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Corporate Governance Group

Client Alert

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FEDERAL COURT VACATES SEC'S PROXY ACCESS RULE

D.C. Circuit finds that the Commission acted "arbitrarily and capriciously" in adopting the controversial rule

Background

As discussed in a previous Client Alert,¹ on August 25, 2010, the Securities and Exchange Commission (the "SEC") adopted changes to the federal proxy rules that would have provided eligible shareholders with access to company proxy materials for the purpose of nominating candidates for election to the board of directors.² Adoption of the new rules was facilitated by passage last year of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provided the SEC with a broad legislative mandate to adopt a proxy access regime after years of debate concerning the advisability and propriety of federally-mandated proxy access.³ It is worth noting that the SEC considered, but ultimately rejected, other formulations, including one "to let each company's board or a majority of its shareholders decide whether to incorporate [the proxy access rule] in its bylaws."

The SEC rulemaking contained two key components: (i) new Rule 14a-11, which mandated access to company proxy statements and cards for any shareholder (or group of shareholders) with a "long-term interest and commitment" in the

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¹ See our previous Client Alert entitled "SEC Adopts Long-Awaited Proxy Access Rules" (dated September 14, 2010).

² See Release No. 33-9136 entitled "Facilitating Shareholder Director Nominations," which is available on the SEC's website at <http://sec.gov/rules/final/2010/33-9136.pdf>.

³ For a further discussion of the Wall Street Reform Act, please see our Client Alerts entitled "Corporate Governance Highlights of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010" (dated July 21, 2010) and "'Accredited Investor' Standard For Reg D Offerings Tightened By Wall Street Reform Act" (dated August 4, 2010).

company⁴ who wishes to nominate a limited number of director candidates⁵ without incurring the expense of conducting a proxy contest; and (ii) amendments to Rule 14a-8(i)(8) that narrow the “election exclusion” for shareholder proposals relating to individual director elections and terms in office. The SEC framed Rule 14a-11 with a view to addressing concerns that the existing proxy system “impedes the expression of shareholders’ right under state corporation laws to nominate and elect directors.” The SEC, by a vote of three to two, adopted Rule 14a-11 with the express goal of ensuring that “the proxy process functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders.”⁶ These rules and rule amendments initially were scheduled to become effective on November 15, 2010 and to be operative for most companies in connection with the 2011 proxy season.

The new proxy access rule generated a flood of controversy (interestingly, among both proponents *and* opponents of federally-mandated proxy access) and, on September 29, 2010, the U.S. Chamber of Commerce and the Business Roundtable filed suit in the United States Court of Appeals for the D.C. Circuit seeking to overturn the rule and asking the SEC to delay its effectiveness. On October 4, 2010, the SEC agreed to a delay in order to “avoid[] potentially unnecessary costs, regulatory uncertainty, and disruption that could occur if the new rules were to become effective during the pendency of a challenge to their validity.”⁷

The D.C. Circuit’s Analysis

In an opinion handed down on July 22, 2011,⁸ the D.C. Circuit vacated Rule 14a-11, holding that the SEC acted “arbitrarily and capriciously for having failed once again ... adequately to assess the economic effects of a new rule,” contrary to the requirements of the Administrative Procedure Act.⁹ According to the D.C. Circuit, when the SEC fails to “apprise itself ... of the economic consequences of a proposed regulation,” then its promulgation will be considered “arbitrary and capricious and not in accordance with law.”

The D.C. Circuit agreed with the opponents of Rule 14a-11 that the SEC had “neglected its statutory responsibility to determine the likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation.” In fact, the D.C. Circuit used particularly harsh language in declaring 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.”

⁴ Under Rule 14a-11, a shareholder or group of shareholders must have continuously held “at least 3% of the voting power of the company’s securities entitled to be voted” for at least three years prior to the date the shareholder or group submits notice of its intent to use the rule.”

⁵ No company would have been required to include in its proxy materials “more than one shareholder nominee or the number of nominees, if more than one, equal to 25 percent of the number of directors on the board.” In a situation where “several nominating shareholders are eligible to use Rule 14a-11, the nominating shareholder or group with the highest percentage of the company’s voting power would have its nominees included in the company’s proxy materials.”

⁶ The rule, however, would have no application where controlling state law or a company’s governing documents “prohibit shareholders from nominating a candidate for election as a director.” Further, a shareholder or group would not have been allowed to use the rule with the intent of effecting a change of control of the company.

⁷ See our previous Client Alert entitled “Effective Date of Proxy Access Rules Delayed” (dated October 5, 2010).

⁸ *Business Roundtable and Chamber of Commerce of the United States of America v. SEC*, No. 10-1305 (D.C. Cir. 2011).

⁹ Because the D.C. Circuit found that the SEC acted “arbitrarily and capriciously” in promulgating Rule 14a-11, it had “no occasion to address the petitioners’ First Amendment challenge to the rule.”

Conclusion

The D.C. Circuit's decision leaves the SEC's efforts to mandate proxy access in a state of limbo. Moreover, companies who have been gearing up to comply with the new proxy access rule – including by making conforming amendments to their advance notice bylaws – are faced with the reality that an impasse on proxy access has once again been reached. Because the Act's mandate that the SEC implement proxy access remains, however, one must assume that the SEC will take up the matter again at some point. Perhaps proxy access will be addressed as part of a more sweeping effort underway at the SEC to reform the proxy system generally. Given the backlog of Dodd-Frank Act rulemaking that currently confronts the SEC (and other federal agencies), as well as the controversial nature of federally-mandated proxy access, the timing for any future SEC efforts cannot be predicted. Certainly proxy access will not be a feature of the 2012 proxy season.

It should also be noted that the D.C. Circuit's ruling does not impact the SEC's amendments to Rule 14a-8, whose effectiveness the SEC also voluntarily delayed when the lawsuit was filed. So it remains possible that the SEC will allow these amendments, which limit the so-called "election exclusion", to take effect. Specifically, the Rule 14a-8 amendments would enable shareholders to require the inclusion in company proxy materials of proposals to amend (or to request an amendment of) the company's governing documents regarding nominating procedures or disclosures related to shareholder nominations, so long as the proposal would not (i) disqualify a particular nominee, (ii) remove a particular director mid-term, (iii) question the "competence, business judgment or character" of any particular nominee or director, (iv) seek to include a specific nominee in the company's proxy materials or (v) otherwise affect the outcome of the upcoming election of directors. If the SEC does decide to allow the Rule 14a-8 amendments to take effect, activist shareholders could then utilize the rule to propose that companies adopt proxy access on a voluntary basis pending further SEC action.¹⁰

¹⁰ Rule 14a-8 requires that a shareholder making a proposal for inclusion in the proxy materials must have continuously held at least \$2,000 in market value, or 1%, of the company's voting shares for a period of one year prior to submitting the proposal.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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