SULLIVAN & CROMWELL LLP

October 23, 2015

SEC Staff Issues Guidance on Excluding Shareholder Proposals: Competing Proposals in Proxy Statements Likely to Increase

Reinstates No-Action Relief on Conflicting Shareholder Proposals but Only if a "Reasonable Shareholder Could Not Logically Vote in Favor of Both Proposals"; and Will Continue to Grant No-Action Relief on Basis of Ordinary Business Operations Consistent With Past Practice Notwithstanding *Trinity Wall Street* v. *Wal-Mart Stores, Inc*.

SUMMARY

The staff of the Division of Corporation Finance of the Securities and Exchange Commission issued a legal bulletin yesterday publishing the outcome of its review of Rule 14a-8(i)(9), which allows the exclusion of a shareholder proposal that "directly conflicts" with a management proposal. Going forward, the staff will grant no-action relief on the basis of a direct conflict "only if a reasonable shareholder could not logically vote in favor of both proposals," a "higher burden" for companies to meet than had been the case previously. As a result, the instances of competing company and shareholder proposals being contained in the same proxy statement are likely to increase.

The legal bulletin also addressed the impact of the Third Circuit's decision in *Trinity Wall Street* v. *Wal-Mart Stores, Inc.* with respect to no-action relief under Rule 14a-8(i)(7), which allows the exclusion of shareholder proposals that relate to "ordinary business operations." Although both the staff and the *Trinity Wall Street* panel separately concluded that a shareholder proposal submitted to Wal-Mart Stores, Inc. was excludable, the majority in *Trinity Wall Street* employed an approach that differed from the staff's historic practice. In the legal bulletin, the staff states that it believes its practice is consistent with the

views expressed by the SEC in evaluating no-action relief under Rule 14a-8(i)(7) and intends to continue its prior application of the rule when considering no-action requests.

Staff Legal Bulletin No. 14H is available at https://www.sec.gov/interps/legal.shtml.

BACKGROUND

In mid-January of this year, the SEC staff announced that it would not provide no-action relief on *any* shareholder proposal on the basis that it conflicted with a management proposal, pending a review of Rule 14a-8(i)(9) that was directed by SEC Chair Mary Jo White.[1]

Although Rule 14a-8(i)(9) has been used for a number of years to exclude governance proposals where management proposed an alternative, it attracted significant attention due to its use by companies to exclude proxy access shareholder proposals as conflicting with management proposals on the same topic but with more restrictive terms. In December 2014, the SEC staff concurred with Whole Foods on the excludability of a shareholder proposal that would give a group of shareholders owning 3% of the company's shares for three years the right to include nominees in the company's proxy materials. Whole Foods expressed its intent to put forward its own proxy access proposal, applying to a single shareholder owning 9% of the company's shares for five years. The staff agreed that there was a basis for the company's conclusion that the two proposals were in conflict and granted no-action relief on December 1, 2014. Following the SEC staff's determination, a significant number of other companies submitted similar letters seeking to exclude proxy access proposals on the basis that they would conflict with management proposals with a range of more restrictive terms.[2]

Given the importance of proxy access as a corporate governance initiative, the SEC staff's application of Rule 14a-8(i)(9) in this context was subject to criticism and requests for reconsideration by a number of shareholder groups. Simultaneously with Chair White's direction to review the rule, the staff reversed the Whole Foods determination and indicated that it would express no views on the application of Rule 14a-8(i)(9) to any proposals during the 2015 proxy season.[3]

Heightened Standard Going Forward

After reviewing the scope and application of Rule 14a-8(i)(9), the SEC staff has concluded that it will grant no-action relief under the rule only "if a reasonable shareholder could not logically vote in favor of both

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1 Chair White's statement is available at http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html.

2 The large number of proxy access proposals for the 2015 proxy season was due to a broad initiative by the NYC Pension Funds to advance the cause of proxy access. See our publication, dated July 20, 2015, entitled "2015 Proxy Season Review" and our publication, dated August 18, 2015, entitled "Proxy Access Bylaw Developments and Trends" for a discussion of the outcome of this initiative.

3 The SEC staff's reversal of its Whole Foods decision is available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2015/jamesmcritchiecheveddenrecon011615-14a8.pdf.

proposals, *i.e.*, a vote for one proposal is tantamount to a vote against the other proposal." The staff acknowledges that its new articulation differs from its previous formulation and is "a higher burden for some companies seeking to exclude a proposal to meet than had been the case."

The SEC staff provides the following two examples of proposals that would not directly conflict under the new heightened standard:

- A shareholder proposal that would permit a shareholder or group of shareholders holding at least 3% of the company's outstanding stock for at least three years to nominate up to 20% of the directors would not be excludable if a management proposal would allow shareholders holding at least 5% of the company's stock for at least five years to nominate for inclusion in the company's proxy statement 10% of the directors. The legal bulletin states that these proposals do not conflict because both "generally seek a similar objective, to give shareholders the ability to include their nominees for director alongside management's nominees in the proxy statement…"
- A shareholder proposal asking the compensation committee to implement a policy that equity awards would have no less than four-year annual vesting would not directly conflict with a management proposal to approve an incentive plan that gives the compensation committee discretion to set the vesting provisions for equity awards. The legal bulletin states that these proposals do not conflict because "a reasonable shareholder could logically vote for a compensation plan that gives the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan."

Exclusion of the shareholder proposals in both of the preceding examples would have been consistent with the prior application of Rule 14a-8(i)(9). Companies had regularly been permitted to exclude certain shareholder governance proposals on the basis that they conflicted with proposals put forth by the company on the same topic but with more restrictive terms. Similarly, companies commonly were permitted to exclude shareholder proposals seeking to prohibit single-trigger change-in-control acceleration of equity awards on the basis that they conflicted with the greater flexibility set forth in equity compensation plans that the companies were putting up for a shareholder vote at the same time.

As examples of proposals that continue to directly conflict under the new standard, the legal bulletin identifies a shareholder proposal seeking a vote against a merger where the company is putting the merger up for a vote and a shareholder proposal that asks for the separation of the company's chairman and CEO where the company is seeking approval of a bylaw provision requiring the CEO to be the chairman at all times. It appears that, on this basis, a shareholder proxy access proposal would continue to conflict with a company proposal seeking to affirm its policy of no proxy access.

It is important to note that companies are not required to obtain no-action relief from the staff in order to exclude a proposal under Rule 14a-8. The relevant SEC rule, Rule 14a-8(j), requires only that the company "file its reasons" with the SEC no later than 80 calendar days before it files its definitive proxy statement. Furthermore, the SEC staff has expressly confirmed that "the staff's no-action responses to Rule 14a-8(j) submissions reflect only informal views. The determinations reached in these no-action

letters do not and cannot adjudicate the merits of a company's position with respect to the proposal. Only a court such as a U.S. District Court can decide whether a company is obligated to include shareholder proposals in its proxy materials."[4] On the other hand, companies should gauge any potential shareholder or proxy advisory firm reaction to the unilateral exclusion of a shareholder proposal. For example, in February 2015, ISS announced that it would generally recommend votes against directors at companies that exclude a shareholder proposal without obtaining no-action relief from the SEC or judicial relief from a U.S. District Court.[5]

Implications

A likely result of the staff's position is the continuation of the trend of competing management and shareholder proposals being contained in the same proxy statement, which began in 2015 as a result of the suspension of no-action relief under 14-8(i)(9). For example, during the 2015 proxy season through June 30, seven companies included competing company and shareholder proxy access proposals in the same proxy statement and six companies had competing special meeting proposals.

In considering whether to respond to a shareholder proposal with a competing proposal, important considerations include:

- ***Whether the required votes are different***. In one instance in the 2015 season, a company proposal failed because of a supermajority vote requirement and a competing shareholder proposal that received a much lower vote in favor passed. In this circumstance, it could be advisable to seek a precatory vote on the management proposal in the first year, and then propose a binding vote in the second year.
- ***Whether to include a binding bylaw/charter proposal or a precatory proposal***. It may be difficult for a detailed bylaw proposal to compete with a more general precatory shareholder proposal. For example, both of the binding bylaw proposals that were made in response to precatory shareholder proxy access proposals during the 2015 season failed, although not necessarily for that reason. In addition, if a detailed company proposal fails where a more general shareholder proposal is approved, it may be difficult when considering implementation of the proposal to determine which elements were viewed negatively by stockholders.
- ***Whether to discuss the implications of adopting both proposals***. Finally, companies should consider disclosure as to what action they plan to take should both proposals pass. Disclosure varied widely in the examples in 2015. A potential approach is a statement that, if the company proposal passes, the company intends to enact that proposal. In this circumstance, shareholders voting for the company proposal would be doing so with the knowledge that it will be enacted if the requisite vote is obtained.

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[4] SEC Division of Corporation Finance, Informal Procedures Regarding Shareholder Proposals, available at http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8-informal-procedures.htm.

[5] ISS FAQs on Selected Topics (Feb. 2015), available at http://www.issgovernance.com/policy-gateway/2015-policy-information/.

RULE 14A-8(I)(7): ORDINARY BUSINESS OPERATIONS

Background

Rule 14a-8(i)(7) allows the exclusion of a shareholder proposal if it "deals with a matter relating to the company's ordinary business operations." This exclusion is based on the principle that shareholders should not manage (or micromanage) a company's day-to-day operations. However, in applying the rule, the SEC and its staff have developed an exception to this basis for exclusion if the proposal also presents a significant social policy issue for consideration. The line between ordinary business operations and social policy matters has been difficult to define, and sometimes seemingly similar proposals yield opposite responses by the SEC staff.

The dispute in *Trinity Wall Street* arose after shareholder Trinity submitted a proposal to Wal-Mart for inclusion in Wal-Mart's 2014 proxy materials. The proposal sought to amend the charter of Wal-Mart's Compensation, Nominating and Governance Committee to provide that the committee would "overs[ee] . . . the formulation and implementation of . . . policies and standards that determine whether or not [Wal-Mart] should sell a product that: 1) especially endangers public safety and well-being; 2) has the substantial potential to impair the reputation of [Wal-Mart]; and/or 3) would reasonably be considered by many offensive to the family and community values integral to [Wal-Mart's] promotion of its brand."

On March 20, 2014, the SEC staff issued a no-action letter stating that it would not object to Wal-Mart excluding Trinity's proposal from its proxy materials on the basis that it addressed ordinary business operations. Trinity sued in the U.S. District Court for the District of Delaware, seeking to preliminarily enjoin Wal-Mart from excluding the proposal in connection with its 2014 annual meeting. Although the District Court declined to enjoin Wal-Mart at that time, it later concluded that Wal-Mart was not entitled to exclude the proposal because it did not meet the requirements of the ordinary business operations exclusion and, in the alternative, because it did meet the requirements for the significant social policy exception. Wal-Mart appealed, and on April 14, 2015 the Third Circuit vacated the District Court's order, permitting Wal-Mart to exclude the proposal from its 2015 proxy materials. The Third Circuit released its opinion on July 6.[6]

Ordinary Business and Ultimate Subject Matter

The Third Circuit notes approvingly the SEC's prior statements that whether a particular shareholder proposal implicates a company's ordinary business operations rests on two central considerations: first, whether the subject matter of the proposal involves tasks fundamental to management's ability to run a company on a day-to-day basis; second, the degree to which the proposal seeks to "micro-manage" the company by probing too deeply into matters of a complex nature upon which shareholders would not be in a position to make an informed judgment. In the context of a proposal that asks for the company to

[6] The Third Circuit's decision is discussed in more detail in our publication, dated July 10, 2015, entitled "Excluding Shareholder Proposals—*Trinity Wall Street* v. *Wal-Mart Stores, Inc.*"

issue a special report or to establish a new board committee, both the staff's 2014 no-action letter and the Third Circuit conclude that the initial step is to identify the "underlying" or "ultimate" subject matter of the proposal. In *Trinity Wall Street*, this was "a potential change in the way Wal-Mart decides which products to sell."

The legal bulletin confirms that the staff will continue to take this approach. Specifically, proposals seeking a report or board committee action on a particular matter will continue to be evaluated by reference to whether the underlying subject matter relates to the company's ordinary business operations "regardless of how the proposal is framed."[7]

Significant Policy Exception

Having concluded that the subject matter of Trinity's proposal related to Wal-Mart's ordinary business operations, the Third Circuit also evaluated the significant social policy exception. For the majority of the court, this analysis had two distinct parts: (1) does the proposal raise a *significant policy issue* and (2) do those issues *transcend day-to-day business*. This two-part approach differed from the SEC staff's historic practice. The majority in *Trinity Wall Street* concluded by empathizing with companies and shareholders struggling with the unclear issues involved in the ordinary business operations exclusion and recommended that the SEC revise its regulations and issue new interpretive guidance in this area.

The legal bulletin states that the staff does not agree with the two-part approach introduced by the Third Circuit. In particular, the staff notes its concern that the approach may lead to the unwarranted exclusion of shareholder proposals and that it goes beyond the SEC's prior statements. In contrast to the two-part approach, the staff views the "significance and transcendence concepts as interrelated, rather than independent," quoting from Judge Schwartz's concurring opinion.

The legal bulletin concludes that the staff intends to continue to apply Rule 14a-8(i)(7) consistent with its historic practice. Therefore, according to the legal bulletin, a proposal relating to a company's ordinary business operations may continue to be subject to the significant social policy exception even if the proposal's subject matter relates to the "nitty-gritty of its core business."

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[7] Citing Rel. No. 34-20091, Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders (Aug. 16, 1983) ("In the past, the staff has taken the position that proposals requesting issuers to prepare reports on specific aspects of their business or to form special committees to study a segment of their business would not be excludable under Rule 14a-8([i])(7). Because this interpretation raises form over substance and renders the provisions of paragraph ([i])(7) largely a nullity, the Commission has determined to adopt the interpretative change set forth in the Proposing Release. Henceforth, the staff will consider whether the subject matter of the special report or the committee involves a matter of ordinary business; where it does, the proposal will be excludable under Rule 14a-8([i])(7).").

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