

John W. White
+1-212-474-1732
jwhite@cravath.com

Matthew Morreale
+1-212-474-1534
mmorreale@cravath.com

Michael Arnold
+1-212-474-1664
marnold@cravath.com

Staff Legal Bulletin No. 14L: More Evidence for the ESG Paradigm Shift

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As we've discussed previously, environmental, social and governance, or "ESG", considerations are now one of the preeminent topics in the financial, corporate and regulatory landscape and a new paradigm through which all corporate actions are increasingly being assessed. This shift has also been strongly reflected in shareholder proposals related to ESG topics. While topics broadly related to "G" matters have long been key areas of focus for shareholder proposals (such as declassifying corporate boards, changing voting standards, proxy access, etc.), recent proxy seasons have a number of shareholder proposals related to E&S matters and an increase in the levels of support those proposals have received.¹

On November 3, the Division of Corporation Finance published Staff Legal Bulletin No. 14L², which will likely result in more E&S proposals appearing in companies' proxy statements. Of particular note, SLB 14L updates the Staff's guidance on grounds for excluding proposals under Rule 14a-8 based on the ordinary business exception in Rule 14a-8(i)(7)³ and the economic relevance exception in Rule 14a-8(i)(5)⁴, and rescinds the prior SLBs 14I, 14J and 14K. These actions, coming on the heels of well-publicized statements by SEC Chair Gensler and other Democratic Commissioners focusing on the importance of ESG disclosures, likely will result in the Staff permitting climate- and other ESG-related proposals it previously would have concluded were excludable.

SUMMARY OF NEW GUIDANCE

Under prior guidance, when reviewing no-action requests involving the ordinary business exception, the Staff evaluated the significance of a policy issue to a particular company, and issuers were expected to provide an analysis from their boards to support the substantive factors behind companies' assertions about the relative unimportance of the policy issue to the company's core business activities or that the difference between the company's existing actions addressing the policy issue and the proposal's request was insignificant. Under SLB 14L, the Staff will no longer focus on how the policy issue relates to the company, but now instead will focus solely on the "social policy significance" of the issue that is the subject of the shareholder proposal, evaluating whether the proposal raises issues with "broad societal impact".

The Staff has also allowed the ordinary business exception to exclude proposals that "micromanage" the company "by probing too deeply into matters of a complex nature." SLB 14L suggests the now-rescinded SLB 14J and 14K may have been interpreted to suggest any limit on company or board discretion could constitute micromanagement. SLB 14L rejects such a broad interpretation of the micromanagement concept, and states that proposals seeking detail or those that promote timeframes and methods do not constitute micromanagement per se. Instead, the Staff will focus on the level of granularity sought in the proposal and whether and to what extent it inappropriately limits discretion of the board or management. In particular, proposals requesting companies to "adopt timeframes or targets to address

climate change” will not be excluded on micromanagement grounds so long as the proposals afford discretion to management as to how to achieve such goals.

The Staff also advised in SLB 14L that in determining whether a proposal involves a matter “too complex” for shareholders as a group, the Staff may consider “the sophistication of investors generally on the matter, the availability of data, and the robustness of public discussion and analysis on the topic”. Based on SLB 14L, we also expect proposals related to disclosure, target setting and timeframes to be less likely to be able to be excluded if the proposal references well-established national or international frameworks as those will be seen by the Staff as indicative of topics that shareholders are well-equipped to evaluate.

Finally, SLB 14L now clarifies that proposals that raise issues of broad social or ethical concern related to a company’s business may not be excluded even if the relevant part of the company’s business falls below the economic thresholds of Rule 14a-8(i)(5) (set forth in footnote 4 above). As with the ordinary business exception, the Staff will no longer expect an analysis from the company’s board for its consideration of a no-action request under Rule 14a-8(i)(5).

KEY TAKEAWAYS AND NEXT STEPS

SLB 14L underscores Chair Gensler’s views that climate and other ESG concerns are material to investment decisions and present a number of challenges for directors and management.

- While it remains to be seen how the new guidance in SLB 14L will be applied in practice, boards and management should remain attuned to future no-action responses from the Staff to help discern their readiness for and response to ESG shareholder proposals. For example, it may take some time to calibrate the Staff’s new views as to how much limitation on board discretion constitutes micromanagement, or the outer limits of concepts like “social policy significance” and “broad societal impact”. Notably, Republican Commissioners Hester Peirce and Elad Roisman released a statement⁵ in response to SLB 14L arguing that it leaves open many questions that the now-rescinded SLBs had been trying to answer. Directors and management should be ready for a significant increase in the number of traditional ESG proposals that may now make it to the ballot, as well as potential new challenges in negotiating with proponents. Companies should craft a strategy in advance to deal with the most prominent topics of ESG proposals. For example, if climate change-related proposals requesting that companies set emissions targets to a specific level and/or on a specific timeline are less likely to be excludable, companies should anticipate potential demands and carefully evaluate whether they are prepared to make those commitments. Relatedly, companies should evaluate—preferably proactively—whether they have the necessary data management and reporting infrastructure to track progress toward their goals for net zero greenhouse gas emissions, especially since that has been signaled as a likely requirement of the SEC’s new climate change disclosure regime. These questions may be increasingly relevant for companies outside of extractive or high-emissions industries, since a low greenhouse gas emissions footprint will no longer be grounds on which to exclude climate change proposals. Similarly, proposals related to human capital management (particularly related to diversity or racial equity) are more likely to make their way to the ballot after SLB 14L.
- Companies may need to be ready to address new types of proposals that may be relevant to issues of “broad societal impact”. For example, the more narrow significant social policy exception may prevent exclusion of shareholder proposals related to hot-button topics such as gun policy, immigration policy, lobbying and political contributions or recent controversies over the types of corporate diversity training sessions that might be seen as inspired by critical race theory. While it may be less likely that these sorts of proposals will receive majority shareholder support compared to traditional ESG topics, such as climate change or human capital management, SLB 14L, at least on its face, seems to provide an opening for the company’s proxy statement to be required to host proposals on a wide range of controversial policies that have a broad societal impact. Companies seeking to have proponents withdraw such proposals before the proxy is published will need to be prepared to engage thoughtfully and comprehensively with shareholders at an early stage.
- Companies should continue to consider the potential relevance and effectiveness of other bases for exclusion, such as that a proposal has already been substantially implemented in accordance with 14a-8(i)(10). This means remaining attentive to relevant developments in company- or sector-specific expectations on various ESG topics, as

well as to actions taken by competitors, as it may be advisable to proactively track actions other companies have taken with respect to such matters.

- Companies should be prepared for heightened expectations and recognize the importance of engagement with interested investors and stakeholders outside proxy season. Establishing strong relationships with potential proponents of ESG-related proposals and significant shareholders who will vote on those proposals will be increasingly important if such proposals are more difficult to exclude through no-action requests.

Companies are increasingly forced to grapple with the effects of the rise of ESG on their business and operations, and the issuance of SLB 14L increases the pressure to engage on ESG-related matters. A clear understanding and robust management of a company's relevant ESG-related matters will allow a company to have informed conversations with its investors and the company will be more effective in its ESG-related shareholder engagement, potentially allowing companies to preempt unwarranted or intrusive ESG proposals.

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New York

Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

London

CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

www.cravath.com

¹ For the 2021 proxy season, and as of June 30, 2021 per ISS's 2021 Proxy Season Review of U.S. E&S Issues publication, there has been a record level of support for E&S proposals (24.7 percent as compared to 11.9 percent for the full year of 2017). The ISS publication can be found at <https://insights.issgovernance.com/posts/2021-united-states-environmental-social-issues-proxy-season-review/>.

² SLB 14L can be found at <https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals>.

³ The ordinary business exception permits a company to exclude a proposal that "deals with a matter relating to the company's ordinary business operations" in order "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."

⁴ The economic relevance exception permits a company to exclude a proposal that "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business."

⁵ Commissioners Peirce and Roisman's statement can be found at <https://www.sec.gov/news/statement/peirce-roisman-statement-shareholder-proposals-staff-legal-bulletin-14l>.