SEC’s Proxy Access Rule Thrown Out By Federal Appeals Court

SEC DID NOT ADEQUATELY CONSIDER THE RULE’S EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION

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Overview

On July 22, 2011, the United States Court of Appeals for the District of Columbia (the “Court”) vacated Rule 14a-11 (“Rule 14a-11”) promulgated under the proxy access provisions of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), which were enacted last year as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). Rule 14a-11 had been adopted by the Securities and Exchange Commission (the “SEC”) on August 25, 2010 along with certain related rule changes to implement proxy access (collectively, the “Proxy Access Rules”).

Rule 14a-11 conferred a substantive federal right the SEC was authorized to confer in the Dodd-Frank Act for certain shareholders to include their nominees for election as director in a company’s proxy statement. Specifically, to facilitate the election of shareholder-nominated directors, Rule 14a-11 would have required a public company to include information about the shareholders’ nominees in the company’s proxy statement and to include the names of such nominees on the company’s proxy voting card. Without Rule 14a-11, a shareholder seeking to have its nominees elected to a public company’s board of directors is generally required to prepare and file its own proxy statement with the SEC, which can be time consuming and very expensive. Under Rule 14a-11, shareholders owning at least 3% of a company’s voting power for at least three years would have had an inexpensive means for opposing the company’s own slate of directors and seeking the election of their own nominees, who could comprise up to a quarter of the company’s board of directors. To use Rule 14a-11, a shareholder would have had to, among other things, not hold its shares with the purpose of changing control of the subject company. Rule 14a-11 would have applied to public investment companies (such as mutual funds) as well as operating companies registered under the Exchange Act. For a more complete discussion of the Proxy Access Rules, please see our article titled The SEC Adopts Final Proxy Access Rules.

The SEC has been trying to implement some sort of proxy access since at least 2003 when it first published proposed proxy access rules. However, proxy access has proven to be quite a divisive issue; the Proxy Access Rules were adopted by the SEC by a rare three to two split vote. The Proxy Access Rules were to become effective on November 15, 2010. However, in response to a motion filed by the
Business Roundtable and the Chamber of Commerce of the United States of America (collectively, the “Petitioners”), the SEC stayed implementation of the Proxy Access Rules pending the Court’s decision.

The Court’s Decision in Business Roundtable and Chamber of Commerce of the United States of America vs. SEC

Shortly after Rule 14a-11’s adoption, the Petitioners, both of which have as members public companies that were impacted by Rule 14a-11, petitioned the Court for review of Rule 14a-11, claiming that the SEC had promulgated Rule 14a-11 in violation of the Administrative Procedure Act (the “APA”) because it “failed to adequately to consider the rule’s effect upon efficiency, competition, and capital formation” as required by the Exchange Act and the Investment Company Act of 1940, as amended (the “ICA”). In an opinion that minced few words, the Court agreed, holding that the SEC “acted arbitrarily and capriciously in violation of the APA for having failed once again . . . adequately to assess the economic effects of a new rule.” The Court went on to state that 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.”

The Court concluded, among other things, that the SEC:

- relied “exclusively and heavily on unpersuasive studies” in connection with its analysis of the benefits of Rule 14a-11 and did not “sufficiently [support] its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value”;

- acted arbitrarily by not seriously evaluating the costs that special interest groups, such as unions and government pension funds, could impose on public companies through their use (or threatened use) of Rule 14a-11 as leverage to gain advantages, such as jobs, for their constituents;

- failed to address the extent to which Rule 14a-11 would displace traditional proxy contests, and that without this information the SEC “has no way of knowing whether the rule will facilitate enough election contests to be of net benefit”; and

- contradicted itself by saying that Rule 14a-11 would be used frequently when estimating its benefits, but that it would be used infrequently when estimating its costs.

The Court also went to considerable lengths to discuss the application of Rule 14a-11 to investment companies (such as mutual funds) even though it made clear that it had no need to do so, as it had already determined that the SEC had acted arbitrarily and capriciously in adopting Rule 14a-11. The Court did so to provide guidance to the SEC should it try, once again, to implement a proxy access rule. In particular, the Court concluded that the SEC failed to adequately address “whether the regulatory requirements of the ICA reduce the need for, and hence the benefit to be had from, proxy access for shareholders of investment companies, and whether the rule would impose greater costs upon investment companies by disrupting the structure of their governance.” The court noted the frequent use by investment companies of “unitary” boards, where one group of directors sits as the board of every fund in a fund complex, and “‘cluster boards,’ comprising two or more groups of directors, with each group overseeing a different set of funds within the complex.” The Court noted further that the SEC failed to address the greater costs that Rule 14a-11 could impose on investment companies by disrupting the “unitary” or “cluster” board structures by allowing a shareholder-
nominated director to sit on the board of a single fund, requiring multiple, separate board meetings (as opposed to concurrent meetings), thus making governance less efficient. The Court noted that the SEC did acknowledge the incremental costs to investment companies. However, it concluded that the SEC’s attribution of the costs to the right under state law to nominate directors was insufficient.

Finally, the Court took strong issue with the SEC’s statement that “any increased costs and decreased efficiency of an investment company’s board as a result of the fund complex no longer having a unitary or cluster board would occur, if at all, only in the event that investment company shareholders elect the shareholder nominee.” The court stated that the SEC’s “rationale is tantamount to saying the saving grace of the rule is that it will not entail costs if it is not used, or at least not used successfully to elect a director. That is an unutterably mindless reason for applying the rule to investment companies.”

**Proposed Amendments to Rule 14a-8(i)(8)**

At the same time the SEC adopted Rule 14a-11, it also adopted amendments to Rule 14a-8(i)(8), which would allow a shareholder proposal to amend a company’s governing documents to provide for proxy access to be included in the company’s proxy materials. As amended, Rule 14a-8(i)(8) still permits a company to exclude such a proposal on other bases set forth in Rule 14a-8, including if such proposal would cause the company to violate any applicable state, federal or foreign law. The amendments to Rule 14a-8(i)(8) provide an alternative route to proxy access under Rule 14a-11, albeit a less certain one. Even though not requested to do so by the Petitioners, the SEC stayed implementation of its amendments to Rule 14a-8(i)(8) at the same time it stayed implementation of the Proxy Access Rules. The Petitioners did not challenge and the Court’s decision did not affect the amendments to Rule 14a-8(i)(8). Thus, the SEC could lift its stay and implement its amendments to Rule 14a-8(i)(8). However, of note, the SEC applied the Rule 14a-8(i)(8) amendments to investment companies, despite objection it had received to such application in the comment process relating to the adoption of the Rule 14a-8(i)(8) amendments.

**Conclusion**

The Court pulled no punches in admonishing the SEC for not thoroughly analyzing Rule 14a-11’s effect upon efficiency, competition, and capital formation. While most of the Court’s reasoning is sound, it may have held the SEC to an unrealistic standard with respect to its ability to predict certain effects of Rule 14a-11. For example, the Court took issue with the SEC’s failure to address the extent to which Rule 14a-11 would take the place of traditional proxy contests. Given that the motivations for proxy contests vary considerably and decisions often turn on unique facts and circumstances, any predictions as to the impact of proxy access on such contests would fairly be considered conjecture. Nevertheless, given the strong wording by the Court and other recent decisions where the Court also found that the SEC failed to assess the economic effects of a new rule,² it appears unlikely that the SEC will appeal this decision. Accordingly, the SEC will have to go back to the drawing board if the agency wishes to continue to pursue proxy access. If the SEC again pursues proxy access, given the criticisms in the Court’s decision as it relates to investment companies, we believe it is less likely that any future proxy access rules developed by the SEC will apply to investment companies. In addition, we are skeptical that the SEC will lift its stay on implementation of its amendments to Rule 14a-8(i)(8) in their current form, in light of the fact that those amendments are applicable to investment companies. Whatever the SEC decides to do, it seems clear that proxy access will not be in place for the 2012 proxy season.
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