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Corporate Governance Update: Shareholder Proposals in an Era of Reform

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Securities and Exchange Commission Chair Jay Clayton has emphasized that corporate governance rulemaking under his leadership will be designed to maximize the long-term interests of the retail shareholder. On several occasions over the past year, Chairman Clayton has indicated that the shareholder proposal process is in need of reform, as it is an area in which the SEC can reduce the costs currently borne by—in Chairman Clayton’s terms—“the quiet shareholder, the ordinary shareholder” on behalf of the “idiosyncratic interests” of a louder few. New SEC guidance released this month begins this process by elevating the role of boards in evaluating shareholder proposals for exclusion under Rule 14a-8. Staff Legal Bulletin 14I represents a meaningful change in the way certain shareholder proposals are addressed by boards of directors and reviewed by the SEC staff, with the potential for significant improvement in both process and results. SLB 14I should be a valuable tool for companies to minimize unnecessary costs of the shareholder proposal process while still ensuring that worthwhile proposals will be presented for shareholder consideration. While further reform of the 14a-8 regime is necessary, SLB 14I is an important development in the right direction.

The Need for Reform

This summer, the Chamber of Commerce’s Center for Capital Markets Competitiveness urged reform of the current shareholder proposal process, characterizing the status quo as “yet another burden on companies and their shareholders that only serves to make the public company model less attractive.” The Chamber observed that the shareholder proposal

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system's protections for ordinary shareholders have weakened over time, with the result that the process "has unnecessarily devolved into a mechanism that a minority of interests use to advance idiosyncratic agendas that come at the expense of other shareholders." Recent data support this view. According to a Manhattan Institute report, half of all shareholder proposals submitted in 2016 addressed a social or policy-related matter, rather than a topic relevant to the long-term performance of the company. The same report found that six individual investors were responsible for one-third of all shareholder proposals in 2016, and 38 percent of the proposals were sponsored by institutional investors with an explicit social, religious, or policy agenda. In other words, the shareholder proposal process has been a costly tool used by few with little-to-no benefit for the majority of investors.

Both the Business Roundtable and the Chamber of Commerce have advocated for changes to the no-action process for excluding 14a-8 shareholder proposals. They cite a lack of clarity and consistency in the criteria for exclusion, and they criticize the narrowness of currently available grounds for exclusion. Both organizations call for the reversal of Staff Legal Bulletin 14H, which followed the SEC's controversial *Whole Foods* no-action decision in 2015 and dramatically limited the exclusion available for shareholder proposals that are in "direct conflict" with company proposals. The Business Roundtable's statement pointed out that this decision had a dramatic impact, yet it was made without SEC rulemaking and as the result of a "decentralized, issue by issue, review" that yields "whimsical changes in direction" and, in their view, does not well serve the majority of shareholders.

Staff Legal Bulletin 14I

SLB 14I primarily relates to two bases for exclusion of 14a-8 shareholder proposals: economic relevance and ordinary business. The economic relevance exception permits a company to exclude from its proxy statement shareholder proposals regarding operations that are not significantly related to the company's business. The ordinary business exception permits a company to exclude proposals that aim to "micromanage" company operations that are properly addressed by management and the board of directors.

With respect to both exceptions, the guidance provided in SLB 14I reflects the SEC's recently articulated perspective that the board of directors is well situated to determine how a proposal relates to the company's business. The SEC will now expect no-action requests under these two 14a-8 grounds for exclusion to include disclosure of the board's process and reasoning in reaching the conclusion that the proposal should be excluded from the company's proxy statement. While the board's analysis is not determinative, the SEC staff will give it due consideration. Mr. Matt McNair, of the Division of Corporation Finance, indicated in recent remarks that, while formal resolutions and board materials are not required to be included in a no-action submission, the information considered by the board and the board's findings and process should be described in detail and will be of increased importance to the SEC staff under this guidance. Mr. McNair also noted that though the board may delegate the matter to a committee, a well-developed record prepared by a board committee and approved by the full board is likely to carry more weight with the SEC staff.

SLB 14I is likely to have a range of positive effects. It may increase the number of proposals that are properly excluded under these two exceptions. At the same time, it may prompt proponents to submit proposals that are in fact relevant to the business of the corporation and thus could lead to improvements in governance or corporate direction. Given that the disclosures made in no-action letter requests are public, boards certainly will find their deliberative processes in this area under greater scrutiny by institutional shareholders; this may have the additional benefit of encouraging boards and shareholders to engage and negotiate in lieu of going through the shareholder proposal exclusion no-action process.

Further Elements of Reform

The federal government and independent groups have recognized the need for additional elements of shareholder proposal reform. Both the Chamber of Commerce and the Business Roundtable have recommended that disclosure and resubmission requirements be strengthened, and the Business Roundtable has advocated raising the eligibility requirements as well. Increases in the ownership eligibility and resubmission thresholds are key elements of the shareholder proposal reforms contained in the Financial CHOICE Act of 2017, which passed the House of Representatives in June but is stalled in the Senate. The U.S.

Department of Treasury released in October a report recommending revisions to the eligibility and resubmission thresholds in order to promote shareholder accountability and reduce unnecessary costs. In remarks earlier this month, at the PLI 49th Annual Institute on Securities Regulation, Chairman Clayton noted with respect to shareholder proposal reform that ownership and resubmission requirements are of particular interest to many.

Every aspect of the shareholder proposal process has come under fire from interested organizations, particularly since the controversial SLB 14H in 2015. Eligibility and resubmission requirements, disclosure requirements, a range of exceptions, proposals by proxy, and the use of graphs and images in proposals (which latter two were addressed in SLB 14I), and the SEC's no-action process itself have been cited as contributing to a situation that is burdensome and counterproductive for the average investor. Yet under the right regulatory regime, shareholder proposals can be a valuable piece of the corporate governance framework. SEC Chairman Clayton has expressed support for the type of shareholder proposals that, despite their short-term costs, can ultimately lead to improvements in corporate governance, and he appears committed to reshaping the shareholder proposal process into one that adds value for investors.

As Chairman Clayton observed in his remarks at the PLI, "the shareholder proposal process is a corporate governance issue that is subject to diverse and deeply held beliefs." To successfully reconcile competing views in governance and shareholder engagement issues generally, Chairman Clayton's focus on "serving the long-term interests of Main Street investors" is the right approach. As boards of directors are the primary guardians of and advocates for long-term shareholder value in our economy, the SEC is wise to elevate their role in this important area of corporate governance. SLB 14I is a first step in the right direction toward meaningful 14a-8 reform.