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New SEC Guidance May Increase the Ability for Companies to Exclude Shareholder Proposals While Also Increasing Scrutiny on Boards

SEC Staff Request Disclosure of "Specific Processes Employed by the Board" in No-Action Review

New guidance released on November 1st by the staff of the U.S. Securities and Exchange Commission (SEC) Division of Corporation Finance has the potential to reshape the playing field of shareholder proposals, with new opportunities and obligations for issuers and company boards. The guidance, which primarily deals with how SEC staff will respond to requests to exclude proposals based on Rule 14a-8(i)(5) (economic relevance) and Rule 14a-8(i)(7) (ordinary business), significantly elevates the role of boards in responding to resolutions. While it remains to be seen how deferential SEC staff will be to a board's reasoning for proposal exclusion and the level of detail and analysis required to support such reasoning, issuers should begin preparing for what will be a dynamic and evolving space for boards and investors.

Economic Relevance and Ordinary Business Exceptions

The guidance released last week provides companies and investors with information about how SEC staff will respond to requests to exclude proposals based on Rule 14a-8(i)(5) (economic relevance) and Rule 14a-8(i)(7) (ordinary business), among other topics.

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

The purpose of the economic relevance exception is to permit a company to exclude a shareholder proposal that "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business."

In the new guidance, SEC staff recounts the history of this exception, noting that recent exception analysis has centered on "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."

Moving forward, SEC staff appears to be refocusing on applying a more plain reading of the Rule, which centers on "a proposal's significance to the company's business when it otherwise relates to operations that account for less than 5% of total assets, net earnings and gross sales." In the guidance, the staff acknowledges the difficulty of determining whether a proposal may be "otherwise significantly related to the company's business" when the subject of the proposal does not meet the 5% threshold. In those circumstances, the staff will request "a discussion that reflects the board's analysis of the proposal's significance to the company" when making a decision to grant no-action relief. In particular, the staff requests disclosure of "specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned."

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

The purpose of the ordinary business exception is "to confine the resolution of ordinary business problems to management and the board of directors." The staff writes that the policy underlying this exception is typically divided into two considerations: the proposal's subject matter and the degree to which the proposal "micromanages" the company.

Moving forward, to assist staff in determining whether a proposal can be excluded based on the ordinary business exception, the staff will seek a "well-informed and well-reasoned" analysis by a company board as to whether a particular social policy issue raised in the proposal transcends ordinary business. The guidance in this section mirrors the reasoning in the (i)(5) guidance in stating that boards are best positioned to know a company's business and implications for a

particular proposal. For consideration under either (i)(5) or (i)(7), SEC staff will expect a company's no-action request to include disclosure of a board's process, reasoning and analysis.

Takeaways for Issuers

This new guidance may be the beginning of an effort by the SEC to address corporate governance and shareholder engagement issues under the leadership of Chairman Jay Clayton. In a news article about the implications of this new guidance for market participants, Bill Hinman, director of the SEC's Division of Corporation Finance, was quoted as saying: "We did not set out to try to make things easier or harder for one side or the other, we were trying to improve the process."

It is foreseeable that the staff guidance could have the effect of both increasing the number of proposal submissions that are excluded while increasing the quality and focus of resolutions filed (as well as the level of investor support they ultimately receive) as shareholders re-fashion their proposals to survive (i)(5) and (i)(7). More broadly, this new guidance is yet another example of the increasing role of directors in all aspects of shareholder engagement. For most companies, director engagement is limited to their largest shareholders. One effect of this new guidance may be to increase the importance of directors developing relationships with a broader group of investors, including those who submit shareholder proposals. It may also encourage boards to engage with proponents earlier in the shareholder proposal process to seek a negotiated agreement for proposal withdrawal.

However, similar to the SEC's guidance around Pay Ratio disclosure, this new guidance may be a doubled-edged sword: while companies may gain a greater ability to exclude proposals, that new ability may be accompanied by a higher level of scrutiny from investors. With filing deadlines fast approaching for many companies that hold annual meetings in the spring, investors will have a short amount of time to adjust their approach to drafting resolutions and subsequent engagement with companies at which resolutions are filed. In the coming months, boards will need to ensure they are staying abreast of new developments in this space as the SEC begins to weigh in on no-action requests.

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