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SEC Guidance on Shareholder Proposals and Procedural Requirements

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

In late October the SEC issued its first updated Staff Legal Bulletin on shareholder proposals in years – Staff Legal Bulletin No. 14H ("SLB 14H"). The legal bulletin comes on the heels of the SEC's announcement on January 16, 2015, that it would no longer respond to no-action letters seeking exclusion of shareholder proposals on the grounds that the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders and the same meeting, as further discussed herein. SLB 14H will only allow exclusion of a shareholder proposal if "a reasonable shareholder could not logically vote in favor of both proposals." As a result of the restrictive language in SLB 14H, it is likely that the direct conflict standard will rarely be used as a basis for excluding shareholder proposals going forward. With the publication of SLB 14H, the SEC will once again entertain and review no-action requests under the "direct conflict" grounds for exclusion.

SLB 14H also provides guidance on the allowable exclusion related to proposals that request actions or changes in ordinary business operations, including the termination, hiring or promotion of employees.

Background

The regulation of corporate law rests primarily within the power and authority of the states. However, for public companies, the federal government imposes various corporate law mandates including those related to matters of corporate governance. While state law may dictate that shareholders have the right to elect directors, the minimum and maximum time allowed for notice of shareholder meetings, and what matters may be properly considered by shareholders at an annual meeting, Section 14 of the Securities Exchange Act of 1934 ("Exchange Act") and the rules promulgated thereunder govern the proxy process itself for publicly reporting companies. Federal proxy regulations give effect to existing state law rights to receive notice of meetings and for shareholders to submit proposals to be voted on by fellow shareholders.

All companies with securities registered under the Exchange Act are subject to the Exchange Act proxy regulations found in Section 14 and its underlying rules. Section 14 of the Exchange Act and its rules govern the timing and content of information provided to shareholders in connection with annual and special meetings with a goal of providing shareholders meaningful information to make informed decisions, and a valuable method to allow them to participate in the shareholder voting process without the necessity of being physically present. As with all disclosure documents, and especially those with the purpose of evoking a particular active response, such as buying stock or returning proxy cards, the SEC has established robust rules governing the procedure for, and form and content of, the disclosures.

The underlying premise of an annual or special meeting is that the company is soliciting the shareholders to vote in favor of particular matters, such as particular directors or particular corporate actions. Accordingly, the proxy is prepared by the company, presenting matters the company's board of directors have already approved or recommended for approval and has an underlying goal of getting the shareholder to return a proxy card with a "yes" vote. However, Rule 14a-8 allows shareholders to submit proposals and, subject to certain exclusions, require a company to include such proposals in the proxy solicitation materials even if contrary to the position of the board of directors, and is accordingly a source of much contention.

Rule 14a-8 in particular allows a qualifying shareholder to submit proposals that meet substantive and procedural requirements to be included in the company's proxy materials for annual and special meetings, and provide a method for companies to either accept or attempt to exclude such proposals. State laws in general allow a shareholder to attend a meeting in person and, at such meeting, to make a proposal to be voted upon by the shareholders at large. In adopting Rule 14a-8, the SEC provides a process and parameters for which these proposals can be made in advance and included in the proxy process.

As shareholder activism in general has increased, Rule 14a-8 has been the subject of much debate and controversy. This debate and controversy has expanded exponentially since the SEC adopted amendments to the rule to require a company to include in its proxy materials any proposals from qualifying shareholders that would amend, or request an amendment to, a company's director nomination procedures in its charter documents, as long as such amendment would not conflict with or violate applicable law.

Over the years the SEC has issued guidance on the rule, including Staff Legal Bulletin No. 14 published on July 13, 2001. An entire treatise could be written on Rule 14a-8, including SEC guidance and court interpretation, and this blog is limited to a high-level review. In late October the SEC issued its first updated Staff Legal Bulletin on shareholder proposals in years – Staff Legal Bulletin No. 14H. The legal bulletin comes following and was likely motivated by the SEC's announcement on January 16, 2015, that it would no longer respond to no-action letters seeking exclusion of shareholder proposals on the grounds that the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders and the same meeting. SLB 14H will only allow exclusion of a shareholder proposal if "a reasonable shareholder could not logically vote in favor of both proposals."

Shareholder Proposals – Rule 14a-8

Rule 14a-8 of Regulation 14A permits qualifying shareholders to submit matters for inclusion in the company's proxy statement for consideration by the shareholders at the company's annual meeting. The rule itself is written in "plain English" in a question-and-answer format designed to be easily understood and interpreted by shareholders relying on and using the rule. Other than based on procedural deficiencies, if a company desires to exclude a particular shareholder process, it must have substantive grounds for doing so.

Shareholder Qualification and Procedure

Procedurally to qualify to submit a proposal, a shareholder must:

- Continuously hold a minimum of $2,000 in market value or 1% of the company's securities entitled to vote on the subject proposal, for at least one year prior to the date the proposal, is submitted and through the date of the annual meeting;
- If the securities are not held of record by the shareholder, such as if they are in street name in a brokerage account, the shareholder must prove its ownership by either providing a written statement from the record owner (i.e., brokerage firm or bank) or by submitting a copy of filed Schedules 13D or 13G or Forms 3, 4 or 5 establishing such ownership for the required period of time;
- If the shareholder does not hold the requisite number of securities through the date of the meeting, the company can exclude any proposal made by that shareholder for the following two years;
- Provide a written statement to the company that the submitting shareholder intends to continue to hold the securities through the date of the meeting;
- Clearly state the proposal and course of action that the shareholder desires the company to follow;
- Submit no more than one proposal for a particular annual meeting;
- Submit the proposal prior to the deadline, which is 120 calendar days before the anniversary of the date on which the company's proxy materials for the prior year's annual meeting were delivered to shareholders, or if no prior annual meeting or if the proposal relates to a special meeting, then within a reasonable time before the company begins to print and send its proxy materials;
- Attend the annual meeting or arrange for a qualified representative to attend the meeting on their behalf – provided, however, that attendance may be in the same fashion as allowed for other shareholders such as in person or by electronic media;
- If the shareholder or their qualified representative fail to attend the meeting without good cause, the company can exclude any proposal made by that shareholder for the following two years;
- The proposal, including any accompanying supporting statement, cannot exceed 500 words. If the proposal is included in the company's proxy materials, the statement submitted in support thereof will also be included.

A proposal that does not meet the procedural requirements may be excluded by the company. To exclude the proposal on procedural grounds, the company must notify the shareholder of the deficiency within 14 days of receipt of the proposal and allow the shareholder to cure the problem. The shareholder has 14 days from receipt of the deficiency notice to cure and resubmit the proposal. If the deficiency could not be cured, such as because it was submitted after the 120-day deadline, no notice or opportunity to cure must be provided.

Company Response to Shareholder Proposal

Upon receipt of a shareholder proposal, a company has many options. The company can elect to include the proposal in the proxy materials. In such case, the company may make a recommendation to vote for or against the proposal, or not take a position at all and simply include the proposal as submitted by the shareholder. If the company intends to recommend a vote against the proposal (i.e., Statement of Opposition), it must follow specified rules as to the form and content of the recommendation. A copy of the Statement of Opposition must be provided to the shareholder no later than 30 days prior to filing a definitive proxy statement with the SEC.

If included in the proxy materials, the company must place the proposal on the proxy card with check-the-box choices for approval, disapproval or abstention.

The company may seek to exclude the proposal based on procedural deficiencies, in which case it will need to notify the shareholder and provide a right to cure as discussed above. The company may also seek to exclude the proposal based on substantive grounds, in which case it will may file a no-action letter with the SEC seeking confirmation of its decision and provide a copy of the letter to the shareholder as further discussed below. The company may also seek to exclude the proposal on the grounds of conflict if it follows the procedures set out in the new SLB 14H also as discussed below.

Finally, the company may meet with the shareholder and provide a mutually agreed upon resolution to the requested proposal. According to the 2014 Annual Corporate Governance Review released by Georgeson, Inc., approximately 43% of the proposals submitted by shareholders in 2014 were later withdrawn or omitted from the proxy statement and not considered at the annual meeting as a result of these negotiations.

Substantive Requirements and Grounds for Exclusion

If a company seeks to exclude a proposal based on most of the substantive grounds (other than direct conflict under Rule 14a-8(i)(9)), it must seek concurrence from the SEC by utilizing the SEC no-action letter process. That is, the company must submit a no-action letter to the SEC explaining the reasons for excluding the proposal and seeking confirmation that the SEC will not consider the exclusion a violation of Rule 14a-8. The letter must be submitted no later than 80 days prior to filing a definitive proxy statement with the SEC. The shareholder must be provided a copy of the no-action letter submittal and such shareholder has the opportunity to reply to the company and the SEC. The SEC may require agreement with the company's request to exclude the proposal, require unconditional inclusion of the proposal, or provide for shareholder revision of the proposal as a condition to requiring its inclusion.

The company faces the burden of proving that a particular shareholder proposal may be excluded from the proxy materials. In the no-action process, the SEC will only consider the facts, arguments and information submitted by the company, so it is very important that a company work with company counsel to ensure a comprehensive submittal. Like the registration process, the SEC bases its determination on the disclosure and ultimate information that will be provided to shareholders in proxy statements, as opposed to the underlying merits of the requested shareholder proposal. Moreover, the decision by the SEC in the no-action process is as to whether they would pursue enforcement against the company for a violation of Rule 14a-8 for an exclusion of the proposal, but is not otherwise binding on the company or shareholder.

On January 16, 2015, the SEC announced that it would no longer respond to no-action letters seeking exclusion of shareholder proposals on the grounds that the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders and the same meeting. With the publication of SLB 14H, the SEC will once again entertain and review no action requests under the "direct conflict" grounds for exclusion.

Rule 14a-8 provides many substantive grounds in which a company may exclude a proposal from the proxy, including if:

- The proposal is not a proper subject for shareholder vote in accordance with state corporate law;
- The proposal would bind the company to take a certain action as opposed to recommending that the board of directors or company take a certain action;
- The proposal would cause the company to violate any state, federal or foreign law, including other proxy rules;
- The proposal would cause the company to publish materially false or misleading statements in its proxy materials;
- The proposal relates to a personal claim or grievance against the company or others or is designed to benefit that particular shareholder to the exclusion of the rest of the shareholders;
- The proposal relates to immaterial operations or actions by the company in that it relates to less than 5% of the company's total assets, earnings, sales or other quantitative metrics;
- The proposal requests actions or changes in ordinary business operations, including the termination, hiring or promotion of employees, provided, however, that proposals may relate to succession planning for a CEO (I note this exclusion right has also been the subject of controversy and litigation and is discussed in SLB 14H);
- The proposal requests that the company take action that it is not legally capable of or does not have the legal authority to perform;
- The proposal seeks to disqualify a director nominee or specifically include a director for nomination;
- The proposal seeks to remove an existing director whose term is not completed;
- The proposal questions the competence, business judgment or character of one or more director nominees;
- The company has already substantially implemented the requested action;
- The proposal is substantially similar to another shareholder proposal that will already be included in the proxy materials;
- The proposal is substantially similar to a proposal that was included in the company proxy materials within the last five years and received fewer than a specified number of votes;

- The proposal seeks to require the payment of a dividend; or
- The proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting.

Staff Legal Bulletin No. 14H

SLB 14H addresses the controversial "direct conflicts" standard for excluding shareholder proposals and provides guidance on the "ordinary business operations" exclusion.

SLB 14H – Direct Conflicts Standard for Exclusion

Beginning in 2009 there has been a substantial increase in proposals and company counterproposals that conflict. In particular, for example, a shareholder could request that the company amend its bylaws to permit shareholders holding 10% of the outstanding stock to hold a special meeting and a company could counter with its own proposal setting a 25% or some other threshold. The company could then seek to exclude the shareholder proposal as conflicting with its own on the same subject.

Last year Whole Foods sought to exclude a shareholder proposal that would allow shareholders owning at least 3% of the outstanding stock for at least 3 years to nominate up to 20% of the directors but no fewer than 2. Whole Foods responded with its own proposal allowing any shareholder that owned at least 9% of the outstanding stock for at least 5 years to nominate 10% of the directors but no fewer than 1. The SEC supported Whole Foods and the shareholder sought reconsideration. The SEC then decided not to address any exclusion requests related on conflicting proposals, including that of Whole Foods. In other words, the SEC bowed out of the fight altogether and spent some time considering its policy. SLB 14H articulates that consideration.

The SEC will only allow exclusion "if a reasonable shareholder could not logically vote in favor of both proposals." With the publication of SLB 14H, the SEC will once again entertain and review no-action requests under the "direct conflict" grounds for exclusion, with no-action relief only being granted if a reasonable shareholder could not logically vote in favor of both proposals.

The SEC's view is that the "direct conflict" right to exclude a shareholder proposal is intended to prevent shareholder proposals that, if voted on along with a management proposal, "could present alternative and conflicting decisions for the shareholders and create the potential for inconsistent and ambiguous results." SLB 14H continues to state that "…we believe that a direct conflict would exist if a reasonable shareholder could not logically vote in favor of both proposals, i.e., a vote for one proposal is tantamount to a vote against the other proposal." The SEC admits that the burden to exclude proposals articulated in SLB 14H is likely higher than they had historically been requiring in the no-action process. As a result of this higher burden, it is generally believed by practitioners that the direct conflict basis for exclusion will rarely be used.

However, the bulletin does give four examples of application of the new standard for review of such direct conflicts. In particular, a direct conflict would exist where: (i) a company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger; and (ii) a shareholder proposal that asks for the separation of the company's chairman and CEO would directly conflict with a management proposal seeking approval of a bylaw provision requiring the CEO to be the chair at all times. Conversely, examples of where no direct conflict would exist include: (i) "a company does not allow shareholder nominees to be included in the company's proxy statement, 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 3 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 5 years to nominate for inclusion in the company's proxy statement 10% of the directors" and (ii) "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 SEC provides guidance on how a company can manage potentially confusing and conflicting proposals that do not rise to the high standard of a direct conflict to support exclusion. In particular, footnote 22 to SLB 14H states: "[W]here a shareholder proposal is not excluded and companies are concerned that including proposals on the same topic could potentially be confusing, we note that companies can, consistent with Rule 14a-9, explain in the proxy materials the differences between the two proposals and how they would expect to consider the voting results. As always, we expect companies and proponents to respect the Rule 14a-8 process and encourage them to find ways to constructively resolve their differences."

SLB 14H – "Ordinary Business Operations" Standard for Exclusion

SLB 14H provides guidance on the "ordinary business operations" exclusion. Rule 14a-8(i)(7) allows the exclusion of a shareholder proposal where the proposal requests actions or changes in ordinary business operations, including the termination, hiring or promotion of employees, provided, however, that proposals may relate to succession planning for a CEO. The "ordinary business operations" basis for exclusion has also been the subject of debate and adversarial proceedings.

In the recent Trinity Wall Street v. Wal-Mart Stores, Inc. ruling by the U.S. District Court in Delaware, the shareholder proposal requested that the board assign a committee the responsibility of "overseeing the formulation, implementation, and public reporting of policies that determine whether the company should sell a product that especially endangers public safety and well-being, has the potential to impair the company's reputation, or would be considered offensive to the values integral to the company's brand." The SEC supported the company's exclusion of the proposal as being the subject of ordinary course of business matters; however, the court sided with the shareholder and concluded that the proposal was improperly excluded.

The court found that "because the proposal merely sought board oversight of the development and implementation of a company policy, leaving day to day aspects of implementation of this policy to the company's officers and employees, the proposal itself did not have the consequence of dictating what products Wal-Mart could sell." The SEC, in contrast, had considered whether the underlying issue involved ordinary business matters and determined in this case that it did. The company appealed the court decision and the court of appeal overruled the Delaware court, supporting both the SEC's no-action decision and Wal-Mart's right to exclude the proposal.

The appellate court agreed with the SEC and Wal-Mart that the proposal's subject matter related to Wal-Mart's ordinary business operations – specifically, "a potential change in the way Wal-Mart decides which products to sell." SLB 14H reiterates that the SEC analysis related to the request to exclude proposals under the ordinary business exclusion focuses on the underlying subject matter of a proposal. The SEC recognizes that it is not always easy to determine if a proposal transcends ordinary business operations and actually relates to significant policy issues, and thus cannot be excluded under the ordinary course of business exclusion rule. That is, even though a shareholder may present a proposal as being one that addresses a significant policy issue, including social policies, the SEC will look beyond that presentation to determine if the proposal is in fact related to ordinary business operations. Summarizing its position, the SEC quotes the court "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business. Rather, a proposal is sufficiently significant 'because' it transcends day-to-day business matters."

I note that although SLB 14H may be attempting to provide further guidance on the subject, the distinction and interrelationship between significant policy decisions and daily business operations remains complex and will continue to be subject to difficult interpretation.

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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