Insights: Alerts

SEC Limits the "Direct Conflict" Exclusion for Shareholder Proposals in Proxy Statements and Reaffirms Its Position on the "Ordinary Business" Exclusion

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On October 22, 2015, the Division of Corporate Finance (the "Division") of the Securities and Exchange Commission (the "SEC") published Staff Legal Bulletin No. 14H (the "Bulletin") narrowing the availability of the "direct conflict" exclusion for shareholder proposals under Rule 14a-8(i)(9) and reaffirming its position on the applicability of the "ordinary business" exclusion under Rule 14a-8(i)(7) in light of the *Trinity Wall Street v. Wal-Mart Stores, Inc.* litigation.

SEC Narrows the "Direct Conflict" Exclusion Under Rule 14a-8(i)(9)

Under Rule 14a-8(i)(9), a company may exclude a shareholder proposal "[i]f the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." In the past, the Division typically granted no-action relief to companies if inclusion of a shareholder proposal in the company's proxy statement could present "alternative and conflicting decisions for the shareholders" and create the potential for "inconsistent and ambiguous results." However, in January 2015, following the Whole Foods no-action letter and the SEC's subsequent withdrawal of its no-action letter, the SEC announced that it would express no view on the application of Rule 14a-8(i)(9) during the 2015 proxy season. The SEC's guidance in the Bulletin reflects a much narrower definition of "direct conflict" that provides shareholders with more latitude to make proposals and places a higher burden on companies to exclude them.

i. The Definition of "Direct Conflict"

In the Bulletin, the Division announced that a "direct conflict" exists, and therefore a company may exclude a shareholder proposal under Rule 14a-8(i)(9), if a reasonable shareholder could not logically vote in favor of both the shareholder and the company proposal. The test has become: "is the vote in favor of one proposal tantamount to a vote against the other proposal?"

The Division provides some examples in the Bulletin to clarify whether a shareholder proposal could be properly omitted under Rule 14a-8(i)(9).

- A company may not exclude a shareholder proposal that seeks a similar objective to the company proposal.
  - For example, a shareholder proposal that seeks to permit shareholders holding at least three percent of the company's outstanding stock for at least three years to nominate up to 20% of the directors would not be excludable if the company proposal seeks to permit shareholders holding at least five percent of the company's outstanding stock for at least five years to nominate up to 10% of the directors. Both

proposals would seek to give shareholders the ability to include their nominees for director alongside the company's nominees in the proxy statement. A company may not exclude such shareholder proposal under Rule 14a-8(i)(9), because the two proposals would have a similar objective and a shareholder vote on both such proposals would not be mutually exclusive.

- A company may not exclude a shareholder proposal that offers specific instruction on the grounds that a company proposal offers general instruction on the same subject matter.
    - For example, a shareholder proposal seeking to direct the compensation committee to grant equity awards vested over a certain time period would not be excludable if the company proposal seeks to provide the compensation committee discretion to set the vesting provisions for equity awards. A shareholder could logically vote in favor of both proposals, providing the compensation committee with the discretion to determine the vesting of awards and approving a specific vesting policy that would apply to future awards granted under an incentive plan. A company may not exclude such shareholder proposal under Rule 14a-8(i)(9), because a shareholder vote in favor of one proposal would not amount to a vote against the other proposal.
- A company may exclude a shareholder proposal where a shareholder vote in favor of one proposal would be tantamount to a vote against the other proposal.
    - For instance, a shareholder proposal asking the shareholders to vote against a merger may be excluded when the company proposal seeks a shareholder vote in favor of the merger. Similarly, a shareholder proposal seeking to separate the company's chairperson from the chief executive officer would be considered to be mutually exclusive with a company proposal seeking approval of a bylaw provision requiring the chief executive officer to be the chair at all times. In these two examples, a company may exclude such shareholder proposal under Rule 14a-8(i)(9), because the two proposals are mutually exclusive and a reasonable shareholder cannot logically vote for both.

ii. Other Considerations

The Division acknowledged that the new definition may result in shareholder vote outcomes that create confusion. For example, a shareholder vote approving both a shareholder proposal seeking to amend the bylaws to permit shareholders holding 10% of the outstanding stock to call a special meeting of shareholders and a company proposal seeking a similar provision for shareholders holding 25% of the outstanding stock may make it difficult for management to interpret the result of the vote. A company concerned that a shareholder proposal on the same subject matter as a company proposal may lead to confusion may use Rule 14a-9 of the Exchange Act to explain in the proxy materials the differences between the two proposals and how the company expects to consider the voting results.

iii. Practical Guidance

The SEC's new interpretation of Rule 14a-8(i)(9) narrows the circumstances under which a company can exclude a shareholder proposal on the grounds that it conflicts with a management proposal and effectively eliminates the strategy of excluding a shareholder proposal by proposing a similar proposal that is more to management's liking. Now that both versions of the proposal – management's and the shareholders – must be presented for a vote, companies have the incentive to be proactive on emerging governance issues. The Division "expect[s] companies and proponents to respect the Rule 14a-8 process and encourage[s] them to find ways to constructively resolve their differences." As a result, companies may avoid the Rule 14a-8 process and preempt shareholder proposals by taking

action before shareholders resort to bringing their own proposals. We saw this approach with respect to proxy access, during the last proxy season.

SEC Reaffirms Its Position on the "Ordinary Business" Exclusion Under Rule 14a-8(i)(7)

The Bulletin also reaffirms the Division's position on Rule 14a-8(i)(7) in response to the recent ruling in *Trinity Wall Street v. Wal-Mart Stores, Inc.* ("*Trinity*"). Under Rule 14a-8(i)(7), a company may exclude a shareholder proposal "[i]f the proposal deals with a matter relating to the company's ordinary business operations." Historically, the Division issued no-action letters to companies under Rule 14a-8(i)(7) when a shareholder proposal presented a subject matter related to a company's ordinary business operations, such as deciding what products and services the company should sell. However, the fact that a shareholder proposal relates to a company's ordinary business matters does not automatically permit a company to exclude such a proposal from its proxy materials. The Division has previously taken the position that, if a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the shareholder proposal may not be excluded under Rule 14a-8(i)(7). The Bulletin clarifies that the SEC will continue to apply the ordinary business exclusion under Rule 14a-8(i)(7) consistent with its past practice rather than the two-part test articulated in *Trinity*. The Division stated that a proposal is not excludable under Rule 14a-8(i)(7) if it transcends a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business."

iv. Practical Guidance

The Bulletin does not change the Division's interpretation of Rule 14a-8(i)(7) and its application going forward will not be affected. However, the Bulletin is not binding on any court. As a result, shareholders or companies that disagree with the Division's interpretation of Rule 14a-8(i)(7) may seek judicial review of the issue and the application of the standard under *Trinity*.

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