

**Milbank**

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# Corporate Governance Group

# Client Alert

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## U.S. COURT OF APPEALS STRIKES DOWN PROXY ACCESS RULE

*But permits amendments to Rule 14a-8 that narrow the “election exclusion” to become effective*

*Yet additional questions may loom regarding future Dodd-Frank rulemaking by the SEC*

On July 22, 2011, in what could be characterized as a major blow to the Securities and Exchange Commission in its ongoing efforts to implement portions of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, the U.S. Court of Appeals for the District of Columbia Circuit issued an order vacating Rule 14a-11 of the Securities Exchange Act of 1934, which provided eligible shareholders with access to company proxy materials for the purpose of nominating candidates for election as directors.

### ***Background to “Proxy Access”***

In 2010, the Dodd-Frank Act was passed and provided the SEC with broad legislative authority to adopt “proxy access” rules.<sup>1</sup> In furtherance of this legislative directive, on August 25, 2010, the SEC adopted the following changes to the federal proxy rules:

- ***New Rule 14a-11:*** This rule was designed to provide holders of “a significant, long term stake in a company” with the right, under certain circumstances, to include their nominees for election as directors in the company’s proxy materials in connection with annual shareholders meetings (or a special meeting held in lieu of an annual meeting). Notably, this new Rule was *not* by its terms available to shareholders who sought to change control of a board or gain more than a limited number of seats. Rather, in those instances, the procedures currently available under Rule 14a 12(c) for waging a proxy contest would continue to apply.

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<sup>1</sup> For a further discussion of the Dodd-Frank Act, please *see* our Client Alert entitled “Corporate Governance Highlights of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010” (dated July 21, 2010).

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- *Amendments to Rule 14a-8*: The new amendments to Rule 14a 8(i)(8) narrowed the “election exclusion” for shareholder proposals relating to individual director elections and terms in office. These amendments enable a qualifying shareholder<sup>2</sup> to require a company to include in its proxy materials a shareholder’s proposal to amend (or to request an amendment of) the company’s governing documents regarding nomination procedures or disclosures related to shareholder nominations, so long as such proposal does 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) “[o]therwise could affect the outcome of the upcoming election of directors.”<sup>3</sup>

Both of these proxy rule amendments were scheduled to become effective in the fall of 2010. In adopting these rules, the SEC had finally overcome its previous failed attempts to adopt proxy access rules, with the most recent unsuccessful attempt occurring back in 2007.

Any triumph that the SEC may have felt was short-lived, however, because on September 29, 2010, the Business Roundtable and the Chamber of Commerce of the United States of America filed a petition in the U.S. Court of Appeals for the District of Columbia Circuit seeking to overturn Rule 14a-11, alleging that the Rule was arbitrary and capricious and that the SEC failed to adequately assess its economic impact as required by statute. In light of these proceedings, on October 4, 2010, the SEC stayed the effectiveness of both Rule 14a-11 and the amendments to Rule 14a-8 pending a decision by the D.C. Circuit.

On July 22, 2011, the D.C. Circuit issued its long-awaited decision, rebuking the SEC for its failure to adequately “assess the economic effects of a new rule” and because the SEC “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.” Accordingly, the Court concluded that the SEC “failed to justify Rule 14a-11” and “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.”

In an unexpected turn of events, the SEC initially responded by issuing a public release on September 6, 2011<sup>4</sup> stating that the Commission would not seek a rehearing of the decision or an appeal to the U.S. Supreme Court regarding Rule 14a-11, but noted that the stay on the effectiveness of the amendments to Rule 14a-8 would expire, in the absence of further SEC action, when the D.C. Circuit’s decision became final.

Shortly after the D.C. Circuit’s decision became final on September 14, 2011, and contrary to what some commentators speculated would happen, the SEC published a release on September 15, 2011 in which the SEC declared that because “[t]he Court’s order did not affect the amendment to Rule 14a-8. . . or the related rules and amendments adopted concurrently with Rule 14a-11 and the amendment to Rule 14a-8,” such rules and amendments would become effective on September 20, 2011.<sup>5</sup>

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<sup>2</sup> Rule 14a-8 requires a shareholder making a proposal to have continuously held at least \$2,000 in market value, or 1%, of a company’s voting shares for a period of one year prior to submitting a proposal.

<sup>3</sup> For a further discussion of the rules, please see our Client Alert entitled “SEC Adopts Long-Awaited Proxy Access Rules” (dated September 14, 2010).

<sup>4</sup> See Statement by SEC Chairman Mary L. Shapiro on Proxy Access Litigation, which is available on the SEC’s website at <http://sec.gov/news/press/2011/2011-179.htm>.

<sup>5</sup> See Release No. 33-9259 entitled “Facilitating Shareholder Director Nominations”, which is available on the SEC’s website at <http://sec.gov/rules/final/2011/33-9259.pdf>.

### *Conclusion*

Throughout this prolonged process, one clear and constant sentiment has been the SEC's commitment to provide proxy access to shareholders, as the agency continues to believe that any such rules will provide "a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies," a right that "is in the best interest of investors and our markets."<sup>6</sup>

That being said, several aspects remain less clear in the aftermath of the D.C. Circuit's decision. For one, it is not certain whether the amendments to Rule 14a-8 are immune to a challenge from petitioners making the same allegations that were successfully made regarding Rule 14a-11. Moreover, assuming the new amendments to Rule 14a-8 remain in place, one cannot predict whether, and if so, how many, shareholders will take advantage of the amendments to Rule 14a-8 to submit proposals in the upcoming proxy season. Accordingly, company boards and governance committees should be prepared to receive and react to such proposals. Finally, and perhaps the most perplexing take-away from this proxy access battle is whether the SEC will face opposition on future rulemaking proposals as the agency works toward implementing the various rules envisioned by the Dodd-Frank Act that have yet to be codified.

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<sup>6</sup> *Id.*

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