

SEC Releases Timely Guidance on Shareholder Proposals

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On November 1, 2017, the staff (the “Staff”) of the Division of Corporation Finance of the Securities and Exchange Commission (the “SEC”) released Staff Legal Bulletin No. 14I (the “Guidance”), providing guidance on the excludability of certain shareholder proposals under the “ordinary business” and the “economic relevance” bases provided in Rule 14a-8 of the Securities Exchange Act of 1934 (“Rule 14a-8”) and on certain other aspects of the shareholder proposal submission process, including:

- a shift in responsibility to the board to analyze significant policy issues associated with a proposal;
- increased emphasis on a proposal’s actual significance to the company’s business;
- eligibility requirements for proposals by proxy; and
- the application of Rule 14a-8(d)’s 500-word limit to images and graphics included in shareholder proposals.

This client alert summarizes the material features of the Guidance and outlines certain practical considerations for companies that may rely on the Guidance in their no-action relief requests.

“Ordinary Business” Exception – Rule 14a-8(i)(7)

Under Rule 14a-8(i)(7), a company may exclude shareholder proposals that concern matters relating to the company’s “ordinary business” operations from its proxy materials. In its analysis of whether a company can properly exclude such a proposal, the Staff considers: (i) the proposal’s subject matter; and (ii) the degree to which the proposal “micromanages” the company. Exclusion of proposals that focus on significant policy issues that transcend ordinary business is not permitted. These substantive determinations—whether proposals that address ordinary business matters nonetheless focus on sufficiently significant policy issues—often raise difficult judgment calls for the Staff.

The Guidance shifts responsibility from the Staff to the board to analyze significant policy issues under the ordinary business exception in the first instance. The Staff believes that the board, with its fiduciary duties of loyalty and care to shareholders, is in a better position to analyze, determine and explain whether a particular policy issue is sufficiently significant because the matter transcends ordinary business and would be appropriate for a shareholder vote. No-action requests made in reliance on Rule 14a-8(i)(7) will now be required to include a discussion of the board’s analysis of the particular policy issue raised and its significance to the company, and this discussion should detail the specific processes that the board used to ensure its conclusions were “well-informed and well-reasoned.” The Guidance does not provide insight into the level of board processes and analysis or how in-depth the description in the no-action relief request must be to be considered sufficient from the Staff’s perspective.

“Economic Relevance” Exception – Rule 14a-8(i)(5)

Rule 14a-8(i)(5) allows a company to exclude from its proxy materials shareholder proposals that: (1) relate to operations which represent less than 5% of the company’s total assets, net earnings, and gross sales; and (2) are not otherwise significantly related to the company’s business. Companies rarely rely on this exception, as historically the Staff has been reluctant to agree that a proposal is not “otherwise significantly related to a company’s business” even when the topic does not meet the 5% threshold when the issue was of broad social or ethical concern. However, the Guidance indicates that going forward the Staff will focus more on the proposal’s actual significance to the company’s business when it otherwise relates to operations accounting for less than 5% of the company’s total assets. Further, the Staff will analyze a proposal’s significance to the company based on the particular facts and circumstances concerning the company, even where the proposal raises significant social or ethical issues. However, the Guidance specifically indicates that the Staff will generally view substantive governance matters as significant to most companies.

Similar to its view on the ordinary business exception, the Staff will look to the company’s board to provide its analysis as to whether a particular proposal is “otherwise significantly related to the company’s business” as part of a company’s no-action request. The company’s discussion should detail the specific processes used to ensure that the board’s conclusions are “well-informed and well-reasoned.”

In addition, the Staff confirmed that it will no longer link this exception to its analysis under the ordinary business exception, whereas previously the availability of relief under Rule 14a-8(i)(7) was largely determinative of the availability of relief under Rule 14a-8(i)(5).

Proposals by Proxy

Although Rule 14a-8 does not specifically address the ability of shareholders to submit proposals through a representative (*i.e.*, proposals by proxy), this procedure is frequently relied upon, especially by shareholder activists. While the Guidance confirms that proposals by proxy are permissible under the rules, it also seeks to create an additional procedural hurdle to prevent abuse. The Guidance outlines what types of documentation must be submitted to prove eligibility. Shareholders must provide documentation, signed and dated, that identifies:

- the shareholder-proponent and the person or entity selected as proxy;
- the company to which the proposal is directed;
- the annual or special meeting for which the proposal is submitted; and
- the specific proposal to be submitted.

If shareholders fail to provide such documentation, their proposals may be excluded on procedural grounds pursuant to Rule 14a-8(b) eligibility requirements, but only after the company notifies the proponent of the specific defect within 14 days of receiving the proposal so that the proponent has an opportunity to cure pursuant to Rule 14a-8(f)(1).

Use of Images – Rule 14a-8(d)

Under Rule 14a-8(d), a shareholder proposal, including any accompanying supporting statement, may not exceed 500 words. The Guidance makes clear that this limit includes any words in the images or graphics, and also provides that an image or graphic may be excluded if it:

- makes the proposal materially false, misleading, vague, or indefinite;
- impugns character, integrity or personal reputation, or makes charges concerning improper or illegal conduct; or
- is irrelevant to consideration of the proposal.

Companies are cautioned not to diminish the appearance of a proponent’s graphic in the proxy materials, and should give its own graphics and proponent’s graphics similar prominence in the proxy statement.

Practical Considerations

The Guidance is part of a continuing effort by the Staff to clarify issues arising under Rule 14a-8 of the Exchange Act. It seeks to introduce further clarity into the process and appears to shift the burden of analysis of availability of bases for exclusion to the board's judgment.

“Ordinary Business” Exception

The Guidance seems to signal Staff deference to the board's judgment in evaluating no-action requests under the ordinary business exception, which could potentially expand the application of this exception; however, the Guidance places significant burdens on the board, including:

- **Timing Issues.** It may be difficult for companies to develop and implement a process for board review and analysis of shareholder proposals within the timing constraints of Rule 14a-8(j), which requires submission of no-action requests no later than 80 calendar days before the company files its definitive proxy statement with the SEC. Allowing for sufficient time to prepare a comprehensive response may be very challenging for companies. Further, some proposals may be so broadly inapplicable to the company as to not merit the time and resources of the board in developing a response, but it is not clear whether the Staff will still require a comprehensive analysis from the company in these situations.
- **Level of Detail.** It is not clear what level of detail the Staff expects in the reporting of the board's processes and analysis. A company may not want to provide certain details in a publicly available document, such as those related to its analysis of employment issues, environmental issues or other sensitive matters.
- **Weight of Precedent.** While previously the Staff had specifically identified certain policy issues that were considered sufficiently significant (such as safety) and certain issues that were considered matters of ordinary business (such as customer relationships), it is unclear whether the Staff will consider these prior determinations to hold precedential value in its analysis of requests for no-action relief on the basis of the ordinary business exception going forward.

“Economic Relevance” Exception

Similar to the considerations related to the ordinary business exception, it remains to be seen how this exception will evolve and how the Staff will analyze no-action requests under the Guidance.

- **Keep Economic Relevance Arguments Separate From Ordinary Business Arguments.** When making a no-action request under this exception, the board should distinguish economic relevance arguments from ordinary business arguments, as the Guidance indicates that, going forward, the Staff will apply distinct analytical frameworks when evaluating such arguments.
- **Addressing Issues of Social or Ethical Significance.** If a shareholder proposal raises an issue of social or ethical significance, the board should explain if those issues do not have a significant actual effect on the company's business, as the Staff specifically stated that “the mere possibility of reputational or economic harm [to the company's business] will not preclude no-action relief.”

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