The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 24929

February 1, 2011

Update on Court Challenge to SEC's Proxy Access Rules

[24929]

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TO: SEC RULES MEMBERS No. 25-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 14-11
ETF ADVISORY COMMITTEE No. 10-11
SMALL FUNDS MEMBERS No. 14-11
INVESTMENT COMPANY DIRECTORS No. 4-11 RE: UPDATE ON COURT CHALLENGE TO SEC'S PROXY ACCESS RULES

As we previously informed you, the ICI and IDC filed a joint "friend of the court" brief in support of the Business Roundtable's and U.S. Chamber of Commerce's petition ("Petitioners") to the U.S. Court of Appeals for the District of Columbia Circuit to vacate the SEC's proxy access rules adopted in August 2010. [1] The ICI/IDC brief urged the Court to vacate the rules solely as applied to funds. The brief argued that the SEC's "one-size-fits-all" approach did not fit the unique structure of fund governance and rested upon reasoning that was arbitrary and capricious.

The briefing schedule for the case continues through February 2011, and the oral argument before a three-judge panel of the Court has been scheduled for April 7th. [2] The SEC has stayed the effectiveness of the rules pending resolution of the case. On January 19th, the SEC filed its initial brief. On January 27th, the Council of Institutional Investors, TIAA-CREF, and several public pension systems and public retirement funds filed an amici brief in support of the SEC (collectively "CII Brief"). The SEC's brief and CII brief as they relate to funds are summarized below. [3]

SEC Brief

The SEC brief stated that the Petitioners' arguments lacked merit for several reasons and stated that, if the Court finds any legal error in the SEC's decision not to exclude funds from the proxy access rules, the SEC agrees that the remedy should be limited to funds. The brief argued that the SEC carefully considered and addressed at length the argument that differences in the regulation of funds as compared to operating companies made it

inappropriate to apply the proxy access rule to funds.

First, the brief argued that the SEC recognized that the Investment Company Act provides a panoply of regulatory protections to fund shareholders but noted a staff study concluding that the protections were meant to provide "additional" safeguards "beyond those required by state law." Thus, the protections of the Investment Company Act do not reduce the importance of the rights to nominate and elect director candidates facilitated by the proxy access rules. The brief argued that the SEC correctly determined that the protections of the Investment Company Act affect neither the state law rights furthered by the rule nor their interaction with the proxy process.

Second, the brief argued that the SEC weighed the distinct costs that may be incurred by funds in complying with the proxy access rule due to their unitary and cluster board structures. The SEC observed that any potential disruptions to board structure would occur only in the event that the shareholder nominee was elected. Funds therefore would have the opportunity to include information in their proxy materials making shareholders aware of their views as to the potential for disruption. The SEC also explained that the election of a shareholder-nominated director would not necessarily result in decreased efficiency of a unitary or cluster board, noting that one commenter argued that competition in the board nomination process might improve efficiency by providing additional leverage for boards in their negotiations with the investment adviser. Further, the brief argued that the SEC reasonably concluded that the potential costs of having separate meetings and board materials for the fund with the shareholder-nominated member were justified by the benefits to shareholders of having the opportunity to knowingly choose this structure.

Third, the brief argued that the SEC did not reverse the policy it adopted in approving an exemption for funds from an NYSE Rule concerning director elections. The brief stated that the SEC's consideration of whether to exempt funds from the proxy access rule was not analogous. While both rules involve shareholder voting, the NYSE rule addresses who exercises the right to vote in uncontested director elections whereas the proxy access rule addresses shareholders' ability to have their director nominees put forth for a vote in the company's proxy materials. The brief argued that, therefore, the SEC's determination that it was reasonable to exempt funds from the NYSE rule in no way renders it unreasonable to reach a different conclusion in the context of the proxy access rule.

Fourth, the SEC's brief explained that with respect to some parts of its empirical analysis, it considered specific data regarding funds. Finally, the brief argued that the SEC considered the proxy access rule's effect on efficiency, competition, and capital formation and reasonably determined that the policy goals and benefits of the rule justified the costs.

CII Brief

First, the brief argued that there is no reason to treat shareholders of investment and operating companies differently, and the SEC properly explained why it declined to do so. In particular, the SEC explained the connection between the facts found (similarities between shareholders' rights and directors' roles for all companies) and the regulatory choice made (applying the proxy access rule to all companies).

Second, the brief argued that the SEC reasonably concluded that Investment Company Act protections do not render the proxy access rule unnecessary. According to the brief, the Investment Company Act imposes duties on fund boards to monitor conflicts of interest with respect to fund investment advisers, but has little to say about shareholder influence over

those directors and their ability to replace incompetent directors. The proxy access rule addresses that separate question. The brief argued that by emphasizing the importance of fund directors in dealing with conflicts of interest created by the external management structure of most funds, the Investment Company Act underscores the need for shareholder input on directors.

The Court's briefing schedule requires Petitioners' reply brief to be filed by February 10th, and final briefs of the Petitioners and Respondent to be filed by February 25th. We will keep you apprised of developments in this matter.

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endnotes

[1] See Memorandum to Closed-End Investment Company Members No. 69-10, ETF Advisory Committee No. 54-10, Investment Company Directors No. 30-10, SEC Rules Members No. 134-10, and Small Funds Members No. 81-10, dated December 10, 2010 [24777].

The SEC adopted Rule 14a-11 and related rule amendments ("proxy access rule") mandating proxy access for all publicly held companies, including closed-end and open-end investment companies (together, "funds"). Under the proxy access rule, qualified shareholders have the right to have their director-nominees included in a company's proxy statement. To be qualified to nominate a directorial candidate, a shareholder must: (1) own, individually or as a member of a group, at least three percent of the voting power of a class of securities subject to the proxy solicitation rules (borrowed shares and short positions excluded); (2) must have held this qualifying amount of securities for at least three years; and (3) may not hold the company's securities with the purpose or effect of changing control of the company.

[2] The panel consists of Chief Judge Sentelle and Circuit Judges Ginsburg and Brown.

[3] The SEC's brief is available at http://blogs.law.harvard.edu/corpgov/files/2011/01/SEC-Proxy-Access-Response-Brief.pdf. The CII's brief is available at http://www.cii.org/UserFiles/file/CII%20TIAA-CREF%20et%20al%20%20amicus%20brief%2001-27-11.pdf.

Thirty-six law professors also filed an amici brief, solely arguing that Rule 14a-11 does not violate the First Amendment. The brief did not address the merits or underlying policies of Rule 14a-11 with respect to operating companies or funds. Petitioners have filed a motion opposing the filing of this brief, arguing that it was not timely filed and that the amici did not demonstrate that filing jointly with other amici was not practicable. The court has not yet ruled on the motion. See Law Professors' Brief as Amici Curiae in Support of the Securities and Exchange Commission, Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission (No. 10-1305).