

SEC Staff Permits Exclusion of Audit Firm Rotation Shareholder Proposals

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In what may be the first major decision this proxy season on shareholder proposals, the SEC staff has granted no-action letters to two companies, [Hewlett-Packard Company](#) and [Deere & Company](#), that had sought to exclude proposals submitted by the United Brotherhood of Carpenters Pension Funds. The proposals had requested that the boards and audits committees establish policies that require the respective audit firms, at least every seven years, to rotate off the engagement for a minimum of three years.

While there is a line of precedents indicating that the SEC staff traditionally viewed the selection and engagement of auditors as part of a company's ordinary business as understood under Rule 14a-8, and not a subject suitable for being voted on by shareholders, recent actions by the PCAOB raised at least the possibility that audit firm rotation could be considered a "significant policy issue" as a subject of widespread public debate. In August, the PCAOB issued a [concept release](#) to solicit comments on ways to enhance auditor independence, objectivity and professional skepticism. A cornerstone of the release is the idea of mandatory rotation of audit firms, which would limit the number of consecutive years for which a firm could serve as auditor. The Release highlighted concerns, from more than 2,800 engagements in eight years of inspections of the largest audit firms, of audit failures that could be attributable to a failure to exercise objectivity, and speculates that mandatory audit rotation could help overcome the basic conflict of auditors attempting to develop engagements into long-term relationships with management. Comments are due on the PCAOB release on December 14, 2011. The European Commission is considering similar issues and may shortly propose legislation.

Carpenters specifically cited the PCAOB release in making its arguments to the SEC staff, but failed to persuade the staff. In its decision, the SEC staff noted, in a bit of awkward phrasing, that "proposals concerning the selection of independent auditors, or more generally, management of the auditor's engagement, are generally excludable under rule 14a-8(i)(7)". The two uses of "generally" in this brief statement suggests that the staff is likely watching this topic, and related proposals, closely.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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