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Court Vacates SEC Shareholder Nomination Rule

The U.S. Court of Appeals for the District of Columbia Circuit sharply criticized the Securities and Exchange Commission and vacated Exchange Act Rule 14a-11, which permitted certain shareholders of public companies to nominate candidates for the board of directors outside a company's normal nomination process. As noted in last week's edition of the *Corporate and Financial Weekly Digest*, the court held that the SEC was "arbitrary and capricious" in promulgating Rule 14a-11 and thus violated the Administrative Procedure Act in failing to adequately consider the Rule's effect upon efficiency, competition and capital formation.

Typically, incumbent directors nominate candidates for board positions by including information about such nominees in a company's proxy materials. A shareholder who wishes to nominate a potential board member not chosen by the board must file his own proxy statement and solicit votes from shareholders, thereby initiating a proxy contest. Rule 14a-11 would have permitted shareholder nominees to be included in a company's proxy statement under certain conditions.

In rejecting Rule 14a-11, the court held that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or 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."

In particular, the court noted that while the SEC acknowledged that companies may incur costs in opposing shareholder nominees, it did nothing to estimate those costs nor did it claim that the costs were inestimable. Additionally, the SEC employed insufficient empirical data in concluding that Rule 14a-11 would improve board performance and increase shareholder value. Commenters pointed out that investors with special interests such as employee benefit funds could gain leverage by threatening to impose additional costs on companies through the use of Rule 14a-11. The court found the SEC's failure to seriously evaluate these potential costs problematic and concluded that the SEC acted arbitrarily in this regard. The court also determined that the SEC also acted arbitrarily in predicting frequent use Rule 14a-11 when estimating its benefits, but infrequent use when estimating its costs.

Finally, the court held that the SEC failed to adequately address the effects Rule 14a-11 would have on investment companies, characterizing the SEC's rationale as "unutterably mindless." Note that this decision does not address the adopted amendments to Rule 14a-8, which allow shareholders to propose amendments to a company’s bylaws to provide a procedure for including shareholder nominees in a company’s proxy statement.

Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission, No. 10-1305 (D.C. Cir. 2011).

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