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Recent Developments Related to the SEC's Shareholder Proposal Rule

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Rule 14a-8 of the Securities Exchange Act of 1934, as amended, enables shareholders who own a relatively small amount of stock in a public company to include proposals in that company's proxy materials distributed in connection with its shareholder meetings. Given that most shareholders do not attend shareholder meetings in person, Rule 14a-8 facilitates shareholders' ability under the laws of most states to propose business from the floor at shareholder meetings. Thus, if a shareholder proposal complies with the procedural and substantive requirements in Rule 14a-8, a shareholder holding as little as $2,000 of the company's stock for at least one year can require a company to solicit proxies on the shareholder's proposal.

In recent years, shareholders have submitted almost a thousand shareholder proposals each year on a variety of corporate governance, executive compensation, and social issues. While the overwhelming majority of these proposals are nonbinding, proxy advisory firms and some institutional investors regularly support certain of these proposals and often will later oppose the election of directors who have failed to implement shareholder proposals that received a majority vote.

Not all shareholder proposals submitted to companies are voted on by the shareholders. Some are withdrawn by the proponents, often after dialogue with the company. Others are excluded from the company's proxy materials due to a failure to comply with the procedural requirements in Rule 14a-8 or under the substantive bases for exclusion in that rule. A company that intends to exclude a shareholder proposal based on Rule 14a-8 is required by the rule to "file its reasons" with the staff (the "Staff") of the Securities and Exchange Commission ("SEC" or "Commission"). While not required, as a practical matter most companies ask the Staff to issue a no-action letter concurring that it will not recommend enforcement action against the company if the proposal is excluded from the company's proxy materials for the reasons stated in the no-action request. The Staff responds to these requests to aid companies and shareholders in complying with Rule 14a-8, and in recent years, the Staff has issued 250 to 400 such responses each year. A less common approach by companies is to seek a declaratory judgment in federal court that the proposal may be excluded under Rule 14a-8 (although in recent years some courts have dismissed these suits for lack of subject matter jurisdiction after determining that the possibility of an SEC enforcement action was not certain or immediate enough).

This article discusses three significant Rule 14a-8 developments during the 2015 proxy season that have the potential to change the shareholder proposal landscape for years to come: (1) the proliferation of proxy access shareholder proposals, (2) the Staff's decision to not express its views on the application of Rule 14a-8(i)(9) (one of the 13 substantive bases for exclusion in the Rule) to exclude conflicting shareholder proposals, and (3) the U.S. Court of Appeals for the Third Circuit reversing a district court decision and holding that a shareholder proposal submitted to Wal-Mart Stores, Inc. was excludable under Rule 14a-8.

Proxy Access Shareholder Proposals

"Proxy access" refers to the ability of shareholders to include their nominees for a company's board of directors in the company's proxy materials (including on the proxy card). Shareholders generally have the right under state law to nominate directors for election to a company's board. However, in the absence of proxy access, shareholders must solicit their own proxies

in order for shareholders to be able to vote to elect their director nominees. Proxy access allows shareholders to require a company to solicit proxies on the shareholders' director nominees similar to shareholder proposals submitted under Rule 14a-8.

After debating proxy access for many years, the SEC adopted proxy access rules in 2010, following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which gave the SEC authority to adopt such rules. The SEC both (1) adopted Rule 14a-11, which required companies to permit proxy access for candidates representing up to 25 percent of the board who were nominated by shareholders that own at least 3 percent of a company's shares for at least three years, and (2) amended Rule 14a-8 to permit proxy access shareholder proposals at individual companies, which previously were excludable under Rule 14a-8. The mandatory proxy access rule was vacated by a federal appeals court in 2011 on the grounds that the SEC violated the Administrative Procedure Act in adopting Rule 14a-11. However, the Rule 14a-8 shareholder proposal amendment was not challenged in court and became effective in 2011.

Between 2011 and 2014, only approximately 57 proxy access shareholder proposals were submitted (some tracked Rule 14a-11, and others experimented with different ownership thresholds), and only 10 companies adopted proxy access. Many of these companies faced various corporate governance challenges that led to a majority vote on a nonbinding Rule 14a-8 shareholder proposal asking the company to adopt proxy access.

Then, in late 2014, the New York City comptroller announced the "Boardroom Accountability Project," which involved the submission of approximately 75 nonbinding proxy access shareholder proposals that mirrored Rule 14a-11. Unlike prior proxy access proponents, the comptroller targeted a wide range of companies, including companies that had not faced governance challenges historically. Companies were selected based on three "priority issues": companies contributing to climate change (i.e., coal, oil and gas, and utility companies), companies lacking board diversity, and companies with failed or low "say-on-pay" votes in 2014. The comptroller has stated that the intent of the Boardroom Accountability Project is universal proxy access since the SEC has not reproposed a mandatory proxy access rule.

The comptroller's proposals requested that a company's board adopt and present for shareholder approval a bylaw that would require the company to include in its proxy materials the names of director candidates nominated by a shareholder (or group of shareholders) that owned at least 3 percent of the company's shares for at least three years. These proposals also asked that the number of proxy access nominees not exceed 25 percent of the board. In addition, other shareholder proponents submitted approximately 33 similar non-binding proxy access proposals for consideration at 2015 annual meetings.

The impact of the comptroller's campaign has been dramatic. As of mid-June, proxy access shareholder proposals have received a majority of votes cast at 46 of the 78 companies holding votes to date in 2015, with support averaging 55.5 percent of votes cast. In addition, during 2015 through mid-June, 37 companies – including large cap companies such as General Electric and Bank of America – have either adopted or announced that they intend to adopt proxy access, largely in response to receiving a proxy access shareholder proposal. Prudential Financial, which did not receive a proxy access shareholder proposal, also adopted proxy access in March 2015. Looking forward, as a result of the momentum of the comptroller's campaign, public companies are likely to continue receiving proxy access shareholder proposals for consideration at late 2015 and 2016 annual meetings. Companies that determine to adopt proxy access may be able either to avoid receiving or to negotiate the withdrawal of these shareholder proposals, or may be able to exclude the proposal as "substantially implemented" under Rule 14a-8(i)(10) (although, based on Staff no-action letter precedent, the terms of the company's proxy access bylaw would need to closely mirror the terms in the shareholder proposal).

At companies considering proxy access shareholder proposals, much of the debate has concerned the scope of any proxy access right, including the minimum percentage of outstanding shares and the minimum holding period that a nominating shareholder must satisfy, whether to limit the number of shareholders that can aggregate their shares to meet the ownership requirements, and the number of proxy access nominees permitted. Imposing eligibility requirements (such as higher share ownership thresholds and limits on the number of shareholders that can aggregate their shares) may mitigate some of the risks associated with proxy access. These risks include the costs and distractions involved in a proxy contest, the potential disruption of board composition and dynamics, and the potential impact on a company's ability to attract new director candidates. However, some will view more lenient eligibility requirements as representing increased responsiveness to shareholders who support proxy access.

Suspension of Rule 14a-8(i)(9) No-Action Letters

Rule 14a-8(i)(9) permits a company to exclude a shareholder proposal if the proposal "directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting." The Staff historically has recognized that "directly conflicts" does not mean that two "proposals must be identical in scope or focus." SEC Release No. 34-40018 (May 21, 1998). However, the Staff has limited the application of Rule 14a8(i)(9) to circumstances where a company can show that including a shareholder proposal in the company's proxy materials along with a company proposal would (as expressed in no-action letters) "present alternative and conflicting decisions for shareholders and that submitting both proposals to a vote could provide inconsistent and ambiguous results." For example, shareholder proposals requesting that shareholders owning 10 percent of a company's shares be permitted to call special shareholder meetings

have consistently been excluded under Rule 14a-8(i)(9) where the company proposed for shareholder approval at the same meeting a higher (e.g., 25 percent) ownership threshold.

Rule 14a-8(i)(9) did not generate significant criticism until late 2014, when Whole Foods Market became the first of 26 companies to seek to rely on the rule to exclude proxy access shareholder proposals from proxy materials for 2015 shareholder meetings. In its no-action request, Whole Foods stated that it would seek shareholder approval at its 2015 meeting of a proxy access bylaw with a more restrictive ownership provision (9 percent/5-year threshold to be satisfied by a single shareholder, as compared to the shareholder proposal's request for a 3 percent/3-year threshold that could be satisfied by multiple shareholders) and would only allow nominations for up to 10 percent of the company's directors. In early December 2014, the Staff issued a no-action letter agreeing that Whole Foods' proxy access shareholder proposal could be excluded under Rule 14a-8(i)(9) due to the company's conflicting proposal. Public pension funds and other shareholders objected to the decision because of both the restrictive nature of Whole Foods' proxy access proposal and because it portended the likely exclusion of at least 25 other proxy access shareholder proposals. In an early January 2015 letter to the Staff, the Council of Institutional Investors criticized the Staff's interpretation as "overly broad and inconsistent with the purpose of" Rule 14a-8(i)(9).

On January 16, 2015, SEC Chair Mary Jo White announced that she was directing the Staff to review Rule 14a-8(i)(9) and report to the Commission on its review. Chair White's announcement cited recent "questions that have arisen about the proper scope and application of Rule 14a-8(i)(9)." Simultaneously, the Staff announced that it would no longer express views during the 2015 proxy season on the application of Rule 14a8(i)(9), pending completion of the requested study. The Staff then reversed the Whole Foods no-action letter and notified each company that had a pending Rule 14a-8(i)(9) no-action request that it would not express any view on exclusion under that rule. The Staff's decision was not limited to proxy access shareholder proposals, meaning that the Staff also declined to issue 26 no-action letters regarding shareholder proposals that historically were excluded under Rule 14a-8(i)(9), including allowing shareholders to call special meetings, adopting clawback policies and eliminating supermajority voting requirements.

Chair White has acknowledged the "not insignificant consternation" regarding the suspension of Rule 14a-8(i)(9) no-action letters and expressed understanding regarding the frustration of companies that had anticipated relying on the rule. But she added that her directive "was driven by a deeper concern that the application of (i)(9), as originally interpreted by the [S]taff, could result in unintended consequences and potential misuse of our process." In a February speech, Keith Higgins, Director of the Division of Corporation Finance, indicated that the Staff would consider as part of its review questions related to when a proposal is conflicting and whether companies need to disclose to shareholders when they have excluded a conflicting shareholder proposal.

The Staff's decision to express no view on the exclusion of shareholder proposals under Rule 14a-8(i)(9) put companies considering a conflicting company proposal in a difficult position late in the proxy season. These companies had the option to seek a declaratory judgment from a federal district court that the shareholder proposal was excludable (although no companies have done so to date), or exclude the shareholder proposal in reliance on past Staff precedent. However, the Council of Institutional Investors and others warned companies that either action could lead to negative shareholder reaction. Of the companies that challenged a proposal through the SEC's no-action letter process solely on the grounds of Rule 14a-8(i)(9), most (22 companies) subsequently decided to include the shareholder proposal in the company's proxy materials and recommend that shareholders vote "against" it. In addition, (1) 10 companies included both the shareholder proposal and a conflicting company proposal in their proxy materials, (2) six companies negotiated the withdrawal of the shareholder proposal, (3) four companies both included the shareholder proposal in their proxy materials with a recommendation that shareholders vote "against" it and adopted measures conflicting with those called for in the shareholder proposal, and (4) four companies included the shareholder proposal in their proxy materials and recommended that shareholders vote "for" it.

In the proxy access context, seven companies included both the shareholder proposal and a company proxy access proposal in the same proxy materials. Two of these company proposals were binding bylaw amendments, while the other five were nonbinding proposals that would not automatically implement proxy access if approved. With respect to the binding company proposals, one company's proposal was defeated while the shareholder proposal was approved, and, at the other company, both the company and shareholder proposals were defeated. At three of the five companies submitting a nonbinding proposal, the company proposal was approved and the shareholder proposal was defeated. Conversely, at the other two companies, the company proposal was defeated and the shareholder proposal was approved.

The Staff's review of its application of Rule 14a-8(i)(9) is ongoing. The Staff has received numerous comment letters related to its review, including from Business Roundtable, California Teachers' Retirement System, California Public Employees' Retirement System, Council of Institutional Investors, several New York City public pension funds, the Society of Corporate Secretaries and Governance Professionals, and several law firms that represent companies in the shareholder proposal no-action letter process. It remains unclear what, if any, changes the Staff will make to its interpretation of Rule 14a8(i)(9), and whether the Commission and Staff process will be completed in advance of the 2016 proxy season.

Shareholder Proposal Litigation

The history of shareholder proposal litigation is limited; however, in recent proxy seasons there has been an increase in litigation

related to shareholder proposals, primarily by companies seeking declaratory judgments to exclude proposals. Some shareholder proposal litigation also has been initiated by shareholders, including, as discussed below, a closely watched lawsuit against Wal-Mart, which omitted a shareholder proposal from its 2014 proxy materials after the Staff issued a 2014 no-action letter concurring with the exclusion of the proposal under Rule 14a-8(i)(7).

A three judge panel of the U.S. Court of Appeals for the Third Circuit unanimously ruled on April 14, 2015, that the shareholder proposal submitted by Trinity Wall Street, a religious organization, was excludable under Rule 14a-8. *See Trinity Wall Street v. Wal-Mart Stores, Inc.*, No. 14-4764, 2015 WL 1905766 (3d Cir. Apr. 14, 2015). The Third Circuit's decision reversed a November 2014 decision by the U.S. District Court for the District of Delaware. *Trinity Wall Street v. Wal-Mart Stores, Inc.*, No. 14-405-LPS, 2014 WL 6790928 (D. Del. Nov. 26, 2014). The Third Circuit expedited its ruling in light of Wal-Mart's looming proxy printing deadline and stated that it would issue an opinion explaining its ruling at a later time.

[Note: On July 6, 2015, shortly before publication of this article, the Third Circuit released its opinion. All three judges on the Third Circuit panel agreed that the shareholder proposal was excludable from Wal-Mart's proxy materials under Rule 14a-8(i)(7), but the opinion of the court authored by Judge Ambro and a concurring opinion authored by Judge Shwartz reflect differing conceptions of the significant policy exception to the Rule 14a-8(i)(7) ordinary business exclusion. Judge Vanaskie joined in Judge Shwartz's further holding that the proposal was excludable under Rule 14a-8(i)(3) because it is vague, while Judge Ambro opted not to reach the issue.]

Trinity submitted the shareholder proposal for consideration at Wal-Mart's 2014 annual shareholders' meeting. The proposal sought to amend Wal-Mart's Compensation, Nominating and Governance Committee's charter to provide for "oversight" concerning the "formulation and implementation" of "policies and standards that determine whether or not the Company should sell a product" that has "the substantial potential to impair the reputation of the Company," including products that endanger "public safety and well-being," or that could be considered "offensive" to "family and community values." The proposal's supporting statement indicated that the requested duties would extend to determining whether to sell "guns equipped with magazines holding more than ten rounds of ammunition ('high capacity magazines')."

Under the SEC's proxy rules, a company is not required to include in its proxy materials shareholder proposals relating to the company's ordinary business operations pursuant to Rule 14a-8(i)(7). Wal-Mart obtained, in March 2014, a no-action letter from the Staff, which concurred that the proposal was excludable under Rule 14a-8(i)(7) because it related to the products sold by Wal-Mart. Trinity then filed suit in federal district court in Delaware in April 2014 seeking to enjoin Wal-Mart from distributing its 2014 proxy materials without including Trinity's proposal. The district court denied Trinity's motion for a preliminary injunction, finding that, given the proposal's focus on the products Wal-Mart sells, Trinity failed to establish a likelihood of success on the merits of its claim that the proposal was not excludable under Rule 14a-8(i)(7).

After Wal-Mart distributed its 2014 proxy materials, Trinity amended its complaint to seek declaratory relief as to the omission of its proposal from the 2014 proxy materials, as well as prospective relief based on Trinity's intent to resubmit the proposal for inclusion in the 2015 proxy materials. Both Wal-Mart and Trinity subsequently filed cross motions for summary judgment, with Wal-Mart also arguing that the proposal was excludable under Rule 14a-8(i)(3) because, given the "subjectivity and ambiguity of key terms in the [p]roposal" such as "values" and "family or community," it was so vague and indefinite that "neither the [shareholders] voting on the proposal, nor the company in implementing the proposal (if adopted), would be able to determine with any reasonable certainty exactly what actions or measures the proposal requires."

Following oral argument, on November 26, 2014, the district court granted summary judgment in Trinity's favor, ruling that the proposal was not excludable under either Rule 14a-8(i)(7) or Rule 14a-8(i)(3) and enjoining Wal-Mart from distributing its 2015 annual meeting proxy materials without including Trinity's proposal. Although Wal-Mart argued that Trinity's proposal related to the products it sells, the district court held that the proposal was "best viewed as dealing with matters that are not related to Wal-Mart's ordinary business operations" because it does not dictate to management, but instead "seeks to have Wal-Mart's Board oversee the development and effectuation of a Wal-Mart policy."

Wal-Mart appealed the district court's decision, arguing that it would "leave the Rule 14a-8(i)(7) ordinary business exclusion in tatters" by creating "what amounts to a board action exception to Rule 14a-8(i)(7), notwithstanding the SEC's plain guidance that no such exception exists." In this regard, during Rule 14a-8 rulemaking in 1976, the SEC rejected a proposed standard under which shareholder proposals involving matters to be handled by management without referral to the board generally would be excludable, while proposals involving "matters that would require action by the board would not be." In addition, Wal-Mart argued that the proposal was excludable under Rule 14a-8(i)(3) as vague and indefinite because key terms were undefined, subjective, and ambiguous. The appeal attracted numerous amicus briefs on both sides, including briefs from major corporate trade associations on behalf of Wal-Mart and a group of law professors and several antigun activists on behalf of Trinity. After the Third Circuit reversed the district court's decision on April 14, 2015, Wal-Mart distributed its 2015 proxy materials without including Trinity's proposal.

The district court's decision and the Third Circuit's reversal generated substantial debate on a number of important issues, including the scope of the ordinary business exclusion under Rule 14a-8(i)(7) and the SEC's no-action letter process. The liti-

gation also demonstrated that shareholders – like companies – may use litigation as an alternative to the no-action letter process.

Conclusion

These developments demonstrate the continued evolution of the shareholder proposal process. With the momentum gained during the 2015 proxy season, proxy access is likely to remain at the forefront and continue to evolve in coming proxy seasons. With respect to the Staff's ongoing review of Rule 14a-8(i)(9), it remains unclear how it will affect both the application of the Rule going forward and the perceived viability of the no-action letter process. Finally, the proceedings in *Trinity Wall Street v. Wal-Mart Stores, Inc.* demonstrate the increasing role of litigation in the shareholder proposal process, and looking forward, the Third Circuit's opinion provides additional guidance on the scope of the ordinary business exclusion.

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