

Meridian Client Update

Court Holds Proxy Access Rule Invalid

In a victory for corporate America and a stunning rebuke of the Securities and Exchange Commission, the D.C. Court of Appeals struck down the SEC's proxy access rule. Mincing no words, the Court found that the SEC's issuance of the proxy access rule was "arbitrary and capricious." The Court appeared to admonish the SEC by noting that this ruling represented the second time in a little over a year that the Court found the SEC to have acted in an "arbitrary and capricious manner."

For nearly ten years, the SEC has attempted unsuccessfully to implement some form of proxy access. In fact, the SEC first considered the issue of proxy access as early as 1942. The SEC's most recent proposal on proxy access was languishing, in part, because some believed the SEC lacked the legal authority to adopt proxy access rules. That all appeared to have changed by virtue of the enactment of Dodd-Frank Wall Street Reform and Consumer Protection Act which expressly authorizes the SEC to promulgate proxy access rules. Wasting little time after the enactment of Dodd-Frank, the SEC on August 25, 2010 voted 3 to 2 to adopt its 2009 proposed proxy access rules subject to certain modifications. The two Republican Commissioners voted against adoption.

The adopted proxy access rule (Rule 14a-11) requires a company subject to the Securities Exchange Act ("Exchange Act") proxy rules, including an investment company registered under the Investment Company Act, to include in its corporate proxy ballot persons nominated by a "qualifying shareholder" or group of qualifying shareholders for election to the board of directors. To use the proxy access rule, a shareholder (or group of shareholders) must have 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 submits notice of its intent to utilize the proxy access rule and must continue to own those securities through the date of the annual meeting. In addition, the shareholder must not have the intent of effecting a change in control of the company.

In adopting the proxy access rule, the SEC concluded that the rule could create "potential benefits of improved board and company performance and shareholder value" sufficient to "justify [its] potential costs."

At the time the proxy access rule was proposed in 2009 and adopted by the SEC in 2010, it faced fierce opposition by business interests. Many in corporate America believed that the SEC was usurping the prerogative of states to regulate the election of corporate directors. Others believed that the SEC overreached in promulgating the proxy access rule. Acting on behalf of their members, **the U.S. Chamber of Commerce and the Business Roundtable** filed suit challenging the legality of the proxy access rule. On October 4, 2010, the SEC voluntarily agreed to a judicial order to stay the implementation of the proxy access rule pending resolution of the legal challenges to the rule.

The resolution of the legal challenge came on July 22, 2011 when the U.S. Court of Appeals for the District of Columbia issued a ruling on the merits of the case. The Court found that the Commission failed to follow the Administrative Procedures Act (“APA”) in promulgating the proxy access rule. The APA is a statutory roadmap that federal agencies must follow in issuing regulations. Under the APA, a federal agency must examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choices made by the agency. The Court noted that under the Exchange Act and Investment Company Act the SEC also “has a unique obligation to consider the effect of a new rule upon efficiency, competition, and capital formation” and to “apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation.” In applying these standards for rulemaking, the Court rejected each and every contention by the SEC that it appropriately promulgated the proxy access rule and found that the SEC failed to adequately “assess the economic effects of the new rule.” This failure by the SEC was tersely summarized in the Court’s opinion:

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.

Based on these findings, the Court held that the SEC acted arbitrarily and capriciously by issuing the new proxy access rule in violation of the requirements of the APA, the Exchange Act and the Investment Company Act.

The SEC has few good options at this point. At a minimum, the SEC could seek to lift the stay on Rule 14a-8 which allows shareholders to submit proposals for proxy access at their companies (Rule 14a-8 is not covered by the Court’s opinion). The SEC also could appeal the Court’s ruling on Rule 14a-11 to the U.S. Supreme Court. However, since the case lacks any novel legal issues or represents one of many conflicting decisions among the appellate courts on the same issue, the Supreme Court is **unlikely** to agree to hear an appeal of the case. The SEC could go back to the drawing board and attempt to develop an analytical basis for proxy access that would comply with the requirements of the APA. The SEC’s full agenda and limited resources suggest that may prove to be highly problematic and time-consuming. Moreover, the opinion of the U.S. Court of Appeals strongly suggests that it will be a tall order for the SEC to effectively demonstrate that the benefits of the proxy access rule outweigh the costs.

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