February 15, 2019

SEC Staff Grants No-Action Relief on Shareholder Proposal Relating to Mandatory Arbitration

On February 11, 2019, the SEC's Division of Corporation Finance issued a no-action letter to Johnson & Johnson, stating that it would not recommend enforcement action if the company excluded from its proxy statement a shareholder proposal relating to mandatory arbitration of federal securities law claims. In connection with the staff's no-action letter, SEC Chairman Jay Clayton issued a public statement, in which he acknowledged that this issue is a "complex matter under both federal and state law," expressed his support for the approach the staff took, and stated that the Commission should decide any policy determination on the issue.

Background

Mandatory arbitration of federal securities law claims is not a new issue. In 2012, the Division declined to accelerate the effective date of a U.S. company's IPO registration statement when the company's governing documents contained a mandatory arbitration provision covering disputes arising under federal securities laws. In that situation, the company chose to eliminate the provision. That same year, the SEC staff granted no-action requests from two companies that had each received a shareholder proposal to adopt a bylaw requiring arbitration of federal securities law claims. The staff concluded that there was some basis for the companies' views that the bylaw, if implemented, would cause them to violate federal law (viz., the "anti-waiver" provisions of the securities laws).

The issue resurfaced in July 2017, when then-SEC Commissioner Michael Piwowar stated in a public appearance that the SEC was open to the idea of allowing IPO companies to include mandatory shareholder arbitration provisions in their organizational documents. In January 2018, the press reported that the SEC was laying the groundwork for a possible policy shift on mandatory arbitration. Some institutional investors, particularly public pension funds, vigorously opposed such a measure, and the controversy greeted Chairman Clayton just a few months after his arrival at the SEC.

Throughout 2018, Chairman Clayton has stated his position on mandatory arbitration in testimony on Capitol Hill, in remarks to the SEC Investor Advisory Committee, and in a letter to Congresswoman Carolyn Maloney (D-NY). The Chairman believes that any analysis of this issue or decision-making by the Commission in the context of a registered IPO by a domestic company would involve Commission action (and not be made through delegated authority) and should be conducted in a measured and deliberative manner. In addition, the Chairman has stated that mandatory arbitration is not a priority for the Commission.

No-Action Letter

Johnson & Johnson, a New Jersey corporation, sought to exclude from its proxy statement under Rule 14a-8(i)(2) a shareholder proposal that requested that the company "take all practicable steps to adopt a mandatory arbitration bylaw." Rule 14a-8(i)(2) permits exclusion of a shareholder proposal that, if implemented, would cause the company to violate any state, federal or foreign law to which it is subject. Johnson & Johnson argued that the shareholder proposal, if implemented, would cause the company to violate federal and state law.

In its no-action letter to Johnson & Johnson, the SEC staff stated that it would not recommend enforcement action against the company should it decide to exclude the proposal on the grounds that it would violate New Jersey state law. The staff relied heavily on an opinion from the New Jersey Attorney General stating that "[u]nder New Jersey law, as under Delaware law, forum-selection provisions relating to claims under the federal securities laws do not address matters of internal concern, and bylaw provisions purporting to dictate the forum for such claims—including but not limited to mandatory arbitration provisions—are void." The staff expressly disclaimed that it was interpreting New Jersey law but was instead recognizing the legal authority of the state attorney general. Moreover, it expressed no view on whether such a provision violates federal law.

Implications

The mandatory arbitration movement lost some of its momentum in December 2018 when the Delaware Court of Chancery ruled that a provision in a corporation's governing documents requiring that any claim under the Securities Act be brought in federal court was invalid under Delaware law.[1] Forum-selection provisions in governing documents are only valid if they deal with internal claims (e.g., derivative actions), and that same rationale would likely apply to mandatory arbitration provisions governing federal securities law claims. Because approximately 75% of public companies are incorporated in Delaware, the Delaware Supreme Court upholding this decision will substantially limit this effort to rein in securities class actions. The Chairman seems disinclined to embroil the SEC in this controversy, and the state law angle may provide him with adequate cover. As a process matter, though, it is clear that if the SEC were to take up the issue it would be at the Commission, not the staff, level.

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[1] *Sciabacucchi v. Salzberg*, C.A. No. 2017-0931-JTL, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018).