

SEC Staff's Latest Guidance Presents Dilemma for Companies Seeking to Exclude Shareholder Proposals on Environmental and Social Issues

by Cam C. Hoang

On November 1, 2017, the SEC Division of Corporation Finance issued a Staff Legal Bulletin No. 14I ("SLB 14I"), which includes guidance on the scope and application of the "ordinary business" basis for excluding shareholder proposals under Rule 14a-8(i)(7) and the "economic relevance" basis under Rule 14a-8(i)(5). Under these two bases, demonstrating that a proposal is not significant to a company's business is a critical component to no-action relief, and specifically, the Staff is looking for board analysis that helps it to understand the nexus between the issue and the company's operations. Conversely, the Staff has clarified that it does not need a company's input on an issue's broader social impact.¹ SLB 14I raises the possibility that environmental and social proposals, many of which were not excludable in the past because of their broader social impact, may now be excludable if a company can convince the Staff that the issues presented are not significant to the business. However, a company seeking to downplay the significance of environmental and social issues in a no-action request may be forced to reconcile the no-action request with conflicting statements on the importance of these same issues in other contexts, including social responsibility reports which have become prevalent for larger public companies.² Furthermore, the benefit of having a proposal excluded may be outweighed by the potential reputational damage to the company and its board of directors if consumers and other stakeholders receive conflicting messages about the importance to the company of environmental and social issues. Therefore, a company considering reliance on SLB 14I guidance should address certain preliminary questions outlined below, and if it proceeds, provide a nuanced analysis of the issue in its no-action requests that either reconciles, distinguishes or reinforces its position on the same issue elsewhere.

Background

SLB 14I is not intended to change the historical framework for analyzing the "ordinary business" exception³. Rule 14a-8(i)(7) permits a company to exclude a proposal that "deals with a matter relating to the company's ordinary business operations." According to the adopting release, the purpose of the exception is "to confine the resolution of

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ordinary business problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems at an annual shareholders meeting.”⁴ The ordinary business exclusion is based on two factors: first, that “[c]ertain tasks are so fundamental to management’s ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight”; and second, the degree to which the proposal attempts to “micromanage” 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.”⁵ However, as explained in the release, proposals on ordinary business matters may nevertheless be included if they raise policy issues that are sufficiently significant to transcend day-to-day business matters. What constitutes a significant policy issue? In a June 30, 2016 stakeholder meeting, the Staff indicated that significant policy issues are matters of widespread public debate, which include legislative and executive attention and press attention. Significant policy issues may evolve. For example, in Staff Legal Bulletin 14E (October 27, 2009), the Staff modified its position on CEO succession planning proposals, determining that going forward, such proposals would raise a significant policy issue regarding the governance of the corporation that transcends the day-to-day business matter of managing the workforce, so that a company generally may not rely on Rule 14a-8(i)(7) to exclude such proposals.

Under Rule 14a-8(i)(5), the “economic relevance” basis for exclusion, a company is permitted to exclude a proposal that:

- relates to operations which account for less than 5% of the company’s total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and
- is not otherwise significantly related to the company’s business.

Historically, the “economic relevance” basis for exclusion has had limited application, because the Staff tended to find relevance where a company conducted any amount of business related to the issue in the proposal, and the issue had significant social impact. Under SLB 14I, there will be renewed focus on the second prong, whether a proposal is “otherwise significantly related to the company’s business.” The significance analysis will be dependent upon the particular circumstances of the company. However, substantive governance matters will be viewed as significantly related to almost all companies. Proponents will bear the burden of demonstrating that a proposal is “otherwise significantly related to the company’s business.” Furthermore, the mere possibility of reputational or economic harm will not preclude no-action relief.⁶ In evaluating significance, the Staff will consider the proposal in light of the “total mix” of information about the issuer.

According to SLB 14I, the board is well situated to analyze, determine and explain whether a particular issue is sufficiently significant because the matter transcends ordinary business and would be appropriate for a shareholder vote. Accordingly, the Staff will expect a company’s no-action request to include a discussion that reflects the board’s analysis of the particular policy issue raised and its significance.⁷ Furthermore, board processes can bolster a case for exclusion: The company should consider

describing the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned. While SLB 14I intentionally did not provide examples of these processes in SLB 14I, details may include board meetings and discussions with consultants. A well-developed record prepared by a board committee, reviewed and approved by the full board, will carry more weight than a simple committee determination, and the findings should be sufficiently detailed.⁸ Companies should be mindful that any processes described will be part of the public record of the no-action letter request.

The analysis for the “ordinary business” basis for exclusion will be evaluated independently from the analysis for the “economic relevance” basis for exclusion, though the latter analysis has historically been informed by the former.⁹

Recommendations

An assessment of whether a company should seek exclusion of a social or environmental proposal on the basis of SLB 14I should take into account the company’s prior assessments and public commitments on the issue. Preliminary questions to address include the following:

- Are we in an industry where it’s feasible to conclude that the issue does not have a significant impact on our business?
- Has this issue been evaluated by our board and management in the past (for example, as part of our enterprise risk management process) and what were the conclusions?
- What has our company represented to the public and outside stakeholders about the significance of this issue to our business? Have we made a public commitment on this issue?
- Is the board willing to have its analysis and conclusions on the issue, as well as the process behind its analysis, made public? And what does that look like?
- Is the nature and/or scope of the issue as described in the proposal different from the nature and/or scope of the issue to which we have made a commitment?
- If we have made a commitment on this issue, is our commitment based the issue’s broader social impact or the issue’s impact to our business?
- Are there alternate bases for exclusion to consider, including “substantial implementation” under Rule 14a-8(i)(3)?

Companies that proceed with a no-action request under the “ordinary business” basis of Rule 14a-8(i)(7) or the “economic relevance” basis of Rule 14a-8(i)(5) as articulated under SLB 14I should provide a nuanced analysis of the issue that either reconciles, distinguishes or reinforces its position on the same issue elsewhere. For example, while a company may generally support sustainable sourcing in its supply chain, the issue of sustainably sourcing certain ingredients or components of its products may not be significant to the business.

In addition, for companies seeking no-action relief for a shareholder proposal in reliance on the “ordinary business” basis, a recent no-action letter indicates that it is not sufficient to assert that the issue has been addressed in the ordinary course of business. Rather,

the Staff is looking for an analysis of whether the issue is significant to the company. See the Staff's determination in *Apple, Inc.* (December 21, 2017) finding that Apple could not exclude a shareholder proposal that the company establish a human rights committee to review, assess, disclose and make recommendations to enhance the Company's policy and practice on human rights. In the *Apple* no-action letter, the Staff was unable to conclude based on the information presented by the company, including the discussion of the board's analysis, that the particular proposal was not sufficiently significant to the Company's business operations such that exclusion would be appropriate. The Staff noted that the company's request specifically stated that "the Board and management firmly believe that human rights are an integral component of the Company's business operations." Further, the Staff said that the board's analysis did not explain why this particular proposal would not raise a significant issue for the Company.

¹ Based on comments by Matt McNair, Senior Special Counsel in the Office of Chief Counsel, SEC's Division of Corporation Finance, in the webinar "Shareholder Proposals: Corp Fin Speaks," November 14, 2017 on TheCorporateCounsel.net.

² According to a report dated May 31, 2017 from the Governance & Accountability Institute, 82% of S&P 500 companies published a sustainability or corporate responsibility report in the year 2016, compared to just under 20% in 2011.

³ Under the traditional framework for ordinary business exception:

- First, does the proposal relate to ordinary business?
 - If so, does it relate to a significant policy issue?
 - If so, is there a significant connection between that issue and the company's business?
- If all three answers are affirmative, the Staff will require inclusion of the proposal.

⁴ See Securities Exchange Act Release No. 34-40018.

⁵ Ibid.

⁶ Based on comments by Matt McNair, Senior Special Counsel in the Office of Chief Counsel, SEC's Division of Corporation Finance, in the webinar "Shareholder Proposals: Corp Fin Speaks," November 14, 2017 on TheCorporateCounsel.net.

⁷ Board analysis is not always required, for example, when there is a well-established line of no-action precedent to support application of the ordinary business exception.

⁸ Based on comments by Matt McNair, Senior Special Counsel in the Office of Chief Counsel, SEC's Division of Corporation Finance, in the webinar "Shareholder Proposals: Corp Fin Speaks," November 14, 2017 on TheCorporateCounsel.net.

⁹ Ibid.