New Guidance from the SEC Incorporates Directors within the Shareholder Proposal Process

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As registrants prepare for the upcoming proxy season, Staff Legal Bulletin No. 14I (the "Bulletin," or "SLB 14I"), recently issued by the SEC Division of Corporation Finance (the "Division"), provides helpful interpretations by the Division's staff and reveal a number of relevant changes in the way certain shareholder proposals will be evaluated. Most notably, it assigns to a registrant's board of directors a key role in analyzing whether proposals fall under the "ordinary business" and "economic relevance" exceptions.

SLB 14I leaves a number of questions for registrants to resolve, such as practically how to incorporate the process of management and board analysis of a proposal within a registrant's planning, decision-making, and timeline for its proxy season. In all, the Bulletin addresses:

- The scope and application of Rule 14a-8(i)(7).
- The scope and application of Rule 14a-8(i)(5).
- Shareholder proposals made by proxy.
- The use of graphs and images consistent with Rule 14a-8(d).

The "Ordinary Business" Exception — Rule 14a-8(i)(7)

The "ordinary business" exception permits a registrant to exclude a shareholder proposal that "deals with a matter relating to the company's ordinary business operations" — that is, a matter better suited to resolution by management rather than by shareholders.[1] The Rule 14a-8(i)(7) exclusion involves a two-factor assessment, evaluating (1) the proposal's subject matter and (2) the degree to which the proposal seeks to "micro-manage" the registrant.

Under the first factor, a proposal may be excluded when it concerns matters so fundamental to management's ability to run the registrant's business that it could not reasonably be made subject to shareholder oversight. However, the principle behind this factor may be overcome when the proposal focuses on "sufficiently significant social policy issues" that transcend day-to-day business matters. Thus, the success or failure of a no-action request to exclude a proposal under this exclusion often hinges on the nexus between the significant policy issue and the registrant's ordinary business operations.

According to SLB 14I, a no-action request for exclusion of a shareholder proposal should include a discussion reflecting the board's analysis of whether a social policy issue in question is sufficiently significant. In the Division's view, a registrant's board of directors is the governing unit within the registrant's organization that is in the best position to make this assessment. The Division also recommends that the registrant's discussion in its no-action request detail the specific processes used by the board in its assessment in order to "ensure that its conclusions are well-informed and well-reasoned."

While squarely incorporating boards into the process of assessing a social policy issue's significance is arguably a good practice of corporate governance, it does present some practical governance issues for registrants that receive shareholders proposals and their planning for their annual meetings of shareholders:

- First, schedules are already tight for many registrants' organizational procedures during the months surrounding fiscal year-ends, including audited financial statements, preparation of the annual report, setting executive compensation and determinations regarding the annual shareholders meeting, and the mailing of proxy statements. For registrants seeking exclusion of a proposal under Rule 14a-8(i)(7), the insertion of board assessment into the process will require careful advance planning to provide additional time for management's effective interaction with the board and the board's deliberations.
- Secondly, some directors on the board may not be as familiar with a specific social policy's significance as other directors. The board chairman and senior management should budget sufficient time for directors to be informed and educated about the particular issues raised and the SEC's process.
- Thirdly, can the board delegate its responsibilities here to its standing committees? Should the Nominating and Corporate Governance Committee first assess proposals touching on corporate governance matters (such as political contributions), and then report to the full board for its determination? Likewise, should the Compensation Committee initially assess proposals dealing with executive compensation matters?

While the staff of the Division has indicated in SLB 14I that it will pay a substantial level of deference to registrants' boards, it is likely that a board's analysis will not be dispositive of the registrant's request to exclude in all instances. It would appear that this would be particularly so where a proposal is very similar to a proposal that has been previously determined by the staff to be not excludible. Regardless, a proactive strategy for registrants that are likely recipients of shareholder proposals should be in place in order to ensure that the board has the proper time and resources for the registrant to prepare and timely submit a no-action request.

The Economic Relevance Exception — Rule 14a-8(i)(5)

The "economic relevance" exception permits a registrant to exclude a shareholder proposal that (1) relates to operations accounting for less than five percent of the registrant's total assets, net earnings, and gross sales for its most recent fiscal year, and (2) is not otherwise significantly related to the registrant's business.

The current version of Rule 14a-8(i)(5), with its two-pronged test, was adopted in 1983 by the SEC. However, in 1985, the D.C. Federal District Court preliminarily enjoined a registrant from excluding a proposal relating to the cruelty of force-feeding geese to produce French paté, even though the sales from that particular business of the registrant accounted for less than five percent of each of the threshold amounts. According to court, its decision had been based "in light of the ethical and social significance of the plaintiff's proposal" and the fact that it implicated "significant levels of sales."[2]

The Division noted in the Bulletin that, as a result of the *Lovenheim* decision, Rule 14a-8(i)(5) had been interpreted by the staff in a manner that significantly narrowed the scope of the second prong of the rule and unduly limited its availability to registrants. After *Lovenheim*, the staff's analysis of "significantly related" under Rule 14a-8(i)(5) was similar to same analysis and interpretations it used in assessing requests for exclusion under Rule 14a-8(i)(7), the "ordinary business" exception.

SLB 14I provides that going forward, the staff's analysis of the second prong under Rule 14a-8(i)(5) will focus on a proposal's significance to the registrant's business when the proposal otherwise relates to operations that account for less than the five percent thresholds. Where a proposal's significance to a registrant's business is not apparent on its face, the shareholder submitting the proposal bears the burden of demonstrating that it is significantly related to its business. Demonstrating that a proposal is so significantly related may be accomplished by a showing that the proposal could have a significant impact on other segments of the registrant's business, or subject the registrant to significant contingent liabilities.

However, raising social or ethical issues in a shareholder's arguments will require tying those issues to a significant effect on the registrant's business. A mere possibility of reputational or economic harm will not preclude the registrant from receiving no-action relief. In determining "significance," the staff will consider the proposal in light of the "total mix" of information about the registrant and its particular circumstances, noting that a matter significant to one registrant may not be significant to another.

SLB 14I also provides that, like the "ordinary business" exception, a no-action request for exclusion of a proposal under Rule 14a-8(i)(5) should include a discussion reflecting the board's analysis of the proposal's significance to the registrant, subject to the same criteria and standards as an analysis made under the Rule 14a-8(i)(7) exception. However, when assessing significance to a registrant's business under Rule 14a-8(i)(5), the Division will no longer rely on precedent from its "ordinary business" exception analyses, in order to ensure that both exceptions serve their unique, independent purposes.

As with the "ordinary business" exception, it remains to be seen how the process for board analysis of a proposal under Rule 14a-8(i)(5) will be handled. In any event, the process should include careful guidance from lawyers to distinguish analyses under each separate exemption.

Proposals by Proxy

The Division has reaffirmed its view that shareholder proposal submission by proxy is consistent with Rule 14a-8. However, due to continuing concerns by registrants, particularly regarding eligibility requirements under Rule 14a-8(b), the Division will expect that proposals by proxy to include documentation describing the shareholder's delegation of authority to the proxy. In particular, such documentation should:

- Identify the shareholder-proponent and the person or entity selected as proxy.
- Identify the registrant to which the proposal is directed.
- Identify the annual or special meeting for which the proposal is submitted.
- Identify the specific proposal to be submitted.
- Be signed and dated by the shareholder.

Failure to include this information may be a basis to exclude the proposal under the eligibility requirements under Rule 14a-8(b).

A registrant seeking to exclude a proposal by proxy on the basis of Rule 14a-8(b) should be mindful that it must send a deficiency notice within 14 calendar days of receiving the proposal so that the proponent has an opportunity to cure.

The Use of Images — Rule 14a-8(d)

The Division has reaffirmed its view that that Rule 14a-8(d), which imposes a 500-word limit to proposals and their accompanying supporting statements, does not preclude shareholders from using graphics in their proposals. In its proxy statement, a registrant should refrain from minimizing the appearance of shareholder graphics and give the shareholder graphics similar prominence to its own graphics. It may also allow shareholder graphics to appear in black and white if its own graphics appear in the same manner. However, noting the potential for abuse, the Division states that exclusion of graphics is appropriate where they:

- Make the proposal materially false or misleading.
- Render the proposal inherently vague or indefinite.
- Impugn character, integrity or personal reputation.
- Make charges concerning improper, illegal, or immoral conduct or association, without factual foundation.
- Are irrelevant to a consideration of the subject matter of the proposal.

Furthermore, exclusion would also be appropriate if the total number of words in the proposal, including the graphics, exceeds 500.

If you have any questions about this topic, please contact a member of our Capital Markets and Securities Practice Group.

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[1] Release No. 34-40018 (May 21, 1998).

[2] Lovenheim v. Iroquois Brands, 618 F. Supp. 554 (Dist. D.C. 1985). The opinion stated that in its most recently completed fiscal year, the defendant's paté sales operated at a net loss and its revenues represented only 0.06% of its total revenues.

[3] *See* Rule 14a-8(f)(1).

[4] Footnote 16 to SLB 14I.