Speech

The Shareholder Proposal Rule: A Cornerstone of Corporate Democracy

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Washington D.C.

March 8, 2022

Council of Institutional Investors Spring 2022 Conference

I. Introduction

Thank you so much for inviting me to speak today at the Council of Institutional Investors ("CII") Spring Conference. This is my first in-person speaking engagement as Director of the Division of Corporation Finance (the "Division"), so I am especially excited to be here with all of you. Before I begin, I would like to remind you that the views I express today are my own, and I am not speaking on behalf of the Commission or the SEC staff.[1]

I would also like to take a moment to recognize the important role of CII and its members in advocating for improvements in corporate governance policies and practices. CII and its members have consistently engaged with the Commission on a wide range of issues and proposed rules. We very much appreciate your thoughtful comments and insights, and we encourage you to continue to engage with us going forward. As many of you know, we are currently in the midst of the 2022 proxy season, and today I would like to discuss a topic that I know is of great importance to CII, its members and the Commission.

One of the many important issues that I have worked on since joining the Division is to assess and re-evaluate the Division's role in the shareholder proposal no-action letter process under Rule 14a-8. Our role during the proxy season is one of the most visible activities the Division undertakes each year. We continually receive feedback from companies, shareholder proponents and their lawyers and representatives on how we manage the process. The Division also regularly issues staff guidance and announcements to help participants better understand our views regarding these issues.

Most recently, in November 2021, we issued a new Staff Legal Bulletin No. 14L ("SLB 14L") and rescinded three earlier staff legal bulletins. In my remarks today I will discuss our decision to issue the new guidance, the importance of adhering to Commission statements when interpreting Commission rules, and how the current shareholder proposal season is progressing.

II. The Shareholder Proposal Rule

First, I would like to provide a little background on Rule 14a-8, which I am sure is familiar to most of you. To understand the purpose of the rule and the Commission's role in applying it, we have to consider the basic bargain for shareholders created under corporate law. When shareholders invest in a corporation they are agreeing to a structure, in which virtually all authority over corporate decisions vests with the board of directors. Directors in turn delegate this authority to officers (the CEO, CFO and others), who manage the day-to-day affairs of the corporation.[2] In return for their investment, shareholders are entitled to a share of the profits of the corporation, through dividend distributions or capital appreciation.

Just as importantly, shareholders enjoy certain governance rights under state law, including the right to elect directors, approve major corporate transactions and express their views on corporate governance matters and other fundamental issues related to the corporation's business. Additionally, shareholders generally have the right to bring matters before other shareholders for a vote at a shareholder meeting. In the distant past, shareholders would have an opportunity to attend a shareholder meeting in-person where such matters would be debated. However, as corporations increased in size and their shares became more widely held, proxy voting became the primary mechanism for shareholders to exercise the rights provided under state corporate law.

As you know, regulation of the proxy process is a core function of the Commission. Section 14(a) of the Exchange Act authorizes the Commission to establish rules and regulations governing proxy solicitations. The Commission's role is to ensure that the proxy rules "replicate as nearly as possible the opportunity that shareholders would have to exercise their voting rights at a meeting of shareholders, if they were personally present."[3] In other words, the federal proxy rules and regulations seek to ensure that shareholders' rights under state law have meaning, even when voting by proxy. Rule 14a-8, the "shareholder proposal rule," is one way in which the Commission seeks to protect and actualize a shareholder's state law rights.[4]

The Commission adopted Rule 14a-8 back in 1942. This rule requires a company subject to the federal proxy rules to include a shareholder proposal in its own proxy statement, subject to certain procedural and substantive requirements. By allowing a shareholder access to a company's proxy statement, the shareholder proposal rule "facilitates shareholders' traditional ability under state law to present their own proposals for consideration at a company's annual or special meeting, and it facilitates the ability of all shareholders to consider and vote on such proposals."[5]

The SEC's proxy rules, however, do not allow shareholders unfettered access to a company's proxy statement. These rules have long required that a shareholder proposal constitute "a proper subject for action by the security holders" in order to be included in the proxy statement.[6] Today, a shareholder proposal may be excluded from a company's proxy materials if the proposal fails to satisfy certain procedural requirements, or falls within one of the thirteen substantive bases for exclusion set forth in the rule. Several of the substantive exclusions limit shareholder proposals to those matters appropriate for a shareholder to address under state law.

In particular, Rule 14a-8(i)(1) expressly provides that a company may exclude a shareholder proposal "[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." Further, Rule 14a-8(i)(7), the ordinary business exception, seeks to avoid undue interference by shareholders in matters that, according to corporate governance principles, lie within the purview of the directors and management. Recognizing that directors are charged with overseeing the "business and affairs" of the corporation, the Commission permits a company to exclude a proposal that "deals with a matter relating to the company's ordinary business operations." The purpose of the exception is to "confine the resolution of ordinary business problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems at an annual shareholders meeting."[7]

The shareholder proposal rule is not self-executing. Each year questions arise as to whether a company may exclude a proposal under one of the bases for exclusion in the rule. To facilitate resolution and to forestall litigation, the Division has engaged in the informal practice of expressing its enforcement position on these matters.[8] If a company intends to exclude a proposal from its proxy, Rule 14a-8(j) requires the company to "file its reasons" for doing so with the Commission. These notifications generally take the form of a "no-action" request seeking the

Division's concurrence that it will not recommend enforcement action if the company omits the proposal. If the staff declines to take a "no-action" position, the company is expected to include the proposal in the proxy statement for a shareholder vote. Proponents or companies can challenge the staff's position in court and from time to time the courts have weighed in on staff or Commission action in interpreting Rule 14a-8.

III. The Ordinary Business Exception

This brings us back to the ordinary business exception and the Division's role in interpreting it.

As I already mentioned, Rule 14a-8(i)(7) states that a proposal may be excluded if it "deals with a matter relating to the company's ordinary business operations." The Commission has stated that this policy rests on two central considerations. The first relates to the proposal's subject matter and goes to the notion that certain matters should not be subject to direct shareholder oversight because they are so fundamental to management's ability to run the day-to-day affairs of a company.[9] The second relates to the degree to which the proposal "micromanages" the company "by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment."[10] Today, I will focus primarily on the first consideration under Rule (i)(7), but will also briefly address micromanagement.

Early on, the Commission and the courts recognized that certain social policy issues rose to a level of importance such that it would not be appropriate to characterize them as "ordinary business." However, what is ordinary or *extraordinary* often lies in the eye of the beholder.

In the late 1960s, we began to see an increasing number of proposals focused on social policy issues, and the staff, the Commission and the courts had to consider how to analyze proposals relating simultaneously to an "ordinary business" matter and a significant social policy issue.[11] For example, in 1970, the D.C. Circuit Court considered whether the Dow Chemical Company could omit a proposal that requested the board to amend the company's charter to prohibit the sale of napalm,[12] which was being manufactured for use in the Vietnam War.[13] Dow argued that the proposal should be excluded because it was submitted primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes and it related to Dow's ordinary business operations. In remanding the case to the Commission for reconsideration, the court stated that "[n]o reason has been advanced…which leads to the conclusion that management may properly place obstacles in the path of shareholders who wish to present to their co-owners, in accord with applicable state law, the question of whether they wish to have their assets used in a manner which they believe to be more socially responsible."[14]

In 1976, the Commission formally recognized that "the term 'ordinary business operations' ha[d] been deemed on occasion to include certain matters which have significant policy, economic or other implications inherent in them."[15] The Commission further indicated that a two-part test would be used to determine whether a proposal could be excluded under the ordinary business exception.[16] Under this two-part test, a proposal could be excluded if it "first involve[d] business matters that are mundane in nature and second, must not involve any substantial policy or other considerations."[17] Despite this additional guidance, the application of the ordinary business exclusion remained inconsistent in the ensuing years.[18]

In 1992, in connection with a no-action request from Cracker Barrel Old Country Store, the Commission took the position that *all* employment related proposals raising social policy issues would nonetheless be excludable under the "ordinary business" exception. The New York City Employees' Retirement System (NYCERS) had submitted a shareholder proposal to Cracker Barrel requesting that the board implement non-discriminatory employment policies. In that matter, Cracker Barrel requested a no-action letter from the Division, claiming the proposal was excludable because it "concerns employment practices and policies, which relate to the ordinary business operations of the Company."[19] In the Cracker Barrel no-action letter, the Division determined that "the fact that a shareholder proposal concerning a company's employment policies and practices for the general workforce is tied to a social issue will no longer be viewed as removing the proposal from the realm of ordinary business operations."[20] Following the staff's no-action letter, NYCERS sued. The district court ruled in NYCERS favor, holding that the statements in the SEC staff no-action letter violated the Administrative Procedure Act by

"abandoning the 'significant policy implications' rule without providing notice and comment."[21] On appeal, the U.S. Court of Appeals for the Second Circuit reversed.

Despite the court's resolution, the staff's Cracker Barrel no-action position continued to draw scrutiny. In 1998, the Commission amended Rule 14a-8 to, among other things, clarify the parameters of the ordinary business exception, and to reverse the position taken in the Cracker Barrel no-action letter. In its adopting release (the "1998 release"), the Commission made clear that proposals on employment matters may *not* be excluded if they also raise important social policy concerns. The Commission also clarified that proposals relating to ordinary business matters, but focusing on sufficiently significant social policy issues, generally would not be excludable because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.[22] This 1998 release represents the most recent statement from the Commission on the ordinary business exception and the social policy exception, and as such, it continues to guide Division action.

Since the 1998 release, the Division staff have worked diligently to address the question of whether a shareholder proposal raises significant social policy issues that transcend the ordinary business of the company. The resolution of such questions necessarily involves a degree of judgement, which sometimes leads to controversy surrounding the staff's positions.[23] Such controversies increased in recent years as further staff guidance and no-action letters took the view that additional conditions and hurdles must be met for proponents to avoid exclusion under Rules 14a-8(i)(7) and under Rule 14a-8 (i)(5), which allows proposals to be excluded if they are not relevant to the company's business. More specifically, under 14a-8(i)(5) a proposal may be excluded if it relates to operations that account for less than 5 percent of the company's total assets, net earnings and gross sales, and is not otherwise significantly related to the company's business. This latter part of the "(i)(5)" test – whether a proposal is "otherwise significantly related to the company's business" – involves considerations similar to those at play when addressing the social policy exception under (i)(7). Staff legal bulletins extended a trend of staff no-action positions that had arguably strayed from the guidance the Commission has provided. Feedback from market participants and staff experience indicated, among other things, that such guidance led to increasingly inconsistent decisions and unpredictable results. Our assessment of recent staff guidance and no-action letters suggested a need to reset and restate the staff's approach to evaluating no-action requests under Rule 14a-8.

IV. Staff Guidance & Announcements

Staff Legal Bulletin No. 14L

In November 2021, the Division issued SLB 14L to provide greater clarity and consistency in applying 14a-8(i)(7) and Rule 14a-8(i)(5).

We issued SLB 14L and rescinded prior Staff Legal Bulletins 14I, 14J, and 14K following our review of them, and after assessing the staff's experience in applying the guidance in them. In the rescinded bulletins, the staff stated that when evaluating arguments under Rules 14a-8(i)(7) and 14a-8(i)(5), the staff would take a company-specific approach when evaluating the significance of a policy issue, rather than focus on the overall significance of the policy issue. Because the staff's analysis focused on an issue's significance to the company, the staff believed that it would be beneficial to understand how a company's own board of directors analyzed the issue. As a result, the staff stated in SLBs 14I, 14J and 14K that a company's no-action request should include a discussion that reflects the board's analysis of the particular policy issue raised and its significance to the company, which the staff referred to as a "board analysis."

We found that focusing the staff's analysis on the significance of a policy issue to a particular company drew the staff into factual considerations that did not advance the policy objectives behind the ordinary business exception, and we found that it failed to yield consistent, predictable results. Accordingly, with SLB 14L, we determined to realign our approach for determining whether a proposal relates to "ordinary business" with the standard the Commission first articulated in 1976, and which the Commission subsequently reaffirmed in the 1998 release.

In SLB 14L, we announced that the staff's review will no longer focus on the significance of a policy issue to a particular company. Instead, our review will focus on the broader social policy significance of the issue in the proposal. As part of this approach, we no longer expect companies to provide a board analysis to demonstrate that the proposal is excludable.

I now want to briefly discuss our guidance in SLB 14L that addresses the framework for evaluating whether a proposal micromanages a company. Guidance in SLBs 14J and 14K addressing the scope and application of micromanagement as a basis for exclusion may have been taken to mean that *any* limit on company or board discretion constitutes micromanagement, which seemed inconsistent with the Commission's articulation of the rule.

In SLB 14L, we announced that, with respect to micromanagement arguments, the staff will more closely follow the Commission's direction in its 1998 release. In that release, the Commission stated that proposals that seek detail or seek to promote timeframes or methods do not *per se* constitute micromanagement. As stated in SLB 14L, our analysis will focus now on the level of granularity sought and whether the proposal inappropriately limits discretion of the board or management. Put differently, we expect the level of detail included in a proposal to accord with what investors need to assess an issuer's impacts, progress towards goals, risks or other strategic matters that are appropriate for shareholder input. We think this approach is consistent with the Commission's statements on the ordinary business exclusion, and consistent with state law principles, which are designed to preserve management's discretion on ordinary business matters, but not to prevent shareholders from providing high-level direction on large strategic matters.

Finally, SLB 14L returns us to our longstanding approach with respect to economic relevance under Rule 14a-8(i)(5). Proposals that raise issues of broad social or ethical concern that are related to the company's business may not be excluded, even if the relevant business falls below the numeric thresholds in the rule. We believe this approach is consistent with how the courts have interpreted the rule. I would like to emphasize, however, that there still must be a nexus between the policy issue and the company. In other words, the social policy issue must be "otherwise related" to the company's business, even if it is below the 5% threshold.

Other Staff Announcements

In addition to the recent SLB 14L guidance, our shareholder proposal task force has taken steps this season to further streamline our review process and return to historical practice. First, we announced that we would return to the practice of issuing a letter in response to each no-action request. We think this approach provides greater transparency to proponents and companies alike, and feedback so far has been overwhelmingly positive. For those of you who preferred the chart that we have posted in recent years, we still plan to publish a chart at the end of the current season that summarizes our responses to that season's no-action requests.

I would also like to mention that the Division updated its guidance on the requirements for presenting shareholder proposals at annual meetings in light of COVID-19 concerns. As you know, Rule 14a-8 requires shareholder proponents, or their representatives, to appear and present their proposals at an annual meeting. Failure to do so absent "good cause" can render future proposals from that proponent excludable for two years. As in 2020 and 2021, the Division has provided guidance that encourages companies to allow proponents or their representatives to present their proposals through alternative means, such as by phone. We have also again clarified that, to the extent a proponent or representative is unable to attend a meeting and present a proposal due to the inability to travel or other hardships related to COVID-19, the staff will consider this to be "good cause" should issuers seek to exclude a proposal on the basis that the shareholder or a representative failed to appear to present the proposal at the annual meeting.

V. The 2022 Proxy Season

I would now like to talk about the current proxy season. From our perspective, the season is going quite well. Our shareholder proposal team has done a great job providing consistent and thoughtful analyses, while managing a large volume of letters in a timely manner. The letters are clear and concise, and we hope they provide sufficient

insight for participants in the process to gauge our approach. Currently, we are beyond the midpoint in terms of our taskforce's work. I will start by sharing some statistics that we have gathered from the current season. Please note that these numbers are as of Friday, March 4th.

The number of no-action requests we have received to date has declined by approximately 9% (231 received this year, compared to 253 last year).

The most common proposal topics are:

- Corporate Governance (64)
- Environmental (31)
- Discrimination (19)
- Human Rights (11)
- Lobbying (9)
- Executive Compensation (8)
- Political Spending (5)

The most frequently asserted bases for exclusion are:

- Rule 14a-8(i)(7) ("ordinary business") (100)
- Rule 14a-8(b) ("ownership and other eligibility provisions") (88)
- Rule 14a-8(i)(10) ("substantially implemented") (86)
- Rule 14a-8(i)(3) ("contrary to the proxy rules") (42)

In general, it appears that companies and proponents are continuing to engage constructively with one another this season. Productive dialogue between parties often results in an amicable and constructive resolution that frequently leads to withdrawal of the shareholder proposal and, where a no-action request has been submitted, withdrawal of the no-action request. In fact, roughly 20% of the requests we have received to date have been withdrawn, and we expect this number to increase over the coming weeks. While not all of these withdrawals are the direct result of fruitful engagement, it appears from where we sit that the vast majority are.

One area where the Division feels that greater cooperation may help improve the process for all parties is with respect to disputes over a proponent's eligibility to submit a shareholder proposal. As you know, the Commission's rules require proponents to satisfy a number of procedural requirements to be eligible to submit a proposal. For example, proponents must meet stock ownership thresholds and represent that they will hold that stock through the date of the company's annual meeting. In many cases, procedural disputes can be resolved more easily and efficiently with greater cooperation among the parties than by the staff through the no-action process. We encourage companies and proponents to work together to resolve these technical issues so that the parties can engage in substantive dialogue on the proposal's merits that hopefully leads to a better outcome for all.

VI. Commission Rulemaking

In addition to "resetting" our guidance, we continue to consider whether shareholders rights are being protected adequately under the proxy rules and are exploring ways to improve the shareholder voting process. To that end, the Commission recently adopted final rules related to universal proxies that were first proposed in 2016.

a. Universal Proxy

A shareholder's right to vote to elect directors is a fundamental element of corporate ownership and is of particular significance in the context of a contested election. Before the Commission adopted the current Universal Proxy rules, shareholders could not select their preferred combination of director candidates from competing slates in a contested election through the proxy process, as they could through in-person voting. Given that the vast majority

of votes are cast by proxy, especially by retail investors, this limited a shareholder's ability to exercise their right to elect directors. The Universal Proxy rule ensures that shareholders voting by proxy are able to vote for directors in a manner consistent with their right to vote in person at a shareholder meeting. The final rule amendments regarding universal proxy will apply to all shareholder meetings involving contested director elections held after August 31, 2022.

b. Rule 14a-8

Additionally, as you may have seen, the Chair has included Rule 14a-8 on his Fall 2021 regulatory agenda. We are considering ways to add clarity and reduce ambiguities and uncertainties surrounding the application of certain provisions in the rule. Thus, we are considering recommending amendments to the rule that would make the process more efficient and predictable for all parties involved. We strongly **e**ncourage your thoughts and comments on any future proposing release.

VII. Conclusion

Thank you again for providing me the opportunity to speak with you about the Division's important work. Events such as this provide opportunities to share our thinking about the important issues before the Division. I look forward to continued engagement with CII and its members and, again, I encourage you to comment on any potential future proposals related to the shareholder voting process, in addition to the many other proposals the Commission has released that are of interest to you and your members.

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[1] The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[2] *See* 8 Del. C. § 141.

[3] *Briefing Paper: Roundtable on the Federal Proxy Rules and State Corporation Law*, May 7, 2007 available at https://www.sec.gov/spotlight/proxyprocess/proxy-briefing050707.htm.

[4] Alan Palmiter & Frank Partnoy, *Corporations a Contemporary Approach* 482, 2010 ("The shareholder proposal rule is a federal mechanism to facilitate state-created shareholder voting rights").

[5] Release No. 34-87458 (Nov. 5, 2019).

[6] See, e.g., Release No. 34-3347 (Dec.18, 1942).

[7] Release No. 34-40018 (May 21, 1998).

[8] Release No. 34-12599 (Jul. 7, 1976).

[9] Release No. 34-40018 (May 21, 1998).

[10] Id.

[11] Release No. 34-39093 (Sept. 18, 1997).

[12] Referred to as "liquid fire," the use of the chemical substance napalm on civilians during the Vietnam War was highly controversial and sparked several protests.

[13] *Medical Committee for Human Rights v. SEC*, 432 F.2d 659 (D.C.Cir. 1970), vacated as moot 404 U.S. 403, 92 S.Ct. 577, 30 L.Ed.2d 560 (1972).

[14] Id.

[15] Release No. 12999 (Dec. 3, 1976).

[16] Kevin W. Waite, *The Ordinary Business Operations Exception to the Shareholder Proposal Rule: A Return to Predictability*, 64 Fordham L. Rev. 1253 (1995).

[17] Id. at 1264.

[18] Id. at 1270; Adrien K. Anderson, *The Policy of Determining Significant Policy Under Rule 14a-8(i)(7),* 93 Denv. L. Rev. F. (2016) available at https://www.denverlawreview.org/dlr-online-article/2016/5/6/the-policy-ofdetermining-significant-policy-under-rule-14a.html?rq=the%20policy%20of%20determining.

[19] *Cracker Barrel Old Country Store, Inc.* SEC No-Action Letter (Oct. 13, 1992).

[20] Id. The full Commission affirmed the Division's position. *See Cracker Barrel Old Country Store, Inc.* (Jan. 15, 1993).

[21] *See New York City Employees' Retirement Sys. v. SEC*, 843 F. Supp. 858 (S.D.N.Y. 1994), *rev'd,* 45 F.3d 7 (2d Cir. 1995).

[22] Release No. 34-40018 (May 21, 1998).

[23] *See, e.g.*, *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015).