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DC Circuit Panel Vacates Proxy Access Rule

Does the Decision Create a Blueprint to Attack Other SEC Rules Being Issued Under the Dodd-Frank Act?

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On July 22, 2011, a three-judge panel of the United States Court of Appeals for the District of Columbia Circuit (DC Circuit) vacated Securities Exchange Act Rule 14a-11. Rule 14a-11 would have allowed qualifying long-term shareholders to nominate a limited number of directors and to include them in the proxy materials of public companies and investment companies. In a pointed opinion focused on the underlying cost-benefit analysis of the rule, the DC Circuit panel found that the Securities and Exchange Commission (SEC) had not sufficiently assessed “the rule’s effect upon efficiency, competition, and capital formation,” among other failings. This ruling marks the third time in six years that the DC Circuit has overturned an SEC rule. Although the SEC may appeal the ruling or consider revising its proxy access rules to address the defects identified by the DC Circuit panel, public companies and investment companies almost certainly can set aside worries about mandatory proxy access for the 2012 proxy season.

However, the ruling did not impact the validity of the SEC’s amendments to Rule 14a-8 (the shareholder proposal rule). The amendments would allow shareholders of public companies and investment companies to propose modifications to a company’s governing documents to establish proxy access procedures (sometimes referred to as the “private ordering” of proxy access). If the SEC lifts its stay of the amendments, we expect that the next round in the proxy access fight will focus on shareholder proposals to include proxy access procedures in 2012 proxy statements. If activists prevail in 2012, these proposals could clear a path for future proxy access under a company’s governing documents and nomination policies.

As the DC Circuit panel so thoroughly recited the SEC’s failings in adopting Rule 14a-11, we wonder if the opinion might set the blueprint for widely expected challenges to some of the other rules being promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Background

Section 971 of the Dodd-Frank Act authorized, but did not require, the SEC to establish proxy access rules. The SEC adopted Rule 14a-11 in August 2010. Before the rule became effective in November 2010, the Business Roundtable and United States Chamber of Commerce petitioned the DC Circuit to review Rule 14a-11, arguing that the SEC violated the Administrative Procedure Act in adopting the rule. The petitioners also filed with the SEC a request to stay the effectiveness of Rule 14a-11 and related amendments pending the outcome of the Rule 14-11 review. The stay was granted.¹

DC Circuit Ruling

The DC Circuit panel agreed with the petitioners and found that the SEC acted arbitrarily and capriciously in adopting Rule 14a-11 because it discounted the costs of the rule, but not its benefits, and failed to adequately assess the economic effects of the rule. The opinion noted, among other things, that the SEC’s analysis had inconsistencies and failed to:

- adequately quantify and explain the rule’s costs, including the costs a company would incur even when a shareholder nominee is not ultimately elected;
- support its predictions of direct cost savings and other benefits for shareholders;
- respond to substantial problems raised by commenters (suggesting that the SEC comment process will have even greater weight with the SEC and the courts in future rulemaking);
- sufficiently support its conclusion that proxy access and “hybrid boards” (which include some dissident directors) would improve board and company performance and shareholder value;
- adequately evaluate the costs that companies could face from use of the rule by shareholders with special interests (for example, union and government pension funds) to pursue self-interested objectives unrelated to shareholder value maximization; and

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- address to what extent the rule would take the place of traditional proxy contests or offer a net benefit.

The opinion was especially pointed in its critique of the SEC's decision to extend the proxy access rule to investment companies. Investment companies are highly regulated and uniquely structured, as the opinion noted. The DC Circuit panel found that the SEC neglected to address adequately whether the characteristics of investment companies reduced the need for, and the benefits of, proxy access and whether the rule would impose greater compliance costs by disrupting investment companies' unique governance structure.

SEC's Next Steps

In response to the ruling, the SEC expressed its disappointment and indicated that it would consider its options. One option would be to seek an appeal of the ruling. Alternatively, the SEC could restart the rulemaking process to address the DC Circuit panel's concerns or temporarily or permanently forego mandatory proxy access.

If the SEC does not pursue an appeal, mandatory proxy access rules may remain suspended. Having adopted the proxy access rules with a close 3-2 vote, the SEC may not be inclined to pursue revised rules in the near term despite ongoing pressures from shareholder activists, such as the Council for Institutional Investors. The SEC is currently inundated with rulemaking mandated by the Dodd-Frank Act (some of which is behind its statutorily-imposed deadlines). Tackling mandatory proxy access seems unlikely when the SEC is overextended on other rulemaking projects, almost certainly not in time to meet the rule's advance notice requirements for the 2012 proxy season.

Possibility of Private Ordering of Proxy Access Remains Alive

Yet, the DC Circuit panel's ruling does not mean that proxy access initiatives will die. The Business Roundtable lawsuit did not challenge, and the DC Circuit panel's ruling did not extend to, the SEC's amendments to Rule 14a-8 that were adopted in tandem with Rule 14a-11. The Rule 14a-8 amendments would allow the private ordering of proxy access through a company's governing documents. The effectiveness of these amendments was stayed by the SEC along with the stay of Rule 14a-11.

The question is whether the SEC will lift the stay. Prior SEC statements suggested that the fate of the Rule 14a-8 amendments was intertwined with that of Rule 14a-11. In the adopting release for the proxy access rules, the SEC stated that it did "not believe that adopting changes to Rule 14a-8(i)(8) alone, without adopting Rule 14a-11, will achieve [its] goal of facilitating shareholders' ability to exercise their traditional state law rights to nominate directors."² In addition, the SEC extended its stay beyond Rule 14a-11 to the Rule 14a-8 amendments "because the amendment to Rule 14a-8 was designed to complement Rule 14a-11 and is intertwined, and there is a potential for confusion if the amendment to Rule 14a-8 were to become effective while Rule 14a-11 is stayed."³

Nonetheless, in its public statement reacting to the DC Circuit panel's ruling, the SEC made a point of noting that the Rule 14a-8 amendments were unaffected by the ruling. Perhaps the SEC's position has shifted away from linking proxy access by private ordering with mandatory proxy access. Indeed, the SEC may conclude that allowing private ordering could provide additional empirical data and experience to address the DC Circuit panel's concerns and inform potential rulemaking efforts in the future.

What Would Private Ordering Mean for Public Companies?

If the SEC lifts the stay on the Rule 14a-8 amendments in the near future, public companies should prepare for proxy access proposals for the 2012 proxy season, especially as a majority of public companies are incorporated in Delaware where state law already allows bylaws to include a proxy access provision. Year-round shareholder engagement to identify and address, among other things, any concerns related to director nominations and performance could go a long way to heading off possible shareholder proposals related to proxy access and other governance-related matters, such as board declassification, majority voting for directors, shareholder action by written consent, shareholder power to call special meetings and an independent board chairman. In addition, public companies without robust advance notice bylaws should

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consider amending their bylaws to provide an effective advance notice mechanism for shareholder proposals, as well as procedures for shareholder nominations.

Plan of Attack for Challengers to Dodd-Frank Act Rulemaking?

We were struck by just how meticulous the DC Circuit panel expected the SEC to be in assessing the “economic effects” of its rules. In particular, the panel found unpersuasive the empirical studies that the SEC cited to justify the rules. The panel further found that the SEC had failed to perform a marginal cost analysis of “management distraction and reduction in the time a board spends ‘on strategic and long-term thinking’” in dealing with nominations by shareholders.

In view of the DC Circuit’s criticisms that the SEC had failed to perform a thorough economic analysis to capture all of the potential costs of proxy access—no mean feat for an agency without unlimited resources—we began to wonder whether many issued and soon-to-be issued rules under the Dodd-Frank Act would be able to pass muster under the DC Circuit’s exacting standards. Perhaps the DC Circuit panel’s opinion provides a blueprint for the numerous opponents of the SEC’s recent and ongoing rulemaking. Stay tuned.

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Andrews Kurth advises numerous public companies, including publicly traded partnerships, in a variety of industries and will continue to follow developments related to the topic of this client alert and other SEC rulemaking and guidance.

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1. See our previous Client Alert “SEC Stays Proxy Access Rules.”
 2. Facilitating Shareholder Director Nominations, Release Nos. 33-9136, 34-62764 and IC-29384, at 230-31 (Aug. 25, 2010).
 3. Order Granting Stay In the Matter of the Motion of Business Roundtable and Chamber of Commerce of the United States of America For Stay of Effect of Commission’s Facilitating Shareholder Director Nominations Rules, Securities Act Release No. 9149; Exchange Act Release No. 63031; Investment Company Act Release No. 29456, at 2 (Oct. 4, 2010).