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# SEC Update

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*This is a commercial communication from Hogan Lovells. See note below.*

# SEC staff issues new guidance on shareholder proposals involving social policy issues

On November 3 the SEC's Division of Corporation Finance issued Staff Legal Bulletin 14L (SLB 14L) to provide new guidance on the application of the "ordinary business" and "economic relevance" exceptions to a public company's obligation under Exchange Act Rule 14a-8 to include shareholder proposals in its proxy materials. The SEC staff will apply the guidance during the 2022 proxy season in evaluating company no-action requests seeking exclusion of shareholder proposals on the basis of these exceptions.

In SLB 14L the Division has rescinded its three most recent staff legal bulletins under Rule 14a-8 and changed the standards it will apply to determine whether shareholder proposals may not be excluded under the ordinary business and economic relevance exceptions because they involve significant social policy issues, such as those relating to climate change or human capital management.

The Division's significance analysis in evaluating no-action requests generally will focus on whether proposals raise issues "with a broad societal impact" (in the case of the ordinary business exception) or "issues of broad social or ethical concern" (in the case of the economic relevance exception), rather than, as in the recent past, on whether they are of significance to the particular company. Under the revised standards, companies no longer may exclude a proposal under the ordinary business exception by establishing that the issues raised by the proposal are not significant for the company, or under the economic relevance exception by establishing that the proposal does not relate to operations that meet company-specific economic thresholds.

In other guidance presented in SLB 14L, the Division updates the application of certain procedural requirements under Rule 14a-8 that it previously addressed in the rescinded legal bulletins.

SLB 14L can be found here.

## Repeal of prior guidance

SLB 14L repeals the guidance provided by the Division regarding the application of the ordinary business and economic relevance exceptions presented in:

- Staff Legal Bulletin No. 14I (SLB 14I), published in November 2017 and discussed in the ***SEC Update*** we issued on November 16, 2017;
- Staff Legal Bulletin No. 14J (SLB 14J), published in October 2018 and discussed in the ***SEC Update*** we issued on November 7, 2018; and
- Staff Legal Bulletin No. 14K (SLB 14K), published in October 2019 and discussed in the ***SEC Update*** we issued on October 23, 2019.

The Division frames the replacement of the rescinded legal bulletins as a "realignment" of the application of the ordinary business and economic relevance exceptions with policy concepts articulated by the Commission in releases it issued in 1976 and 1988 and as a revival of standards previously applied by the staff in reviewing exclusion determinations. The Division believes that the changes will better serve the policy objectives underlying Rule 14a-8 by reducing limits on the rights of shareholders to bring important social policy issues before other shareholders through the proxy process.

## New guidance on ordinary business exception

SLB 14L outlines a new framework for determining whether a company may rely on Rule 14a-8(i)(7) to exclude from its proxy materials a shareholder proposal that "deals with a matter relating to the company's ordinary business operations." The staff has long used a "significance" concept in assessing the application of this exception.

The Division states in SLB 14L that it will no longer take a "company-specific approach" in its significance analysis for determining whether a proposal raises policy issues of such importance that they transcend a company's ordinary business affairs and render the exception unavailable. Instead, the Division will "focus on the social policy significance of the issue that is the subject of the shareholder proposal," rather than on the issue's significance for the particular company. Consistent with this turn in direction, the Division says it no longer will expect a company's board of directors to conduct the type of extensive analysis of the relationship of such policy issues to the company's business which the staff had solicited in the rescinded bulletins.

The Division also states in SLB 14L that companies seeking to exclude a proposal involving significant policy issues on the basis that it seeks to "micromanage" the company's operations will be required to establish that the proposal "inappropriately limits the discretion of the board or management" and not simply that it seeks detail or advocates the adoption of specific time-frames or particular methods.

### *Consideration of significant policy issues*

The staff's new approach to proposals raising significant policy issues represents a marked shift away from the prior guidance the Division has now rescinded. A review of the rescinded guidance highlights the key elements of the change in approach.

***Prior guidance on significant policy issues.*** Rule 14a-8(i)(7) permits a company to exclude from its proxy materials a shareholder proposal that "deals with a matter relating to the company's ordinary business operations." This exception is based on the general principle of state corporation law that a corporation's directors and officers, rather than its shareholders, are responsible for conducting the corporation's day-to-day operations, and shareholders therefore should not have a vote on matters relating to the company's ordinary business.

Notwithstanding these considerations, the staff applying the prior standard generally did not deem a proposal that otherwise related to a company's ordinary business operations to be excludable where the proposal implicated a policy issue of such significance that it transcended the company's day-to-day business activities. In the significance analysis it conducted in recent years, the staff concentrated on whether the social policy was significant *for the company*.

The Division acknowledged in SLB 14I that determining whether a proposal raised a significant policy issue often required the staff to make difficult judgments regarding the connection between the policy issue and the company's business operations. The staff therefore called on companies to assist it in making these judgments in appropriate cases by involving the board of directors to determine whether a proposal raised a policy issue that was significant for the company. The staff said in SLB 14I that if the board determined that a proposal did not raise a significant policy issue, the company's no-action request to exclude the proposal should include a discussion of the board's analysis of the policy issue and its lack of significance in the company's circumstances.

Subsequently, in SLB 14J, the Division encouraged companies to enhance their discussion of the board's analysis by including in their submission a "delta analysis" that described the differences (or the "delta") between the proposal's specific request and any actions already taken by the company to address the policy issue raised by the proposal, and that explained why, as a result of those actions, the policy issue was not significant for the company. Under this guidance, the matter the staff said it would consider—and the matter it believed the company should address in its discussion of the board's analysis—was whether the company's prior actions had diminished the significance of the policy issue to such an extent that the proposal did not present a policy issue that was significant for the company.

***New guidance on significant policy issues.*** The Division announces in SLB 14L that it has now concluded that under the foregoing approach "an undue emphasis was placed on evaluating the significance of a policy issue to a particular company at the expense of whether the proposal focuses on a significant social policy." In the staff's view, its prior company-specific approach is not effective in preserving the rights of shareholders to bring significant social policy issues before a meeting, and has enmeshed the staff in factual determinations—such as those presented in a board's analysis—that

do not advance the policy objectives underlying the ordinary business exception.

The Division highlights the following elements of the new approach it will follow in evaluating no-action requests under the exception:

- *Focus on broad societal impact of proposal issue*: The staff will "focus on the social policy significance of the issue that is the subject" of the shareholder proposal. In its review, the staff "will consider whether the proposal raises issues with a broad societal impact, such that they transcend the ordinary business of the company." The Division indicates that this emphasis will align the staff's approach with the policy objectives articulated by the Commission in its 1976 and 1988 releases.
- *No focus on significance of company nexus*: The staff "will no longer focus on determining the nexus between a policy issue and the company" in evaluating the significance of the policy issue. The staff's approach thus appears to eliminate consideration of the significance of the issue for the particular company, as opposed to society at large. The Division fleshes out its intention by explaining, for purposes of illustration, that under the approach a company may not exclude a proposal raising human capital management issues with a broad societal impact "solely because the proponent did not demonstrate that the human capital management issue was significant to the company."
- *No role for board analysis*: The shift in approach has clear implications for the documentation of no-action requests. The Division states that it no longer will request companies to include in their submissions a board analysis to support an exclusion determination. The Division has concluded that the company-specific focus of the board analysis, including in particular the "delta" component, may have tended to "distract" the staff from properly applying the exception.

Neither SLB 14L nor the Commission's releases it cites delineate any criteria to help shareholder proponents and companies determine whether a proposal raises an issue with a broad societal impact. The bulletin's references to issues of human capital management and climate change, however, identify two types of issues that presumably will be considered socially significant. The SEC's no-action file on environmental, social, and governance (ESG) proposals, particularly for the last few years, also can be consulted to identify likely candidates for this treatment.

### *Consideration of micromanagement claims*

The ordinary business exception also rests on the assumption that proposals that seek to "micromanage" the company's operations inappropriately probe into complex matters on which shareholders generally are unable to make an informed judgment, even if the subject matter of the proposal is not an improper one for shareholder oversight. Micromanagement amounts to "ordinary business" that justifies exclusion of the proposal under this exception.

***Prior guidance on micromanagement claims.*** In SLB 14J the Division clarified the basis on which it then evaluated claims that a proposal sought to micromanage a company and therefore was excludable. The staff used as its framework the Commission's statement that a proposal entails micromanagement if it "involves intricate detail, or seeks to impose specific time-frames or to impose specific methods for implementing complex policies." In applying this framework, the staff focused on the manner in which the proposal sought to address an issue, and looked both at the nature of the proposal and the circumstances of the company to which the proposal was addressed.

The Division subsequently amplified this guidance by explaining in SLB 14K that it evaluated micromanagement claims in light of the "level of prescriptiveness" with which a proposal approaches its subject matter. An overly prescriptive proposal could unduly limit the flexibility of management and the board to manage complex matters. Echoing the Commission's 1988 guidance, the staff said that it might concur with an exclusion determination if the proposal sought "intricate detail" or imposed "a specific strategy, method, action, outcome or timeline for addressing an issue."

***New guidance on micromanagement claims.*** The Division expresses the view in SLB 14L that the staff's evaluation of micromanagement claims under the rescinded bulletins "expanded the concept of micromanagement beyond the Commission's policy directives" and that this approach may mistakenly "have been taken to mean that any limit on company or board discretion constitutes micromanagement."

SLB 14L outlines the following contours of the approach the Division believes will restore an appropriate standard for evaluating micromanagement claims:

- *Focus on "granularity" of limits to discretion*: The staff will continue to consider whether a proposal would have the effect of inappropriately" limiting company discretion in pursuing corporate policies or goals. In its consideration, the staff will "focus on the level of granularity sought in the proposal," since excessive detail could represent an impermissible effort to direct management on how to achieve a particular corporate result. The staff will expect the level of detail "to be consistent with that needed to enable investors to assess an issuer's impacts, progress toward goals, risks or other strategic matters appropriate for shareholder input."
- *No reliance on per se indicators*: Under the new standard, and consistent with the Commission's 1988 guidance, the Division affirms that "specific methods, timelines, or detail" contained in a proposal will not necessarily constitute micromanagement. The staff will eschew a focus on *per se* indicators of micromanagement in favor of a "measured" analysis that considers whether the proposal provides management with appropriate "high-level direction on large strategic corporate matters" or seeks to fetter management's discretion with an unduly detailed set of requirements.

  The Division invokes the Commission's statement in its 1988 release that in appropriate contexts proposals may include detail as to "time-frames or methods" without micromanaging the company. The Commission observed that timing questions "could involve significant policy where large differences are at stake," in which case "proposals may seek a reasonable level of detail" on timing matters. The Division follows up this guidance by stating that the staff no longer will concur with the exclusion of climate change proposals on micromanagement grounds because they suggest "targets or timelines," so long as "the proposals afford discretion to management as to how to achieve such goals."
- *Review of ability of investors to evaluate matters*: The Division suggests it will review more closely company claims that proposals probe matters "too complex" for shareholders as a group to make an informed judgment. In considering whether shareholders are "well-equipped to evaluate" a particular matter, the staff says it "may" consider such factors as the "sophistication" of investors generally on the matter, references in the proposal to "well-established national or international frameworks when assessing proposals relating to disclosure, target setting, and timeframes" (which are abundant for many ESG matters), the availability of data, and "the robustness of public discussion and analysis" of the matter.

Although the Division's discussion of the new approach to evaluating micromanagement claims highlights its potential application to climate change proposals, the Division underscores that the approach "may apply to any subject matter."

## New guidance on economic relevance exception

In SLB 14L the Division states that the staff will return to an earlier approach for determining whether a company may rely on Rule 14a-8(i)(5) to exclude from its proxy materials a shareholder proposal on the basis of the economic relevance exception.

***Prior guidance on evaluating economic relevance.*** The economic relevance exception permits a company to exclude from its proxy materials a proposal that (1) relates to operations accounting for less than five percent of the company's total assets at the end of its most recent fiscal year, and for less than five percent of its net earnings and gross sales for its most recent fiscal year, and (2) is "not otherwise significantly related to the company's business."

The Division clarified in SLB 14I that if a proposal related to operations that accounted for less than five percent of the company's total assets, net earnings, and gross sales, the staff would assess whether the proposal was "significantly related" to the company's business. If the proposal was not significantly related to the company's business, the company could exclude it.

The Division further observed in SLB 14I that the analysis of any policy issue's significance to a company's business would depend on the circumstances of the individual company, rather than on the importance of the issue "in the abstract." Therefore, an issue might be significantly related to the business of one company but not to the business of another. The staff emphasized that, as with an evaluation of the significance of a policy issue in the context of the ordinary business exception, determining whether a proposal is "otherwise significantly related to the company's business" could involve difficult judgments. Accordingly, consistent with its guidance on the ordinary business exception,

the staff indicated that a company's no-action request under Rule 14a-8(i)(5) should disclose the board's analysis of the proposal's significance to the company's business.

***New guidance on evaluating economic relevance.*** The Division states in SLB 14L that it no longer will approve exclusion under the economic relevance exception of proposals that "raise issues of broad social or ethical concern related to the company's business" solely because the proposals relate to operations that fall below the economic thresholds of Rule 14a-8(i)(5). The staff characterizes the new approach as a return to the analysis it pursued before the adoption of SLB 14I.

SLB 14L does not expressly state that the staff no longer will consider whether the proposal is "significantly" related to the company's business. It appears from the context of the guidance, however, that the staff's intention is to untether the exclusion determination from any analysis of significance for the company's business, as it will under the ordinary business exception. The new standard refers to relevant proposals simply as those that raise issues "related" to the company's business, without any mention of significance. Further, SLB 14L rescinds the legal bulletin that elevated the significance analysis as a component of the staff's no-action review. In addition, the Division notes that, in light of the revised framework, companies will not be requested to submit a board analysis to support their no-action request.

## Procedural requirements for submission of proposals

The Division also uses SLB 14L to reiterate and update prior guidance on compliance with procedural requirements governing the submission of shareholder proposals and to address the use of e-mail by shareholder proponents and companies in their Rule 14a-8 communications.

### *Use of images in shareholder proposals*

The Division addresses the provision of Rule 14a-8(d) that permits the exclusion of a proposal that, when combined with any supporting statement, exceeds 500 words. The rule does not address whether graphs or other images may be included in a proposal and whether the inclusion of a graph or image is considered in evaluating compliance with the 500-word limit. The Division confirms its guidance in rescinded SLB 14I that:

- the inclusion of graphs or other images in a proposal will not serve as a standalone basis under Rule 14a-8(d) for excluding the proposal; and
- any words that are contained in the graph or other image will count towards the 500-word limit.

The Division reiterates its guidance in the prior bulletin that the potential for abuse in shareholder proponents' use of graphs and other images may be addressed through other provisions of Rule 14a-8.

### *Proof-of-ownership letters*

The Division updates the guidance it issued in Staff Legal Bulletin 14F (SLB 14F) and SLB 14K regarding company practice in contesting the sufficiency of shareholders' proof of ownership of securities for purposes of establishing eligibility under Rule 14a-8(b) to submit a proposal.

The staff repeats its prior admonition to companies not to apply "an overly technical reading" of proof-of-ownership letters submitted by shareholder proponents as a means of excluding proposals. The staff says that it will continue to apply—and expects companies to apply—a "plain meaning approach" to determining whether the ownership letter satisfies the rule's requirements. For this purpose, it should be sufficient "if the language used in such letter is clear and sufficiently evidences the requisite minimum ownership requirements."

The Division updates the suggested form of proof-of-ownership letter it published in SLB 14F in order to reflect changes in submission requirements adopted in 2020, including the introduction of tiered minimum ownership levels based on length of ownership. In its guidance, the Division suggests the following formulation: "As of [date the proposal is submitted], [name of shareholder] held, and has held continuously for at least [one year] [two years] [three years], [number of securities] shares of [company name] [class of securities]." The Division clarifies that proponents and their brokers and banks are encouraged to use this sample language, but are not required to do so, and that "drafting variances" from the sample language do not provide a basis for excluding a proposal if the language sufficiently evidences the required ownership.

The Division indicates that companies should identify any specific defects in the proof-of-ownership letter even if the company sent a deficiency notice to the shareholder proponent before receiving the proponent's proof of ownership, if the deficiency notice does not identify the defects.

The Division explains that it is sufficient under the 2020 rule amendments for brokers or banks submitting a proof-of-ownership letter on behalf of a shareholder proponent to provide confirmation of the number shares held continuously by the proponent. The broker or bank is not required separately to calculate the share valuation, which may be directly provided by the shareholder proponent to the company.

### *Use of e-mail communications*

The Division recommends that companies and shareholder proponents observe procedures suitable for proving receipt and time of receipt of e-mail communications for purposes of Rule 14a-8, including use of reply e-mails or other techniques to confirm receipt of a communication. The staff emphasizes the importance of establishing timely delivery of a proposal, a deficiency notice by the company, and the shareholder proponent's response to a deficiency notice. The Division encourages shareholder proponents to contact the company to obtain the company's e-mail address if one is not included in the company's proxy statement, and encourages the company to provides its e-mail address upon such a request.

## Looking ahead

SLB 14L represents a noteworthy change to the approach the Division has used in recent years to evaluate Rule 14a-8's ordinary business and economic relevance exceptions. The Division signals that it believes the staff during this period has applied inappropriately permissive standards in approving exclusion determinations under the exceptions. The Division intends to re-position its standards to achieve a better alignment with the Commission's policy objectives.

The new standards promise to narrow the grounds for exclusion of many proposals that raise ESG issues by focusing the analysis on whether the issues have a broad societal impact. With the elimination of the company-specific approach in evaluating significance, it is unclear whether the relevance of a proposal's issues to the company will play any meaningful role in the exclusion determination under the exceptions. In a statement on the new guidance, Commissioners Hester Peirce and Elad Roisman observe that SLB 14L leaves unanswered the question of whether the new analysis under the ordinary business exception will require inclusion of any proposal the staff deems to involve a socially significant issue.

However the staff refines the scope of the exceptions during the no-action process, the relevance of a proposal to the company's business as a consideration under the new framework appears to have been whittled down to something very modest.

The Division is candid about its expectation that the changes will "streamline" and "simplify" the staff's process for evaluating no-action requests. For the 2022 proxy season, however, quicker staff response times may be diminished by the challenges that will confront the staff in applying the new standards to a rapidly evolving landscape for ESG proposals.

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