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New Staff Legal Bulletin and Proxy Voting Guidelines Released Ahead of the 2016 Proxy Season

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Just ahead of the 2016 proxy season, the Staff of the Division of Corporation Finance of the SEC released new guidance—Staff Legal Bulletin No. 14H ("SLB 14H")—describing how the Staff will evaluate issuers' arguments for omission of a shareholder proposal from their proxy materials under Rules 14a-8(i)(9) and (i)(7).

In addition, Institutional Shareholder Services Inc. ("ISS") and Glass, Lewis & Co., LLC ("Glass Lewis") recently updated the guidelines that each of these proxy advisory services will use in making their voting recommendations for the 2016 proxy season. The updates address topics such as director overboarding, executive compensation disclosure, shareholder rights, committee performance and risk oversight.

SLB 14H

SLB 14H addressed the Staff's views regarding the application of Rule 14a-8(i)(9) (proposals that "directly conflict" with management proposals) and Rule 14a-8(i)(7) (proposals relating to "ordinary business operations"), which are two important substantive bases for the omission of a proposal from an issuer's proxy materials.

Rule 14a-8(i)(9) Guidance

Rule 14a-8(i)(9) permits an issuer to omit a proposal submitted by an eligible shareholder from the issuer's proxy statement if the shareholder proposal "directly conflicts" with a management proposal set forth in the same proxy statement. Rule 14a-8(i)(9) has been used in recent years to exclude shareholder proposals addressing topics such as compensation plan provisions, proxy access, shareholders' ability to call a special meeting, and shareholders' ability to take action by written consent. The SEC has stated that the subject proposals need not be "identical in scope or focus" in order for this basis for exclusion to be available. See SEC Release No. 34-40018 (May 21, 1998). Consistent with the SEC's position, the Staff has historically concurred that where a shareholder proposal and a management proposal present alternative and conflicting decisions for shareholders, and where submitting both proposals could provide inconsistent and ambiguous results, the shareholder proposal could be excluded under Rule 14a-8(i)(9).

Rule 14a-8(i)(9) During the 2015 Proxy Season

On January 16, 2015, Chair Mary Jo White directed the Division of Corporation Finance to review the proper scope and application of Rule 14a-8(i)(9), and the Staff thereafter announced that it would express no view on no-action requests relating to the exclusion of shareholder proposals in reliance on Rule 14a-8(i)(9). Without having the ability to seek the Staff's concurrence to exclude a shareholder proposal based on Rule 14a-8(i)(9), issuers pursued a number of alternative methods for addressing shareholder proposals that conflicted with management proposals. The most common alternative methods were (i) including both the shareholder proposal and the

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management proposal in the proxy statement, with an explanation to shareholders regarding any differences in scope of applicability and recommending that shareholders vote in favor of the management proposal; and (ii) including only the shareholder proposal, and recommending that shareholders vote against that proposal.

Analysis of Rule 14a-8(i)(9) According to SLB 14H

In SLB 14H, the Staff expressed the view that there is a "direct conflict" between a shareholder proposal and management proposal only where "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 Staff noted that this analysis "more appropriately focuses on whether a reasonable shareholder could vote favorably on both proposals, or whether they are, in essence, mutually exclusive proposals." In communicating this interpretation, the Staff focused on the principle that Rule 14a-8(i)(9) is designed to ensure that the shareholder proposal process is not used as a means to circumvent the SEC's proxy rules governing solicitations.

In SLB 14H, the Staff provided the following examples to provide a better understanding of the Staff's focus on "whether a reasonable shareholder could logically vote for both proposals."

- **Direct Conflict Exists**. The Staff stated that (i) "where a company seeks shareholder approval of a merger, and a shareholder proposal asks shareholders to vote against the merger"; or (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," the Staff "would agree that the proposals directly conflict."

- **Direct Conflict Does Not Exist**. In illustrating those circumstances in which a direct conflict would not exist for purposes of Rule 14a-8(i)(9), the Staff provided the following examples: (i) "if 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 Staff noted that these situations would not present a "direct conflict" because "a reasonable shareholder, although possibly preferring one proposal over the other, could logically vote for both."

  With respect to the proxy access example described above, the Staff stated that there would be no direct conflict because "both proposals generally seek a similar objective, to give shareholders the ability to include their nominees for director alongside management's nominees in the proxy statement, and the proposals do not present shareholders with conflicting decisions such that a reasonable shareholder could not logically vote in favor of both proposals." The Staff analyzed the compensation example similarly, stating that "a reasonable shareholder could logically vote for a compensation plan that gives

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the compensation committee the discretion to determine the vesting of awards, as well as a proposal seeking implementation of a specific vesting policy that would apply to future awards granted under the plan."

The Staff noted that SLB 14H could impose "a higher burden for some companies seeking to exclude a proposal to meet than had been the case under our previous formulation." As a result, issuers may turn to Rule 14a-8(i)(10) in seeking to exclude a shareholder proposal that is very similar to a management proposal or action. Rule 14a-8(i)(10) provides an exclusion from an issuer's obligation to include shareholder proposals from eligible shareholders in the issuer's proxy statement if the issuer's existing policies and practices "substantially implement" the shareholder proposal.

Rule 14a-8(i)(7) Guidance

Rule 14a-8(i)(7) provides that a proposal is excludable when the proposal deals with a matter relating to the company's ordinary business operations. A recent Third Circuit Court of Appeals decision in *Trinity Wall Street v. Wal-Mart Stores, Inc.* held that an issuer could exclude a shareholder proposal from its proxy materials based on Rule 14a-8(i)(7), but raised some questions as to the proper framework for analysis under Rule 14a-8(i)(7). Notwithstanding the fact that the outcome of the Third Circuit decision was in line with the Staff's earlier conclusions in the same matter, the Staff expressed a concern in SLB 14H that the decision could lead to the unwarranted exclusion of a shareholder proposal. In this regard, SLB 14H specifically addressed the Third Circuit's majority ruling regarding the "significant policy issue" exception to the ordinary business exclusion, which described a two-part test under which "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business." The Staff noted that the court "found that to transcend a company's ordinary business, the significant policy issue must be 'divorced from how a company approaches the nitty-gritty of its core business.'" The Staff concluded that it would continue to follow the one-part "ordinary business" analysis that it has historically applied, based on the SEC's view (which was articulated by the concurring judge in the Third Circuit decision) that proposals focusing on a significant policy issue are not excludable under the ordinary business exception "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." As a result, the Staff indicates in SLB 14H that "a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the 'nitty-gritty of its core business.'"

ISS VOTING POLICY UPDATES

The ISS voting policy updates are relevant to shareholder meetings taking place on or after February 1, 2016. The three principal updates highlighted by ISS relate to its director overboarding policy. ISS also updated its policy regarding how it will assess board actions that significantly reduce shareholder rights without seeking approval by shareholders, and expanded its "Problematic Pay Practice" policy to add "Insufficient Executive Compensation Disclosure by Externally Managed Issuers (EMIs)."

Director Overboarding. Current ISS policy considers a director "overboarded" if he or she sits on more than six public company boards—or, if he or she is also a CEO, more than two public company boards (not counting subsidiaries of the CEO's "home board").

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In its updated policy, ISS noted that, for most directors except for standing CEOs, the maximum number of public company boards that a director can sit on before being considered "overboarded" is being reduced from six to five. ISS will allow a one-year grace period until 2017, giving directors and companies sufficient time to make any changes in advance of the 2017 proxy season, should they wish to do so. During 2016, ISS will highlight if a director is on more than five public company boards, but adverse voting recommendations will not be issued under this new overboarding policy unless the current policy's maximum of six boards is exceeded. For CEOs, the current overboarding limit will remain at two outside directorships. ISS revised its policy in light of the increasing demands on public company directors over the decade since its prior framework was first developed.

Unilateral Board Actions. When a unilateral board amendment of the articles or bylaws adversely affects shareholder rights – so -called unilateral board actions – current ISS policy provides for adverse vote recommendations on individual directors or the full board at the next annual meeting. Unilateral board actions many include, among other things, "classifying the board" or "establishing supermajority vote requirements for bylaw/charter amendments."

ISS has updated its policy to distinguish between (i) unilateral board adoptions of bylaw or charter provisions made prior to or in connection with a company's initial public offering (IPO); and (ii) unilateral board amendments to those documents made after a company's IPO. For newly public companies that have taken action to diminish shareholder rights prior to or in connection with the IPO, the updated policy calls for a case-by-case approach to withhold votes in subsequent years, with significant weight given to shareholders' ability to change the governance structure in the future through a simple majority vote, and their ability to hold directors accountable through annual director elections. A public commitment by the company to put the adverse provisions to a shareholder vote within three years of the IPO can be a mitigating factor.

For established public companies, ISS's updated policy generally calls for continuing to withhold votes from directors who have unilaterally adopted a classified board structure, implemented supermajority vote requirements to amend the bylaws or charter, or eliminated shareholders' ability to amend the bylaws altogether.

Compensation of Externally Managed Issuers. ISS had not historically considered insufficient disclosure of compensation arrangements for executives at an externally managed issuer as a problematic pay practice under ISS policy.

ISS had revised its policy to provide that an externally managed issuer's failure to provide sufficient disclosure for shareholders to reasonably assess compensation for the named executive officers will be deemed a problematic pay practice, and generally warrant a recommendation to vote against the say-on-pay proposal.

Proxy Access. Under the revised policy, ISS has not revised its fundamental approach to management and shareholder proposals to adopt proxy access. ISS will continue to vote case-by-case for each director on the ballot in the case of a proxy contest or proxy access, considering the following factors:

- Long-term financial performance of the company relative to its industry;
- Management's track record;

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- Background to the proxy contest (if applicable);
- Nominee qualifications and any compensation arrangements;
- Strategic plan of dissident slate and quality of critique against management;
- Likelihood that the proposed goals and objectives can be achieved (both slates); and
- Stock ownership positions.

ISS will provide further information on which provisions of proxy access are overly restrictive in an FAQ document to be released in December 2015.

GLASS LEWIS VOTING POLICY UPDATES

Conflicting Management and Shareholder Proposals. When analyzing and determining whether to support conflicting management and shareholder proposals, Glass Lewis indicated that it will consider the following:

- The nature of the underlying issue;
- The benefit to shareholders for implementation of the proposal;
- The materiality of the differences between the terms of the shareholder proposal and management proposal;
- The appropriateness of the provisions in the context of a company's shareholder base, corporate structure and other relevant circumstances; and
- A company's overall governance profile and, specifically, its responsiveness to shareholders as evidenced by a company's response to previous shareholder proposals and its adoption of progressive shareholder rights provisions.

Exclusive Forum Provisions. In its revised policies, Glass Lewis refined its approach to companies that include exclusive forum provisions in their governing documents in connection with an initial public offering. Specifically, Glass Lewis will no longer recommend that shareholders vote against the chairman of the nominating and governance committees in such situations, but instead, for new public companies, will weigh the presence of an exclusive forum provision in the bylaws in conjunction with other provisions that it believes will unduly limit shareholder rights. Such provisions include supermajority vote requirements, a classified board or a fee-shifting bylaw provision. However, Glass Lewis's policy to recommend voting against the chairman of the nominating and governance committee when a company adopts an exclusive forum provision without shareholder approval outside of a spin-off, merger or IPO will not change.

Environmental and Social Risk Oversight. Glass Lewis codified its policy regarding the responsibilities of a board of directors for oversight of environmental and social issues. In cases where the board or management, in Glass Lewis's view, has failed to sufficiently identify and manage a material environmental or social risk that did or could negatively impact shareholder value, Glass Lewis will recommend shareholders vote against directors

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responsible for risk oversight in consideration of the nature of the risk and the potential effect on shareholder value.

Nominating Committee Performance. Glass Lewis revised its guidelines to clarify that it may consider recommending shareholders vote against the chair of the nominating committee where the board's failure to ensure the board has directors with relevant experience, either through periodic director assessment or board refreshment, has contributed to a company's poor performance.

Director Overboarding. Glass Lewis noted that, in 2016, it will closely review director board commitments and may note as a concern instances of directors serving on more than five total boards, for directors who are not also executives, and more than two total boards for a director who serves as an executive of a public company.

Glass Lewis's voting recommendations in 2016, however, will continue to be based on the firm's existing thresholds of three total boards for a director who serves as an executive of a public company, and six total boards for directors who are not public company executives.

Glass Lewis indicated that, beginning in 2017, it generally will recommend voting against a director who serves as an executive officer of any public company while serving on a total of more than two public company boards, and any other director who serves on a total of more than five public company boards.

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