's rather than the management's proposal in such instances.

With respect to Rule 14a-8(i)(7), notwithstanding the decision in the *Trinity Wall Street* case, the staff indicated it will continue to apply Rule 14a-8(i)(7) as it has in the past. As such, companies should not rely on the Third Circuit's more company-friendly, two-part test, but instead should only seek to exclude shareholder proposals which relate to the company's ordinary business and which do not address a significant policy issue.

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