The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 25350

July 22, 2011

DC Court of Appeals Vacates SEC's Proxy Access Rule

[25350]

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TO: BOARD OF GOVERNORS No. 4-11
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ETF ADVISORY COMMITTEE No. 49-11
INVESTMENT COMPANY DIRECTORS No. 12-11
SEC RULES MEMBERS No. 88-11
SMALL FUNDS MEMBERS No. 51-11 RE: DC COURT OF APPEALS VACATES SEC'S PROXY ACCESS RULE

The Institute is very pleased to report that the United States Court of Appeals for the District of Columbia today issued an opinion vacating Securities Exchange Act of 1934 Rule 14a-11, holding that the Securities and Exchange Commission acted arbitrarily and capriciously for having failed to adequately assess the economic effects of the rule. [1] In particular, the Court stated that, "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. For these and other reasons, its decision to apply the rule to investment companies was also arbitrary." The court's opinion is summarized below.

Background

As we previously informed you, in August 2010, the Commission adopted changes to the federal proxy rules to facilitate shareholders' ability to nominate directors of companies, including funds. [2] In particular, new Rule 14a-11 under the Securities Exchange Act required companies, in certain circumstances, to include shareholder nominees for director in their proxy materials. [3] The Business Roundtable and U.S. Chamber of Commerce filed a petition challenging the validity of the rules with respect to both operating companies and investment companies. The SEC subsequently stayed the effectiveness of the rules pending resolution of the case. [4] In December, ICI and IDC, as amici curiae ("friends of the court"), filed a joint brief [5] in support of the petitioners. [6] The ICI and IDC brief urged the Court

to vacate the proxy access rules solely as applied to investment companies.

Summary of Opinion

The Court agreed with the petitioners that the Commission's prediction directors might choose not to oppose shareholder nominees had no basis beyond mere speculation.; It stated that although it is possible that a board, consistent with its fiduciary duties, might forgo expending resources to oppose a shareholder nominee, the Commission presented no evidence that such forbearance is ever seen in practice. The Court also pointed out that while the Commission acknowledged that companies might expend resources to oppose shareholder nominees, it did nothing to estimate and quantify the costs it expected companies to incur. By so doing, it neglected its statutory obligation to assess the economic consequences of the rule.

The Court also agreed with petitioners that the Commission relied upon insufficient empirical data when it concluded that Rule 14a-11 will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees. The Court also objected to the Commission's discounting of the costs of Rule 14a-11 as a mere artifact of the state law right of shareholders to elect directors. In particular, it stated that the Commission reasoning that any costs were attributable to state law failed to view a cost at the margin and is "illogical and in an economic analysis unacceptable." The Court also noted that the Commission acted arbitrarily by "ducking serious evaluation of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds."

The Court specifically addressed the Commission's treatment of investment companies and stated that "[l]est the Commission on remand apply to investment companies a newly justified version of the rule, however, only to be met in court again by valid objections, we think it prudent to take up the more serious concerns posed by investment companies but left unaddressed by the Commission."

The Court stated that it agreed with petitioners and amici curiae, Investment Company Institute and Independent Directors Council, that the Commission failed adequately to address whether the regulatory requirements of the Investment Company Act of 1940 reduce the need for, and hence the benefit from, proxy access for fund shareholders and whether the rule would impose greater costs upon investment companies by disrupting the structure of their governance. The Court went on to state that, "while the Commission acknowledged the significant degree of 'regulatory protection' provided by the Investment Company Act, it did almost nothing to explain why the rule would nonetheless yield the same benefits for shareholders of investment companies as it would for shareholders of operating companies."

The Court also pointed out that the Commission failed to deal with the concern that the rule would impose greater costs on investment companies by disrupting the unitary and cluster board structures with the introduction of shareholder-nominated directors who sit on the board of a single fund, thereby requiring multiple, separate board meetings and making governance less efficient.

In addition the Court pointed out the Commission's failure to adequately address the probability the rule will be of no net benefit as applied to investment companies by: failing to consider that the less frequent use of the rule by investment company shareholders also reduces the expected benefits; and the Commission's assertion that the use of

confidentiality agreements could meaningfully reduce costs is an “ipse dixit without evidentiary support.”

Finally, the Court highlighted the Commission’s argument that any increased costs and decreased efficiency of an investment company’s board as a result of a fund complex no longer having a unitary/cluster board would occur, if at all, only in the event the shareholders elect the shareholder nominee. The Court stated in response that “this rationale is tantamount to saying the saving grace of the rule is that it will not entail costs if it is not used… this is an unutterably mindless reason for applying the rule to investment companies.”

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Attachment

endnotes

[1] See Business Roundtable, et. al v. SEC No. 10-1305 (D.C. Cir. Decided July 22, 2011).

[2] See Memorandum No. 24533 (Sept. 9, 2010).

[3] Both ICI and IDC participated in the comment process and objected to the application of Rule 14a-11 to funds. See Memorandum No. 23725 (Aug. 18, 2009); Memorandum No. 24083 (Jan. 14, 2010); and Memorandum No. 24235 (April 15, 2010).

[4] See Memorandum No. 24581 (Oct. 6, 2010).

[5] See Brief of Amici Curiae Investment Company Institute and Independent Directors Council In Support of Petitioners and Vacatur as Applied to Registered Investment Companies (December 9, 2010).

[6] See Business Roundtable, et al. v. SEC, No. 10-1305 (D.C. Cir. Filed Sept. 29, 2010). See also Opening Brief of Petitioners Business Roundtable and Chamber of Commerce of the United States of America (D.C. Cir. Filed Feb. 25, 2011).