

## ADVISORY | Securities and Corporate Governance

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### SHAREHOLDER ACCESS LITIGATION AND BEYOND

On July 22, 2011, the U.S. Court of Appeals for the D.C. Circuit issued a long-awaited decision in the case of *Business Roundtable and Chamber of Commerce v. Securities and Exchange Commission*, No. 10-1305 slip op. (D.C. Cir. Jul. 22, 2011), which vacated Rule 14a-11, the SEC's shareholder access rule. By vacating the rule, the D.C. Circuit has dealt a significant blow to the SEC's long-standing efforts to adopt a rule that would require, under certain circumstances, that public companies include in their proxy materials shareholder-proposed nominees to the board of directors. The decision also has import that goes significantly beyond shareholder access, as it will challenge the SEC (and, likely, other agencies) in assessing the economic consequences of future rulemakings. Nevertheless, the court's decision does not end the shareholder access debate. Under an amendment to the shareholder proposal rule (Rule 14a-8) that was adopted last year at the same time as the shareholder access rule and voluntarily stayed by the SEC pending the outcome of the shareholder access rule litigation, shareholders may yet be able to submit shareholder proposals that seek to establish shareholder access regimes in 2012. The SEC has not yet indicated whether it will lift this stay, but there is no legal reason why it could not do so.

#### BACKGROUND

After failing to reach consensus on the issue on several prior attempts, in 2010 the SEC adopted a rule that established a right of certain qualifying shareholders to have their nominees to the board included in a company's proxy materials. This rule was preceded by a lengthy, and at times, contentious comment period. During the process, the SEC received over 600 comment letters that were sharply divided, including over whether the SEC should adopt a shareholder access rule at all, limits as to the companies covered by the rule and whether companies and shareholders should be entitled to pursue a "private ordering" mechanism under which they could "opt-out" of the rule through company- or shareholder-proposed procedures. Following the close of the initial comment period, the SEC reopened the comment period to invite comments regarding additional data and analyses that were submitted during the first comment period.

As a result of all of the information provided during the comment periods, the SEC's adopting release for the shareholder access rule included a long and detailed discussion and economic analysis that addressed the many competing studies, cost estimates and projections that were submitted regarding the proposed rule. Not surprisingly, this process did not lead to unanimity among the Commissioners, and the SEC ultimately approved the shareholder access rule by a 3-2 vote over the dissent by the two sitting Republican Commissioners.

The final shareholder access rule, along with the concurrent amendment to the shareholder proposal rule and related other amendments, included three principal elements:

- A universal shareholder access rule in Rule 14a-11, which would have required that a public company include in its proxy materials candidates to the board who had been nominated by

shareholders who continuously owned 3% of the voting power of the company's securities for three consecutive years at the time of the nomination;

- An amendment to Rule 14a-8 that would have precluded a company from relying on the so-called "elections exclusion" to block from its proxy materials a shareholder proposal that seeks to establish a shareholder access regime; and
- Disclosure rules that would have required that nominations through the universal access rule or comparable company-adopted shareholder access procedures were accompanied by the same level of information that is made available during a traditional proxy contest.

The shareholder access and accompanying rules were set to become effective in late 2010 and would have applied to companies that mailed their proxy materials on or after March 13, 2011. On September 29, 2010, however, the Business Roundtable (the "BRT") and the U.S. Chamber of Commerce (the "Chamber") filed a petition for review of the shareholder access rule in the U.S. Court of Appeals for the D.C. Circuit on grounds, among others, that the rule was arbitrary and capricious and violated the Administrative Procedure Act as well as the First and Fifth Amendments to the Constitution.

The BRT and the Chamber also requested that the SEC stay the effectiveness of Rule 14a-11, a request that the SEC accommodated on October 4, 2010 at the same time that it voluntarily stayed the effectiveness of the amendment to Rule 14a-8 as well as the related other amendments adopted in 2010.

## THE COURT'S RULING

The Court's unanimous decision vacated Rule 14a-11 on the basis that the SEC acted arbitrarily and capriciously in adopting the rule, noting:

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.

In so noting, the Court explained further that the SEC had failed to conduct a proper inquiry into the costs and benefits of the proposed rule, noting:

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.

The Court's decision was largely predicated on its application of Section 3(f) of the Securities Exchange Act of 1934, which directs the SEC to consider whether a proposed rule will promote "efficiency, competition, and capital formation." Notably, the Court did not address other arguments made by the BRT and the Chamber, namely that the SEC chose not to adopt a so-called "private ordering" alternative (other than through Rule 14a-8 shareholder proposals) that would have allowed companies and shareholders to individually decide whether to implement a shareholder access regime that was more or less prescriptive than the regime established by Rule 14a-11. The Court also did not address the constitutional arguments made by the BRT and the Chamber.

## IMPLICATIONS

The Court's decision will have several important implications for the 2012 proxy season and beyond.

- ***The SEC will have to restart the rulemaking process to adopt a new “universal” access rule.*** By vacating Rule 14a-11, the Court has effectively removed it from the proxy rules. As a consequence, and unless the SEC chooses to appeal the Court's decision, the SEC will have to start a new rulemaking process if it intends to re-adopt Rule 14a-11 or some other form of universal shareholder access. That would require the agency to publish a proposed rule, allow interested parties to submit comments on the proposed rule and then approve the proposal following the comment period. In light of the substantial criticisms of the SEC's rulemaking process, its ambitious rulemaking agenda under the Dodd-Frank Act and the current political climate, it appears unlikely that the SEC will have the desire or the ability to re-adopt Rule 14a-11 in the near future.
- ***There may yet be a “proxy access” regime in place for the 2012 proxy season.*** As noted earlier, the Court invalidated Rule 14a-11, however it did not address the amendment to Rule 14a-8 that was adopted contemporaneously with the adoption of Rule 14a-11. In fact, the only impediment to the proxy access regime permitted by the amendment to Rule 14a-8 is the SEC's self-imposed stay, which could be lifted in time for the 2012 proxy season. Whether the SEC will lift the stay remains to be seen. Several factors, nonetheless, suggest that it might do so, including recent statements by SEC officials and the fact that the SEC has pursued a shareholder access rule for decades and now can achieve that goal in part by simply lifting the stay on Rule 14a-8. Along similar lines, all three of the Commissioners who voted in favor of the proxy access rules remain at the SEC.
- ***Assuming the SEC lifts its stay on its amendments to Rule 14a-8 in time for the 2012 proxy season, companies and shareholders should prepare now for that change.*** The timing of the D.C. Circuit's decision gives the SEC enough time to lift its stay so that shareholders can submit shareholder access proposals for consideration during the 2012 proxy season. Under Rule 14a-8, a shareholder proposal must be submitted to a company no later than 120 days in advance of anniversary of the release date for the prior year's proxy materials. For calendar year companies, this deadline is typically in November or December. As a practical matter, this means shareholders who are interested in submitting shareholder access proposals must decide relatively soon if they will submit such proposals under Rule 14a-8 to companies for the 2012 proxy season. Companies, too, should prepare for the submission of these kinds of proposals in the Fall. This timing will allow companies and shareholders to engage in the issues involved in shareholder access to the ballot before submission deadlines.
- ***The SEC and other agencies will need to redouble their economic analysis in the rulemaking process.*** The most significant aspect of the shareholder access decision is its impact on future rulemakings by the SEC and other federal agencies. At its core, this case was about the level of economic analysis that an agency must employ when considering the potential consequences of a rulemaking. The adopting release for Rule 14a-11 included a long and detailed analysis that was intended to address the very issues that the Court ultimately concluded had been inadequately assessed in the rulemaking. While many will observe that the Court has given the SEC a roadmap for adopting future rules, including potentially a revamped shareholder access rule, a closer reading of the opinion suggests that any such rulemaking will have to be accompanied by substantial economic analysis that may be beyond the resources that the agency can reasonably expend on any one rulemaking. Moreover, the shareholder access litigation sets a high standard for rulemaking by any agency, finding that the arbitrary and capricious standard requires a federal rulemaking to explicitly address the major comments raised in opposition to the rulemaking and provide a detailed explanation of why the rulemaking

was not changed in response to such comments. In effect, this decision further elevates the importance of comment letters and even statements by dissenting agency officials.

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