Client Alert.

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SEC Proxy Access Rule Vacated

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On July 22, 2011, the United States Court of Appeals for the District of Columbia Circuit (the "Court") vacated the U.S. Securities and Exchange Commission's (the "SEC") Rule 14a-11. This "proxy access" rule was adopted shortly after Section 971 of the Dodd-Frank Act clarified the SEC's authority to promulgate the rule. The Court held that the SEC was arbitrary and capricious in adopting the rule, thus leaving the SEC to now consider how it will proceed on the issue of proxy access.

BACKGROUND OF PROXY ACCESS

The SEC's efforts toward adopting a proxy access rule have been ongoing for a very long time. The SEC first solicited public comment on a proxy access rule proposal in 1942, and that proposal was never adopted. In 1977, the SEC again requested comment on whether shareholders should have access to the proxy statement for the purpose of nominating directors to serve on the board as part of a larger project examining corporate governance. At that time, the SEC concluded that due to the emerging concept of nominating committees, there was no need to propose and adopt a proxy access rule. The topic was again addressed in 1992, when the SEC rejected the notion of a universal proxy access rule in favor of the "short slate" proxy contest rules. The SEC then began considering the adoption of some form of proxy access in earnest beginning in 2003, when it proposed a rule providing proxy access to five percent shareholders upon the occurrence of certain triggering events. That proposed rule was not adopted, and in 2007 the SEC proposed, but did not ultimately adopt, a universal proxy access rule for five percent shareholders. The debate over proxy access continued following the financial crisis, and the SEC continued its rulemaking efforts beginning with a 2009 proxy access rule proposal.

Section 971 of the Dodd-Frank Act provided the SEC with authority to promulgate "proxy access" rules, allowing specified shareholders to include director nominees in a company's proxy materials. The Dodd-Frank Act did not prescribe specific standards for these rules. The SEC issued final rules facilitating shareholder director nominations on August 25, 2010, and such rules were scheduled to become effective on November 15, 2010.

As adopted, Rule 14a-11 would have provided qualifying shareholders or groups holding at least three percent of the voting power of a company's securities, and who have held their shares for at least three years, with the ability to request that public companies or investment companies include the shareholder or shareholders' director nominees in their proxy materials, upon meeting certain other requirements. An amendment to existing Rule 14a-8 would have provided that companies may not exclude from their proxy materials shareholder proposals for less restrictive proxy access procedures.

THE LITIGATION CHALLENGING RULE 14A-11

On September 29, 2010, the Business Roundtable and Chamber of Commerce of the United States of America filed a petition with the United States Court of Appeals for the District of Columbia Circuit, seeking judicial review of the changes to the SEC's proxy access and related rules, and on the same day filed with the SEC a request to stay the effective date of newly adopted Exchange Act Rule 14a-11 and associated amendments to the SEC's rules. On October 4, 2010, the SEC granted the request for a stay of the rules pending resolution of the petition for review by the Court.

THE COURT'S DECISION

On July 22, 2010, the Court held that the SEC was "arbitrary and capricious" in promulgating Rule 14a-11, and vacated the rule. The Court indicated that the SEC failed to adequately address the economic effects of Rule 14a-11. Under Section 706(2)(A) of the Administrative Procedure Act, a court can set aside an action by a federal agency when the agency's action is deemed to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." The SEC has a statutory obligation to assess the economic implications of a new rule, and must articulate the connection between the facts that the agency found and the determinations made in the course of the rulemaking.

In the opinion, the Court stated:

> We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again — as it did most recently in *American Equity Investment Life Insurance Company v. SEC*, 613 F.3d 166, 167–68 (D.C. Cir. 2010), and before that in *Chamber of Commerce*, 412 F.3d at 136 — adequately to assess the economic effects of a new rule. Here the Commission 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. For these and other reasons, its decision to apply the rule to investment companies was also arbitrary. Because we conclude the Commission failed to justify Rule 14a-11, we need not address the petitioners' additional argument the Commission arbitrarily rejected proposed alternatives that would have allowed shareholders of each company to decide for that company whether to adopt a mechanism for shareholders' nominees to get access to proxy materials.

The Court expressed significant concerns about the conclusions that the SEC reached and the agency's consideration of comments during the course of the rulemaking. The Court did not address the First Amendment challenge to the rule that had been raised by the petitioners. The Court also specifically addressed the application of Rule 14a-11 to investment companies and indicated that the rule would be invalid as applied specifically to investment companies. The Court noted concerns with the portion of the rulemaking that related specifically to investment companies.

THE SEC'S NEXT STEP

The SEC must now determine whether to appeal the decision of the Court. The Court's strong rebuke of the agency's rulemaking process comes at a time when the SEC is engaged in an extraordinary amount of rulemaking directed by the Dodd-Frank Act. The Court sets a high bar for the agency to meet in order to avoid having its rules vacated, and thus the decision has wide-ranging implications beyond the issue of proxy access.

On remand from the Court, the SEC could revisit its economic analysis in its Rule 14a-11 rulemaking and could seek to address the concerns raised by the Court. It is possible that the SEC could revisit Rule 14a-11 and seek to make modifications to the rule and its associated consideration of the economic implications of the rule.

The Court's decision did not address the SEC's amendment to Rule 14a-8(i)(8) , which was not a subject of the litigation. The SEC could potentially revisit Rule 14a-8(i)(8), and thereby permit the type of "private ordering" for proxy access through the shareholder proposal process that many commenters had supported in the course of the proxy access rulemaking.

The SEC issued a statement from the Director of the Division of Corporation Finance indicating that the SEC staff is disappointed with the Court's decision and stating that they were considering their options. The statement also noted that the amendments to Rule 14a-8(i)(8) adopted at the same time as Rule 14a-11 were unaffected by the Court's decision.

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