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Responding to Rule Changes When the Rule Has Not Actually Changed: How Companies Should Approach Shareholder Proposals This Proxy Season

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Key Takeaways:

- The SEC's "shareholder proposal rule" was adopted to provide proponent shareholders access to management and fellow shareholders, but with limits to ensure that such access was not being misused or abused for personal gain.
- SEC Staff responses to shareholder proposal no-action requests last season (the "shift in approach") disrupted the balance of shareholder access versus potential for abuse, increasing costs for companies (and their shareholders), diverting management's attention away from running the company, and increasing the number of proposals included in proxy statements.
- The SEC's recent proposal to amend Rule 14a-8 could create additional uncertainty for companies this season and encourage the submission of proposals by proponents whose interests are not aligned with those of shareholders seeking a return on investment.
- It may be appropriate to submit a no-action request this season even if success seems unlikely due to the SEC's shift in approach last season.

Background

Rule 14a-8 under the Securities Exchange Act of 1934, as amended ("Rule 14a-8"), provides shareholders an avenue to present environmental, social and governance proposals within a company's proxy statement and on the company's proxy card for consideration at the company's annual meeting. Because the company bears the associated costs, the Rule 14a-8 process saves the proponent the cost of preparing and mailing its own proxy statement. Shareholder proposals are frequently opposed by boards of directors for requesting action that is divorced from shareholder value.

Since the rule's initial adoption in 1942, the SEC has amended the shareholder proposal rule several times to curb or prevent excessive or otherwise inappropriate use of the shareholder proposal rule that could result in the waste of companies' and other shareholders' time and resources.

Rule 14a-8 requires that a company include a shareholder proposal in its proxy statement unless a specific basis for exclusion in the rule is available. The burden of establishing the basis for exclusion falls on the company, typically through the SEC's no-action letter process under which the staff responds publicly by stating that it either concurs with or is unable to concur with the company's arguments for excluding the proposal.

The SEC's shareholder proposal no-action letter review process has always been opaque. While the staff may state the basis for its decision with a sentence or two, the underlying staff analysis is not made public. That said, companies and proponents have traditionally been able to ascertain the expected staff response based on prior precedent, as the staff — for the most part — was consistent in its application of Rule 14a-8 and also regularly published guidance.

Last year, the staff significantly narrowed the scope of several bases for exclusion under Rule 14a-8 by publishing Staff Legal Bulletin No. 14L ("SLB 14L") at the beginning of the proxy season and by applying certain other bases for exclusion that were not addressed by SLB 14L differently than in the past. Suddenly, years of staff guidance and no-action precedent could no longer be relied upon, which resulted in increased costs for companies to evaluate and prepare no-action requests, only to have them denied.

SEC Staff Shift in Approach

SLB 14L rescinded several years of guidance and announced a sharp reversal of the staff's application of the rules. Specifically, all staff shareholder proposal guidance published during the prior presidential administration was rescinded, and the staff explained, for instance, that certain climate change and human capital related proposals that previously would have been excludable would going forward be required to be included in company proxy statements. In addition, in SLB 14L, the staff announced changes to its application of the bases for exclusion in Rule 14a-8(i)(7) (the "ordinary business exception") and Rule 14a-8(i)(5) (the "economic relevance exception").

The ordinary business exception permits exclusion of a shareholder proposal when the proposal involves ordinary business operations that are fundamental to management's ability to run the company on a day-to-day basis. The SEC does not allow exclusion of proposals that focus on policy issues that are deemed to be so significant that they transcend ordinary business. Staff Legal Bulletin No. 14E ("SLB 14E"), published in 2009, explains that a sufficient nexus must exist between the nature of the proposal and the company in order for the significant social policy issue to transcend ordinary business. SLB 14L, without rescinding SLB 14E, declared that the staff "will … instead focus on the social policy significance of the issue that is the subject of the shareholder proposal."

The staff also reversed course on another long-standing interpretation of Rule 14a-8(i)(7), the "micromanagement" argument, which allows exclusion of a proposal pursuant to the ordinary business exception if the proposal "micromanages" a company "by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment." The staff explained in SLB 14L that it would apply a new approach to its evaluation of micromanagement arguments that would result in fewer shareholder proposals meeting the standard for exclusion.

Following the shift in approach, the ordinary business exception became largely unavailable for proposals that focus on ordinary business matters yet mention a social or environmental issue. For example:

- One company received a proposal requesting a report on the public health costs created by certain of the company's products. The company noted in its no-action request that it had received a substantially similar proposal from the same proponent the prior year, and that the staff had granted the request for exclusion pursuant to Rule 14a-8(i)(7), even denying the proponent's request for reconsideration. Last season, despite the proposal and the circumstances of the company being the same as the prior year, the staff denied the company's no-action request because, in the staff's view, the proposal "transcends ordinary business matters."

- Another company requested exclusion of a proposal seeking a report on the risks and costs to the company resulting from state policies restricting access to reproductive healthcare. The company explained that it received a nearly identical proposal the prior year, which the staff allowed it to exclude pursuant to Rule 14a-8(i)(7). Last season, however, the staff rejected the company's ordinary business argument, stating that the proposal "transcends ordinary business matters."
- The Staff denied no-action relief to companies requesting to exclude proposals seeking a report on the alignment of their retirement plan options with the companies' climate action goals. The staff had previously granted relief pursuant to Rule 14a-8(i)(7) when a proposal requested inclusion of climate-friendly retirement plan options because proposals related to employee retirement plans fell within the ordinary business exception.

Adding to the uncertainty created by the shift in approach, there was a noteworthy amount of inconsistency in the staff's application of Rule 14a-8(i)(7) last season that suggests not all requests for relief this season will be futile. For instance:

- Several companies were able to exclude proposals seeking publication of their employee-training materials pursuant to Rule 14a-8(i)(7) on the grounds that the proposals sought to micromanage the companies. In addition, several proposals requesting reports related to, for example, a company's equal employment opportunity policy, workforce turnover rates or employment standards were deemed excludable pursuant to Rule 14a-8(i)(7) as relating to, but not transcending, ordinary business matters. However, several other proposals related to companies' workforce management were deemed not excludable pursuant to Rule 14a-8(i)(7) because they raised "human capital management issues with a broad societal impact."

With respect to the economic relevance exception, the staff in SLB 14L declared that going forward, "proposals that raise issues of broad social or ethical concern related to the company's business may not be excluded, even if the relevant business falls below the economic thresholds of Rule 14a-8(i)(5)."[1] This new exception to the rule appeared to render Rule 14a-8(i)(5) useless if a "broad social or ethical concern" is referenced in the proposal at issue:

- One company sought exclusion of a proposal requesting a report on the company's policies and practices, and options for changes to such policies, to help ensure its product offerings reduce and do not increase the potential for racist police brutality. Just the prior year, a company in the same industry with a similar set of facts received no-action relief pursuant to the economic relevance exception for substantially the same proposal. Last season, despite establishing that the proposal did not meet Rule 14a-8(i)(5)'s numerical thresholds, the staff denied relief because it was "unable to conclude that the [p]roposal [was] not otherwise significantly related to the [c]ompany's business."

- In the same no-action request referenced earlier related to the public health costs created by certain of the company's products, the company argued that the proposal could be excluded pursuant to Rule 14a-8(i)(5) because in addition to not meeting the economic relevance test in the rule, the company is not primarily engaged in the business that was the focus of the proposal and, in addition, the company is not "a meaningful contributor to the broad policy concerns raised by the proposal." The staff did not concur with the company's argument and stated in its response that the proposal is "otherwise significantly related to the [c]ompany's business."

The shift in approach had a drastic effect on the number of shareholder proposals that went to a vote last year. The total number of shareholder proposals that went to a vote during the first half of 2022 was 538, a 39.7% increase from the 385 proposals voted on during the same period in 2021. Notably, there was not a corresponding increase in proposals that received majority support from company shareholders; in fact, that number remained relatively flat (73 proposals received a majority vote in 2022 versus 76 in 2021).[2]

Proposal to Amend Rule 14a-8

On July 13, 2022, the SEC proposed amendments that would further limit the availability of the bases of exclusion in Rule 14a-8. Specifically, the proposals relate to Rules 14a-8(i)(10), (11), and (12), which allow a company to exclude a shareholder proposal that has already been substantially implemented by a company, is duplicative of another proposal on the ballot, or was previously presented for a shareholder vote and did not receive a certain percentage of votes in favor, respectively. The SEC proposed to amend Rule 14a-8(i)(10) to require a higher standard for determining that a proposal has already been "substantially implemented;" specifically, the company would have to show that it has implemented the "essential elements" of the proposal in order to exclude it. Therefore, the more prescriptive a proposal, the more difficult it would be for a company to establish that each essential element has been implemented. The SEC proposed to amend Rule 14a-8(i)(11) to define "substantially duplicates" to mean that a proposal "addresses the same subject matter and seeks the same objective by the same means" as a previously submitted proposal. Presently, Rule 14a-8(i)(11) provides for exclusion of a proposal when the two proposals at issue share the same "principal thrust" or "principal focus," a much lower standard for exclusion. Lastly, Rule 14a-8(i)(12), which currently allows exclusion of proposals that address “substantially the same subject matter” as a proposal that was previously considered by shareholders, would be amended to require that the proposal at issue “substantially duplicates” the earlier proposal, using the same narrow definition from proposed Rule 14a-8(i)(11).

Note that even before the SEC proposed changes to Rule 14a-8 in July, the staff last season already appeared to apply a different “substantial implementation” standard. For example:

- One company received a proposal requesting that it publish a report explaining “if and how it intends to measure, disclose, and reduce” certain greenhouse gas emissions. The company requested relief pursuant to Rule 14a-8(i)(10), explaining to the staff that it had already fully implemented the proposal’s request by publishing a report explaining that it does not currently and does not intend in the future to measure, disclose or reduce the greenhouse gas emissions specified in the shareholder proposal. The staff denied the company’s request for no-action relief.
- Another company received a proposal requesting a report providing “action steps to foster greater racial equity on the board.” The company requested no-action relief pursuant to Rule 14a-8(i)(10) because it had already published a diversity report that addressed its board diversity efforts. The staff denied the company’s request.
- Another company received a proposal requesting a report on the company’s lobbying expenditures, including a list of items that should be disclosed in the report. The company’s no-action request to the SEC staff explained that the company had already published such a report, which addressed each prong of the proposal. The staff denied the company’s request, stating its view that “the [c]ompany’s public disclosures do not substantially implement the [p]roposal.”

If adopted as proposed (or applied as proposed), the amendments would serve to increase the number of shareholder proposals that must be included in a company’s proxy statement because fewer shareholder proposals would be excludable under Rule 14a-8. The amendments would likely also result in duplicative and even conflicting proposals at shareholders meetings when, for example, two proposals on the ballot request the same objective by different means.

The proposed amendments do not reflect the SEC’s long-standing history of addressing potential abuse of the shareholder proposal rule. For instance, when amending the resubmission basis for exclusion in 1983, the SEC noted that commenters “felt that it was an appropriate response to counter the abuse of the security holder proposal process by certain proponents who make minor changes in proposals each year so that they can keep raising the same issue despite the fact that other shareholders have indicated by their votes that they are not interested in that issue." The proposed amendments to Rule 14a-8(i)(12) appear to ignore that concern entirely.

What To Do This Season

To the extent possible, potential arguments for exclusion should be evaluated against similar proposals that the SEC staff considered in the 2021-22 season. Earlier seasons may no longer provide reliable precedent. Given the shift in approach and the proposed amendments to Rule 14a-8, at least five of the 13 substantive bases for exclusion are likely to be significantly less available to companies this season.

Based on data recently published by the SEC, one shareholder proposal can cost a company more than $100,000, a cost that is ultimately borne by that company's shareholders. Many companies report spending significantly more than that. This cost is generally meaningfully higher for those companies that request no-action relief and may be even higher now given the decreased regulatory certainty and increased time and money required to evaluate whether or not a proposal will be viewed by the staff to be excludable.

Companies may wonder whether there is any benefit to submitting shareholder proposal no-action requests this season, especially for proposals that were denied exclusion following the shift in approach. We believe it may be appropriate to continue to submit requests for proposals that traditionally had a chance of being granted relief. Absent the SEC amending Rule 14a-8 to codify the shift in approach, arguments rejected last season may become viable in the near future. Swift changes to the application of Rule 14a-8 resulting from staff actions can just as easily be reversed when a new Commission takes over. Arguments that do not win this season may be resurrected in the future, and the staff may find arguments for newer proposals to be persuasive when told to apply a different (i.e., more traditional) approach.

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1. Rule 14a-8(i)(5) allows exclusion "[i]f the proposal 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."↩

2. Data from Morrow Sodali "Lighthouse" (Sept. 2022), *available at* https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-

378577d0b150/UploadedImages/Lighthouse_NA___sept_2022___web_144dpi.pdf ↩

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