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D.C. Circuit Vacates SEC's Proxy Access Rule

BY CHARLIE HAAG AND JENNIFER BROWN

On July 22, 2011, the U.S. Court of Appeals for the D.C. Circuit delivered a stinging blow to shareholder activists by vacating Rule 14a-11,[1] the proxy access rule. The Business Roundtable and the U.S. Chamber of Commerce had argued, and the court agreed, that the Securities and Exchange Commission acted ''arbitrarily and capriciously'' in failing to adequately assess the economic effects of the rule.[2] The decision marks a significant turn in the decades-old battle over proxy access—a topic that is among the most controversial of the SEC's rulemaking efforts.

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Proxy Access: A Brief History

Advocates of proxy access have long argued that the SEC should give shareholders the ability to include their director nominees in an issuer's proxy statement. Such access to issuer proxy statements, according to these advocates, is a logical extension of shareholders' fundamental right under state corporate laws to elect directors.

Companies and business interests on the other side of the debate have argued that proxy access is an issue best left to state corporate law.

On August 25, 2010, by a divided 3-2 vote, the SEC adopted final rules that allowed qualified shareholders to include director nominees in an issuer's proxy materials.[3] The adoption of Rule 14a-11 followed years of rule proposals by the SEC and thousands of comment letters by parties arguing for or against various aspects of the proposals.

The SEC first proposed a proxy access rule in the 1940s. Neither that proposal, nor any other proxy access proposal before Rule 14a-11 in 2010, was adopted by the SEC.

The SEC began a new series of rulemaking efforts in 2003. In October of that year, the SEC proposed proxy access rules that prompted a vigorous debate. But that proposal, like its predecessors, was abandoned.

In the following years, shareholder activists sought access to issuer proxy statements through Rule 14a-8, the SEC's shareholder proposal rule. Activists used Rule 14a-8 to propose bylaw amendments at target issuers. If adopted, these bylaw amendments would allow shareholders to include director nominees in the target issuer's proxy statement. This so called ''private ordering'' would permit various forms of proxy access when allowed by state law and approved by shareholders.

In 2006, the Second Circuit Court of Appeals ruled in favor of allowing this private ordering under Rule 14a-8.[4] In response to the Second Circuit's decision, the SEC pro-

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[1] Securities Exchange Act of 1934, Rule 14a-11.

[2] Business Roundtable v. SEC, No. 10-1305, slip op. (D.C. Cir. July 22, 2011).

[3] 75 Fed. Reg. 56,668 (2010).

[4] AFSCME v. Am. Int'l Grp., Inc., 462 F.3d 121 (2d. Cir. 2006).

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posed two alternative amendments to Rule 14a-8 in July 2007. The SEC ultimately adopted the alternative that allowed companies to exclude these proxy access proposals under Rule 14a-8, thereby preventing attempts at private ordering.

The decision raises questions about the adequacy of the SEC's ongoing rulemaking efforts under Dodd-Frank.

The SEC proposed new proxy access rules again in June 2009. The rules were subjected to two separate comment periods, with the second period ending in January 2010. Later that year, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank expressly authorized the SEC to adopt proxy access rules. Soon after Dodd-Frank was enacted, the SEC adopted Rule 14a-11 and related amendments to Rule 14a-8. The new rules were set to take effect on Nov. 15, 2010, but the SEC stayed their implementation on Oct. 4, 2010, pending resolution of the litigation discussed in this article.

The Latest Proxy Access Rule

Rule 14a-11[5] would have allowed

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proxy access to a qualified shareholder to nominate the greater of one director or 25 percent of an issuer's board of directors. To utilize the rule, a shareholder, or group of shareholders, would have needed to meet the following criteria:

- ownership of at least three percent of the issuer's voting power for at least three years prior to submitting a director nominee, and
- no intent to change the control of the issuer.

[5] For an analysis of Rule 14a-11, see the Jones Day commentary "SEC Adopts Final Rules Facilitating Shareholder Nominations of Directors" (September 2010), http://www.jonesday.com/sec_adopts_final_rules/.

The court came down hard on the SEC for failing "once again" to provide adequate economic analysis for a new rule, citing two other cases where SEC rules were vacated.

The rule would have required public companies, including investment companies registered under the Investment Company Act of 1940, to include in their proxy materials the names of any person nominated for the board of directors by a qualifying shareholder. The SEC stated that the rule would address concerns that expenses associated with the proxy process hamper shareholders' rights under state corporate laws to nominate and elect directors. The SEC reasoned that access to issuer proxy statements could create "potential benefits of improved board and company performance and shareholder value" sufficient to justify the costs imposed on issuers.

The Court's Decision

Analyzing the SEC's adoption of Rule 14a-11 under the framework of the Administrative Procedure Act (APA),[6] the court held that the SEC acted "arbitrarily and capriciously" for failing "adequately to assess the economic effects of a new rule." The SEC failed to "examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made." Further, the court found the SEC did not meet its statutory obligation under the Securities Exchange Act of 1934 and Investment Company Act of 1940 to consider the effect of the rule upon "efficiency, competition, and capital formation."

Judge Douglas Ginsburg, writing for a unanimous panel, strongly criticized the SEC's process and analysis in adopting the final rule and found the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."

[6] 5 U.S.C. § 551 *et seq.*

The SEC predicted that the rule would lead to direct cost savings for shareholders by eliminating postage, printing, and advertising costs for qualified shareholders as compared with a traditional proxy contest. The court agreed with the petitioners that the SEC failed to quantify the costs issuers would incur in opposing shareholder nominees as a result of increased shareholder nominations. Therefore, the court found the SEC neglected its statutory duty to assess the economic consequences of the rule.

The decision . . . should provide a clear roadmap for future challenges to SEC rulemaking.

The petitioners argued that directors could interpret their fiduciary duties as requiring that they challenge a shareholder nominee if they felt such a nominee was not as strong as the board's own nominee. The Chamber of Commerce predicted boards would incur substantial expense in opposing shareholder nominees and pointed to estimates of from $4 million to $14 million for a large company to wage a proxy contest.

The court agreed with the petitioners and found that the SEC's retort that directors might choose not to oppose shareholder nominees was mere speculation. The SEC had provided no empirical support for its claim. The court also rejected the SEC's argument that the ownership limits for shareholder qualification under the rule would lead to infrequent proxy contests, because the SEC did not consider the potential monetary costs of a contested election, whatever the frequency. Because information about those costs was readily available, the court found the SEC was remiss in assessing the economic consequences of the rule.

The SEC claimed that the rule would improve board performance and increase shareholder value by facilitating the election of shareholder nominees. However, the court found that the SEC discounted several empirical studies put forth by commenters and relied "exclusively and heavily upon two relatively unpersuasive

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studies'' to support its claim. Accordingly, the court determined the SEC did not provide sufficient support for its suggested benefits of the rule.

It is likely that the SEC will revise or rewrite the rule to comply with the APA through the roadmap laid out by Judge Ginsburg's opinion.

The court agreed with the petitioners that the SEC failed to consider that institutional investors with special interests (such as unions and state pension funds) might use the rule to advocate their own positions and achieve goals other than increasing shareholder value. The court found the SEC's ''ducking'' of these concerns as further evidence the agency acted arbitrarily.

The court also expressed concern about the possibility of an increasing number of election contests. Judge Ginsburg noted that the SEC had not addressed ''whether and to what extent Rule 14a-11 will take the place of traditional proxy contests,'' so there was no way to know whether enacting the rule would facilitate enough election contests to provide a net benefit.

Finally, the court found the SEC's decision to apply the rule to investment companies was also arbitrary for the same reasons mentioned above and other reasons unique to investment companies. Judge Ginsburg noted that investment companies are subject to different requirements that provide for different shareholder protections than other public companies. While the SEC acknowledged this difference in the regulation, it did not explain why Rule 14a-11 would provide the same benefit for shareholders of investment companies as it would for shareholders of other companies.

Next Steps and Implications

The court came down hard on the SEC for failing ''once again'' to provide adequate economic analysis for a new rule, citing two other cases where SEC rules were vacated. The decision raises questions about the adequacy of the SEC's ongoing rulemaking efforts under Dodd-Frank. In a June 29 speech on an unrelated Dodd-Frank rule proposal, SEC Commissioner Kathleen Casey commented on the lack of a full cost-benefit analysis:

> The prevailing position is that we need not conduct a cost-benefit analysis on those items mandated by Dodd-Frank itself, but instead that we may confine our cost-benefit analysis only to those provisions that we are proposing at our discretion. I should note that this approach is even more limited than it seems, because we do not even conduct cost-benefit analysis of the discretionary choices we make within mandatory rulemaking items.[7]

Given the SEC's current work load . . . it is likely impossible that a new proxy access rule could become effective for the 2012 proxy season.

The court's decision seems directly contrary to the ''prevailing position'' of the SEC according to Commissioner Casey. The decision, then, should provide a clear roadmap for future challenges to SEC rulemaking.

The decision is also a somewhat surprising victory for supporters of board-centric corporate governance and the control of the states over governance matters. This is true despite the court's failure to address either the constitutionality of the rule or the petitioners' argument that the SEC arbitrarily rejected proposed alternatives to the rule. The most significant alternative to Rule 14a-11 seems to be a private ordering regime as discussed above. Delaware amended its corporate law in 2009 to facilitate proxy access bylaw amendments like those that could be proposed under a revised Rule 14a-8.

However, it seems the SEC may allow its amendments to Rule 14a-8 to become effective.

It remains to be seen how the SEC will respond to the decision. On the same day the court handed down its ruling, the SEC released the following statement:

> We are disappointed by today's decision striking down a rule that made it easier for shareholders to nominate a candidate to a company's board of directors. We are considering our options going forward. We note that our rule allowing shareholders to submit proposals for proxy access at their companies, which we adopted at the same time, is unaffected by the court's decision.

The SEC could appeal the decision to the full panel of judges of the D.C. Circuit or to the Supreme Court. Alternatively, the SEC could attempt to rewrite the rule to conform to APA requirements by strengthening its economic analysis. Given the SEC's current work load under Dodd-Frank rulemaking initiatives, it is likely impossible that a new proxy access rule could become effective for the 2012 proxy season, even if the SEC were inclined to pursue a new rule.

Based on the SEC's statement, however, it seems the SEC may allow its amendments to Rule 14a-8 to become effective. These amendments expressly permit private ordering by allowing eligible shareholders to propose amendments to a company's governing documents concerning nomination procedures or other director nomination disclosure provisions. These amendments were also stayed pending the lawsuit because the amendment was ''designed to complement'' the proxy access rule and the rules were ''intertwined.'' The Business Roundtable and Chamber of Commerce did not challenge the amendments to Rule 14a-8.[8]

Where Do Issuers Go From Here?

Issuers should watch the SEC closely for a new proxy access pro-

[7] Kathleen L. Casey, Commissioner, Securities and Exchange Commission, Statement at Open Meeting: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participant (June 29, 2011), available at http://www.sec.gov/news/speech/2011/spch062911klc.htm.

[8] For additional commentary on this issue, see Jones Day's Alert ''D.C. Circuit Court of Appeals Vacates Proxy Access Rule'' (July 2011), http://www.jonesday.com/dc_circuit_court_of_appeals_vacates/.

posal. Because the court found nothing wrong with the substance of Rule 14a-11, but rather attacked the rule on administrative grounds, it is likely that the SEC will revise or rewrite the rule to comply with the APA through the roadmap laid out by Judge Ginsburg's opinion. Proxy access is a goal of current commissioners, and they may look to reintroduce the rule. Even though a proxy access rule likely cannot be ready for the 2012 proxy season, it is possible that a new rule will be adopted within the next several proxy seasons.

Issuers should carefully review their bylaws and other policies regarding shareholder proposals to be prepared for the revised Rule 14a-8 to be effective as soon as the upcoming 2012 proxy season.

The amendments to Rule 14a-8 were not touched by the court's decision. From the SEC's reaction to the decision (quoted above), it is clear the SEC is considering how to move forward with these amendments. Issuers should watch for the SEC's decision with regard to removing the stay on the Rule 14a-8 amendments. While the SEC views the Rule 14a-8 amendments and Rule 14a-11 as intertwined, it will likely now remove its voluntary stay and allow shareholder proposals under the amended Rule 14a-8 to move forward without the proxy access rule. Issuers should carefully review their bylaws and other policies regarding shareholder proposals to be prepared for the revised Rule 14a-8 to be effective as soon as the upcoming 2012 proxy season.

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