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Business Roundtable v. Securities and Exchange Commission: The SEC's First Big Shot at Proxy Access in the Shadow of Dodd-Frank

By Raymond E. Areshenko*

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I. INTRODUCTION

"Arbitrary and Capricious" is a moniker that has enjoyed common usage since the passage of the Administrative Procedures Act (APA), which mandated that a regulatory agency must refrain from rulemaking in such a manner.[1] To that end, the Investment Company Act of 1940 requires that the Securities and Exchange Commission ("Commission") consider a rule's effect on the promotion of efficiency, competition, and capital formation.[2] The primary purpose of the Commission is investor protection.[3] Since executive agencies have been granted the power to create and enforce rules, there has naturally been a friction between the regulators and those who are regulated. While members of the Commission are only to be removed for cause,[4] they are still political appointees and subject to political pressure like most other members of the government. Sometimes they have to be reined in by the other branches through our system of checks and balances.

The U.S. Court of Appeals for the D.C. Circuit recently overturned Exchange Act Rule 14a-11, holding that the Commission's promulgation of the rule was arbitrary and capricious in regard to several issues because it failed to consider the rule's

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[1] 5 U.S.C. § 706(2)(A) (2006) (requiring that a reviewing court shall set aside and hold unlawful any agency actions, findings, or conclusions when the court finds that the agency promulgated the rule in an arbitrary and capricious manner).

[2] 15 U.S.C. § 78c(f) (2006); Investment Company Act of 1940, 15 U.S.C. § 80a-2(c) (2006).

[3] 15 U.S.C. § 77b(b) (2006).

[4] Humphrey's Ex'r v. United States, 295 U.S. 602, 620 (1935) (a Commissioner may be removed by the President for inefficiency, neglect of duty, or malfeasance in office).

effect on efficiency, competition, and capital formation.[5] The Commission declined to seek further review with the U.S. Supreme Court.[6] The Court of Appeals, expressing a bit of frustration by stating that the Commission "failed once again," found that the Commission inadequately determined the likely economic consequences of its rule upon efficiency, competition, and capital formation.[7] In addition, the court found that many other APA requirements germane to the promulgation of Rule 14a-11 were completely ignored by the Commission.[8]

Rule 14a-11 was part of the enormous rulemaking directive that the passage of The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") gave the Commission.[9] Rule 14a-11 was designed to allow shareholders to force a company's management to include shareholder-nominated board of director candidates on the company's proxy ballots.[10] The primary way shareholders of publicly traded companies vote for directors and other resolutions is through the use of proxy materials that the

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[5] Bus. Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011). The primary challengers to the rule were the Business Roundtable and the U.S. Chamber of Commerce. *Id.* at 1144. *See also id.* n. 17.

[6] Mary Schapiro, Chairman, SEC, Press Release 2011–179 (Sep. 6, 2011), *available at* http:/www.sec.gov/news/press/2011/2011-179.htm [hereinafter Schapiro Press Release]. The Commission confirmed that it will not seek a rehearing or U.S. Supreme Court review of the decision to vacate the rule. However, it will continue to analyze the decision and submitted comments, with the goal of making rules that will provide shareholders with further opportunities to nominate directors. *Id.*

[7] *Bus. Roundtable*, 647 F.3d at 1147–48. The court stated that the Commission committed another instance of arbitrary and capricious rulemaking in this case, repeating similar errors that they recently made in *American Equity Investment Life Insurance Co. v. SEC*, 613 F.3d 166, 167–68 (D.C. Cir. 2010), and in *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).

[8] *Bus. Roundtable*, 647 F.3d at 1148–56.

[9] Kathleen L. Casey, Commissioner, Speech at Commission Hearing: The Regulatory Implementation and Implications of Dodd-Frank (Jan. 23, 2011), *available at* http://www.sec.gov/news/speech/2011/spch012311klc.htm (referring to the Commission's rulemaking authority to adopt new proxy access rules as "discretionary"); *see also* Michael Lyle et. al., *Dodd-Frank, One Year Later: A Primer On The Federal Rulemaking Process*, THE METROPOLITAN CORPORATE COUNSEL, at 30 (Aug., 2011), *available at* http://www.metrocorpcounsel.com/pdf/2011/August/30.pdf.

[10] *Bus. Roundtable*, 647 F.3d at 1147.

company distributes to each shareholder at certain intervals, usually some period before the annual shareholder meeting.[11] This process could be likened to the absentee ballots commonly used in the United States where a voter is mailed voting materials ahead of time. Rather than waiting to go to the polls on the day of the election, the voter fills out the ballot and returns it in the mail by a predetermined date. Rule 14a-11 required a publicly traded company to include information on, and the ability to vote for, shareholder-nominated candidates for director positions ("dissident directors").[12] The basic requirements a shareholder or group of shareholders had to meet in order to nominate a candidate for election to the board of directors were: ownership of three percent of the company's voting stock (usually common stock), holding that amount for at least three years, holding it through the election, and having no intent to effect a change of control.[13]

It is clear that the Commission wishes to put more restrictions on the management of companies.[14] With the ever-present pressure of politics upon agencies, it is exceedingly important for the courts to firmly guard against arbitrary and capricious encroachments upon companies, as such encroachments are not useful regulations that maximize shareholder value and protect their interests. Although many people may view business regulation as unimportant in their daily lives, there are actually serious implications for most. For one, the population is increasingly reliant on their own retirement and investment accounts to support themselves in their later years. National stories about the wide spread failure, or impending failure,

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[11] *Id.* at 1146–47.

[12] *Id.* at 1147. The rule applied to companies subject to the Exchange Act, to include investment companies registered under the Investment Company Act. *Id.*

[13] 75 Fed. Reg. 56675 (Sept. 16, 2010). There were four basic requirements to be able to nominate a candidate: that the shareholder or group of shareholders own at least three percent of the voting shares of the company, held that amount for at least three years from the date of submitting the nomination, hold them through the election, and intend to continue holding them after the election. Amongst many other requirements was declaring that the shareholder or group harbored no intent to effect a change of control of the company, and that the shareholder or group has no direct or indirect agreements with the company in regards to a nominee. *Id.*

[14] Schapiro Press Release, *supra* note 6 (reaffirming her commitment to making it easier for shareholders to nominate director candidates with the goal of making boards more accountable for their actions).

of pension plans to meet their funding obligations are common. These failures are widespread in a range of fund types including those operated solely for a single company, to large funds representing hundreds of thousands of government workers. Moreover, most private employers have shifted from the more traditional defined-benefit pension plans, to defined-contribution IRA and 401k plans, placing greater responsibility on individual workers. Inadequacy (and future unreliability) of Social Security payments is a growing concern. Even most state and local government pensions are paid from funds which invest heavily in publicly traded companies. Because of this, it is very important that the management of publicly traded companies have adequate oversight. But equally important is preventing the government from imposing unnecessary expenses on companies and their shareholders, or devising machinery whereby others can impose these burdens that will hamper their competitiveness in our increasingly competitive and global marketplace.

Part II of this case note will briefly discuss the historical background of the Commission and its rule-making power, and how Rule 14a-11 came to fruition. Part III will outline the basic facts of this case[15], including the points and arguments made by opponents and proponents of Rule 14a-11. Part IV will provide more in-depth facts, analyze the points made by the parties, and detail how the court ruled on each issue. Finally, Part V will discuss the impact that this ruling may have on the business of publicly traded corporations in the future, along with how this may affect future Commission rulemaking.

Of further note, other rules and modifications to rules were announced by the Commission in the same releases containing Rule14a-11.[16] The Petitioners made various arguments related to some of these other issues in the same lawsuit and these are outside the scope of this particular court ruling and thus not included in this case note.[17] Unless otherwise stated, "Petitioners" refers to the

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[15] *Bus. Roundtable*, 647 F.3d 1144.

[16] 75 Fed. Reg. 56668 (Sept. 16, 2010).

[17] *Id.*; Pet'r's Opening Br., Final Brief of the Securities and Exchange Commission, Respondent, Bus. Roundtable v. SEC, 2011 WL 2014799 (D.C Cir. Feb. 25, 2011) (No. 10-1305). The other issue most predominantly addressed in

primary parties seeking review, the Business Roundtable, and the U.S. Chamber of Commerce.[18] Unless otherwise stated, the "Respondent" is the Commission.

II. HISTORICAL BACKGROUND

The APA was enacted in 1946 in response to the increased number of regulatory agencies during the Roosevelt administration.[19] Fear of unelected regulators and their authority to effectively promulgate and administer new laws led to the desire to limit the administrative agency concept.[20] Some even feared that this would result in a form of government that resembled communism and would operate on ulterior motivations and promulgate arbitrary directives.[21]

Under the APA's standard of review, an agency rule or regulation must not be arbitrary, capricious, an abuse of discretion, or

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the final release, and in Petitioners' and Respondent's briefs, was the alteration of Rule 14a-8.

[18] The state of Delaware filed a brief as Amicus Curiae in support of overturning the rule. Br. of the State of Delaware as Amicus Curiae in Support of Pet'r, Bus. Roundtable v. SEC, 2011 WL 2014797 (D.C. Cir. Feb. 24, 2011) (No. 10-1305). Seeking to overturn the rule as applied to registered investment companies, the Investment Company Institute and Independent Directors Council also filed a brief of Amici Curiae. *See* Brief of Amici Curiae Investment Company Institute and Independent Directors Council in Support of Pet'r's And Vacatur as Applied to Registered Investment Companies, Bus. Roundtable v. SEC, 2011 WL 2014798 (D.C. Cir. Feb. 25, 2011) (No. 10-1305).

[19] George B. Shephard, *Fierce Compromise: The Administrative Procedure Act Emerges From New Deal Politics*, 90 NW. U. L. REV. 1557, 1558–59 (1996) (George B. Shephard is an Assistant Professor of Law at Emory University School of Law).

[20] *Id.* at 1559. The APA was debated in the 1930's and 40's, a time when communism was a very real and imposing threat the public. To supporters of the New Deal, these agencies were simply designed to promote efficiency–to others it was the creeping of communism into the government. *Id.* The debate over the APA stemmed from a fight over the New Deal generally, and the APA's passage was ultimately a cease-fire that favored New Deal proponents. *Id.* at 1559–60.

[21] *See generally Id.* at 1557. While modern society has become accustomed to administrative agencies promulgating regulations, this was a much newer concept for the U.S. during the New Deal era. *Id*. In addition, there was no standard of review with which an aggrieved party could contest what they believed to be onerous regulations. *Id*.

otherwise not in accordance with the law.[22] In relating the arbitrary and capricious standard to a given agency decision, the court must determine the reasonableness of the agency decision and if the decision is lacking in foundation.[23] A court shall determine that an agency has acted arbitrarily and capriciously if it (1) totally fails to consider a significant part of the problem with the proposed rule, (2) explained its decision using evidence that runs counter to the explanation, or (3) is based off a conclusion that is so unlikely to match reality that it cannot be ascribed to differences in view.[24] Courts use a narrow standard of review for determining whether a rule is arbitrary and capricious and do not substitute their own judgment for that of an agency.[25] However, they must still be sure that the Commission "examine[d] the relevant data and articulate[d] a satisfactory explanation for . . . the facts found and the choice made."[26]

When the Commission establishes regulations, it is required to comply with the Securities Exchange Act of 1934.[27] When making rules applicable to investment companies, the Commission must follow the Investment Company Act of 1940.[28] In addition to the arbitrary and capricious standard of review required by the APA, the Commission is uniquely required under the Exchange Act to consider whether a rule will unduly burden efficiency, competition, or capital formation.[29] In addition to the present case, the Commission's rules were invalidated on three other recent occasions

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[22] 5 U.S.C. § 706(2)(A) (2006); Alaska Dep't. of Envtl. Conservation v. EPA, 540 U.S. 461, 465 (2004).

[23] Kaufman v. Kansas Dep't. of Soc. and Rehab. Services, 811 P.2d 876, 884 (Kan. 1991).

[24] Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (finding the NHTSA's rescission of the passive restraint requirement in Standard 208 was an arbitrary and capricious action).

[25] *Id.*

[26] *Id.*

[27] Securities Exchange Act of 1934 is codified as 15 U.S.C. § 78.

[28] Investment Company Act of 1940 is codified as 15 U.S.C. § 80.

[29] 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c) (2006), the Commission is unique in that it is required to become informed of the consequences its rule-making may have on efficiency, competition, and capital formation in order that its rule-making does not cause more harm than help to those considerations than it helps.

for failing to consider efficiency, competition, and capital formation.[30]

Rule 14a-11 was designed with the goal of facilitating shareholder ability to nominate and elect directors to a company's board of directors.[31] The most important way shareholders may influence a company is through voting power, which enables all owners of a company's voting stock to elect directors.[32] The Commission viewed the 2008 financial crisis as emblematic of the need for shareholders to be able to effectively exercise this power, and it determined that the need was not being fully met under the current rules.[33] The Commission focused on the proxy process because its purpose is to come as close as possible to replicating the in-person voting process for shareholders.[34] After a comment period

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[30] Chamber of Commerce v. SEC, 443 F.3d 890 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133, 145 (D.C. Cir. 2005) (the court held that the Commission acted arbitrarily and capriciously when promulgating a rule requiring mutual fund companies to have a board of no less than 75% independent directors, as opposed to the current 50% requirement, and to have an independent chairman); American Equity Life Insurance Co. v. SEC, 613 F.3d 166, 167–68 (D.C. Cir. 2010) (the court held that the Commission acted arbitrarily and capriciously when considering the effect of efficiency, competition, and capital formation when the Commission declared that fixed indexed annuities were not annuities pursuant to the Securities Act). The Commission must make a thorough effort in order to determine as *best as they can* the effects of their rulemaking. *Chamber of Commerce*, 412 F.3d at 144; *American Equity*, 613 F.3d at 166. Where the Commission fails to become fully knowledgeable (thus depriving the public and the Congress of knowledge) of the facts and considerations of the economic results of the proposed rule, the subsequent promulgation of that rule is arbitrary and capricious. *Chamber of Commerce*, 412 F.3d at 144.

[31] 75 Fed. Reg. 56668 (Sept. 16, 2010).

[32] *Id.* at 56669. Noting that one of the core methods shareholders have to influence the operation of a company is by right to participate in the elections of the company's directors. *Id.*

[33] *Id.* at 56669–70. The Commission felt that there were questions of whether company boards were providing adequate oversight of management, whether they were focused on shareholder interests, and whether boards should be more accountable for their decisions regarding risk management and compensation. *Id.*

[34] *Id.* at 56670. The Commission reasoned that the proxy voting process is not similar enough to voting at the meeting because most proxy voting shareholders cast their ballots well before the shareholder meeting, resulting in a missed opportunity to nominate a director or view the materials regarding another shareholder-nominated director. *Id.*

in which the Commission received a series of sharply divided comments, it decided that state laws governing shareholders' ability to include their director nominees in the company's proxy voting materials were insufficient.[35] The final version of Rule 14a-11 provided that a shareholder or group of shareholders meeting certain requirements could force the company to include its director nominee on the company's proxy materials.[36] Traditionally, how or whether shareholders can nominate a candidate for a director position are issues of state law and a company's bylaws.[37] Rule 14a-11 was designed to reach all companies subject to the Exchange Act, with the ability to opt-in, but not opt-out.[38]

III. FACTS

The Commission announced its intent to publish 14a-11 in June 2009, outlining the proposed terms of the rule and inviting

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[35] 75 Fed. Reg. 56670–71 (Sept. 16, 2010).

[36] *Id.* at 56674–75 (requiring that the shares have voting power, be equal to at least three percent of the company, that the three percent that has been held for at least three years, and that the shareholder or group intend to keep the shares through the election). To illustrate the potential size of these groups, three percent of the largest company on the Fortune 500, Wal-Mart Inc., is $5,482,929,000 as of March 25, 2011. Forbes 500, Full List (Oct. 5, 2011), *available at* http://money.cnn.com/magazines/fortune/fortune500/2011/full_list/. Three percent of the smallest company on the Forbes 500, Seaboard Corp., is $84,450,000. *Id.* Proxy materials would have to include information about the shareholder and the shareholder's ability to vote for the nominee. 75 Fed. Reg. at 56677.

[37] Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1784 (2006) (relating Delaware law as a reflection of their legislative preference for private ordering and flexibility to create and alter securities law). It is well known that corporations of any significant size tend to incorporate in Delaware. *Id.* at 1749. Moreover, it would be well beyond the scope of this writing to examine the securities law of every state. Delaware is the only state that filed a brief in this case, and the laws of no other states were given any significant consideration during the promulgation of this rule, by the parties to this case, or by the court. (Lawrence A. Hamermesh is a Ruby R. Vale Professor of Corporate and Business Law at Widener University School of Law).

[38] 75 Fed. Reg. 56678–79 (Sept. 16, 2010). Barring conflict by state law or a company's governing documents that were in compliance with applicable state law, Rule 14a-11 would be mandatory for any applicable company.

comment.[39] The Commission received hundreds of comments that ranged from letters by experts to in-depth economic and legal reports.[40] After an opportunity to review the comments and make adjustment to the proposed rule, the Commission published the final version of Rule 14a-11 in the Federal Register on September 16, 2011.[41] The Commission scheduled Rule 14a-11 to take effect on November 15, 2010, but it never went into effect as they stayed the rule pending the outcome of this case.[42] Because the APA provides for review motions to be submitted directly to the U.S. Court of Appeals, the Petitioners sought review with that court shortly after Rule 14a-11's promulgation.[43] The Petitioners argued against Rule 14a-11 on several points asserting that the Commission promulgated the rule arbitrarily and capriciously by inadequately and improperly measuring the effect of the rule on competition, efficiency, and capital formation.[44] A three-judge panel heard oral arguments on April 7, 2011, and issued its unanimous (there was no concurring opinion either) ruling in favor of the Petitioners and vacating Rule 14a-11, on July 22, 2011.[45] The Commission subsequently stated

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[39] Proposing Release, 74 Fed. Reg. 29024 (June 18, 2009).

[40] *See generally* Adopting Release, 75 Fed. Reg. 56668 (Sept. 16, 2010).

[41] 75 Fed. Reg. 56668 (Sept. 16, 2010).

[42] Press Release, No. 33-9259, SEC (Oct. 14, 2010), *available at* http://www.sec.gov/rules/final.shtml.

[43] Pet'r's Opening Br., Bus. Roundtable v. SEC, 2010 WL 5116461, at *1 (Feb. 25, 2011) (No. 10-1305). The Investment Company Act provides that any party or entity who is aggrieved by rules promulgated by the Commission may obtain a review of the rule by the United States Court of Appeals within their corresponding jurisdiction, or by the Court of Appeals for the District of Columbia. 15 U.S.C. § 80a-42(a) (2006). The petitioner must, within sixty days of the order, request that the rule be either modified or set aside partially or in entirety. *Id.* No review will be granted on any basis not previously objected to (or a show of good cause for failing to object) during the comment period, or other similar public input mechanism. *Id.* Any Commission findings as to facts will be upheld so long as they were supported with "substantial evidence . . . ." *Id.* The judgment and decree of the reviewing court will be final, and subject to review only by a grant of certiorari by the United States Supreme Court. *Id.*

[44] Bus. Roundtable v. SEC, 647 F.3d 1144, 1146–47 (D.C. Cir. 2011).

[45] *Id.* at 1144. Again, the court in this case only ruled on 14a-11, without considering all of the arguments the Petitioners brought, and without ruling for the Petitioners on all factors they argued.

that it would not seek review of the decision with the U.S. Supreme Court.[46]

The court found that the Commission failed to adequately consider the economic consequences of Rule 14a-11 when formulating the rule.[47] The Commission noted that the rule imposed the cost of printing and mailing materials about the shareholder nominated candidates onto the companies rather than the nominating group.[48] Nevertheless, without basis, it decided that those costs, amongst many other costs such as opposing the candidate, would be outweighed by the benefits to shareholders who no longer had to print and mail their own materials.[49] Moreover, the Commission concluded without sufficient evidence that the mere presence of these dissident shareholders would increase board productivity and overall value to shareholders.[50] The court also pointed out that the Commission ignored the issue of how the rule will affect the total number of proxy contests because the adopting release did not address the extent to which Rule 14a-11 will make traditional proxy contests available under applicable state corporate laws.[51]

The court agreed that the Commission failed to consider how special interests, namely institutional investors such as unions and government pension funds, would employ the rule for their own

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[46] Schapiro Press Release, *supra* note 6.

[47] *Bus. Roundtable*, 647 F.3d at 1148–50. The court determined that the Commission inconsistently framed the costs and benefits of the rule; failed to estimate necessary cost figures; and generally failed to assess the "likely economic consequences of Rule 14a-11 and to connect those consequences to efficiency, competition, and capital formation." *Id.*

[48] *Id.*

[49] *Id.* at 1150. Petitioners provided estimates ranging from $4 million to $14 million at large companies and $800,000 to $3 million at smaller companies. *Id.* These costs would include media and public relations efforts, advertising through various means, consultants, and the time of employees and managers. *Id.* Moreover, the court found that the Commission opportunistically assumed frequent rule use when measuring benefits, but infrequent rule use when addressing costs. *Id.* at 1154.

[50] *Id.* at 1149. The Commission took these costs into consideration, but did not necessarily agree as to the amount and concluded that the benefits of Rule 14a-11 would be worth anticipated costs. *Id.*

[51] *Id.* at 1153. The court reasoned that without this information, there would be no way to know whether the rule will be a net benefit. *Id.*

ends.[52] In its adopting release, the Commission reasoned that the shareholder ownership requirement would limit any undue use of Rule 14a-11 by special interest groups.[53] However, the court found that the Commission ignored compelling arguments and studies that indicated how special interests could gain disproportionately more towards their own objectives with the use or threat of dissident directors than any marginal increase in value they would otherwise receive with or without a dissident director.[54] Moreover, the court agreed with the Petitioners that these special interests could burden a company with the significant costs of a proxy fight simply by threatening to nominate a dissident.[55]

The State of Delaware submitted a brief of amicus curiae in support of the Petitioners, arguing that Rule 14a-11 directly overrode and contradicted Delaware corporate law.[56] The court declined to address that issue, as moot, since they vacated the rule without having to address Delaware's argument.[57] The court also declined as moot the Petitioner's argument that the rule violated First Amendment free speech rights.[58]

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[52] *Bus. Roundtable*, 647 F.3d. at 1151–52.

[53] 75 Fed. Reg. 56766 (Sept. 16, 2010). Because shareholders would need to own at least three percent of the company for at least three years, groups who met this requirement would have demonstrated a long-term commitment to the company. *Id.*

[54] *Bus. Roundtable*, 647 F.3d at 1152 (rebutting the Commission's reasoning that it was sufficient protection that shareholders would have the opportunity to view the company's argument against a special interest nominee and not vote for that candidate). The court agreed with Petitioners that even if a dissident board member was ultimately not elected, the company could expend significant resources fighting the election, or even the threat of nomination. *Id.* Also, the rule placed no restriction on what the relationship was to the nominating shareholder group. 75 Fed. Reg. 56675 (Sept. 16, 2010). Only one dissident nominee would have to be included in the materials and the shareholder or group with the largest voting block would have their nominee included in the materials, regardless of which shareholder or group was the first to nominate a candidate. *Id.*

[55] *Bus. Roundtable*, 647 F.3d at 1152.

[56] Final Br. of the State of Delaware, Bus. Roundtable v. SEC, 2011 WL 2014797, at *2, *7 (Feb. 24, 2011) (No. 10-1305) (arguing that Rule 14a-11 conflicts with Delaware law's "private ordering" right which permits shareholders to internally self-regulate the way a company handles its affairs).

[57] *Bus. Roundtable*, 647 F.3d at 1149.

[58] *Id.* at 1156.

Lastly, the court took issue with the inclusion of investment companies in the rule.[59] Investment companies, such as mutual funds, are often directed by a board that is overseeing more than one fund.[60] If shareholders from a specific fund were able to nominate a dissident director who then wins a seat on an investment company's board, the board would be required to hold separate meetings for only that fund, since a dissident director would not be privy to board discussions about other funds.[61] The Commission did not completely ignore this dilemma, but attributed whatever costs would be incurred as stemming from the rights shareholders have to nominate director candidates under state corporate laws.[62] The Commission concluded that in any event, the benefits of Rule 14a-11 justified the costs.[63] Moreover, the Commission acknowledged that fewer fund shareholders would utilize the rule because funds have a greater number of retail customers who fail to meet the Rule 14a-11 qualification threshold and because investment companies are not necessarily required under state law to hold annual meetings.[64] The court finally determined that the Commission used circular logic to justify application of the rule to investment companies and to justify its belief that the rule's lesser use by investment company shareholders would result in lower overall cost.[65]

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[59] *Id.* at 1154.

[60] *Id.* at 1154. Typically, the boards of many investment companies are either unitary boards that oversee all of the funds in the group, or cluster boards, which are multiple boards within a group that each oversee a number of funds. *Id.* The court cited a survey that indicated that eighty-one percent of boards are unitary, and fifteen percent are cluster. *Id.*

[61] *Id.* at 1154. The court noted the obvious inefficiencies of a system where a board that before included discussion of a certain fund, amongst other funds, at its meeting now had to convene additional meetings for that particular fund in order to include a dissident board member elected to that specific fund. *Id.*

[62] *Bus. Roundtable*, 647 F.3d at 1154.

[63] *Id.* at 1155. The Commission acknowledged Rule 14a-11 would result in inefficiencies, increased costs, and that the use of Rule 14a-11 would likely be lower than other publicly held companies. They dismissed this in conclusory fashion by stating that the benefits justified the costs. *Id.*

[64] *Id.*

[65] *Id.* at 1156.

IV. SUMMARY OF OPINION

The court agreed with the Petitioners that the promulgation of Rule 14a-11 was arbitrary and capricious.[66] Since the court determined that Rule 14a-11 was arbitrary and capricious before analyzing all the points, they declined to address the Petitioners' argument that the Commission arbitrarily rejected the argument that individual company shareholders could propose proxy access rules for their own companies.[67]

A. Consideration of Economic Consequences

Given that the Commission is charged with considering a rule's effect on "efficiency, competition, and capital formation," the Commission asserted that Rule 14a-11 "may have the potential of improving board accountability and efficiency and increasing shareholder value."[68] The court first addressed the Commission's conclusion that Rule 14a-11 would result in shareholders receiving direct savings because of reduced costs for printing and postage to distribute information about the nominee to the other shareholders.[69] The Commission estimated that those costs would be approximately $18,000 for each nominee, in addition to numerous other costs.[70] The Commission hypothesized that Rule 14a-11 will reduce shareholder concerns about collective action and free-riders, which occur when all shareholders receive the "benefit" of expenditures made by other shareholders.[71]

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[66] *Id.* at 1148.

[67] *Bus. Roundtable,* 647 F.3d at 1148.

[68] *Id.* at 1149 (citing 75 Fed. Reg. 56761).

[69] *Bus. Roundtable,* 647 F.3d at 1149 (citing 75 Fed. Reg. 56756).

[70] 75 Fed. Reg. 56756 (Sept. 16, 2010). The Commission reasoned that shareholders would be more likely to use Rule 14a-11 because of the savings that would result from not having to do their own mailings. *Id.* In addition, the Commission cited comments that the mailing alone only represented about 5% of the cost of nominating a director candidate due to the costs of advertising, attorneys, obtaining shareholder lists, public relations, proxy solicitors, etc. *Id.* The commission disputed commentators who noted that a "'mere $18,000'" did not justify the expense of the rule. *Id.* at 56757.

[71] *Bus. Roundtable*, 647 F.3d at 1149. Free-rider and collective-action concerns relate to the apprehension shareholders may have towards spending a

The court pointed out that the Commission designed Rule 14a-11 to impose upon companies the cost of preparing, printing, and mailing the required disclosures and other solicitations related to a director campaign.[72] The court also cited the Commission's recognition that the rule could have an adverse effect on the performance of the company and the board due to, for example, the distraction to management of a proxy fight.[73] The court noted the Commission's conclusion that Rule 14a-11 would still "promote the 'efficiency of the economy on the whole,' and the benefits of the rule would 'justify the costs' of the rule."[74] The Petitioners' primary economic arguments were that the Commission "neglected both to quantify the costs companies would incur . . . and to substantiate the rule's predicted benefits."[75] They also stated that the Commission "failed to consider the consequences of union and state pension funds using the rule" or to "properly evaluate the frequency with which shareholders would initiate election contests."[76]

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significant sum to get a nominee elected to the benefit of the rest of the shareholders while the paying shareholder or group only gets a fractional benefit. 75 Fed. Reg. 56756.

[72] *Bus. Roundtable*, 647 F.3d at 1149 (citing 75 Fed. Reg. 56678) (discussing the complexity expense of various other issues related to 14a-11 such as priority of shareholder nomination when a current dissident director is getting ready to leave, legal advice specific to each company's situation, and the costs of court fights between the companies and shareholders).

[73] *Bus. Roundtable,* 647 F.3d at 1149 (citing 75 Fed. Reg. 56765). The Commission acknowledged that election contests are "distracting and time-consuming" to a company's board and management; that companies may have to reevaluate and possibly change their own procedures for facilitating shareholder nominations; and that the rules could result in lower quality boards if unqualified individuals were elected. 75 Fed. Reg. 56765; *see also* Pet'r's Opening Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *32 (Feb. 25, 2011) (No. 10-1305).

[74] *Bus. Roundtable*, 647 F.3d at 1149 (citing 75 Fed. Reg. 56771/3). The Commission concluded that the Rule's "possible" benefits of improved board accountability and company performance justified the acknowledged costs and would "promote the efficiency of the economy on the whole."

[75] *Bus. Roundtable*, 647 F.3d at 1149.

[76] *Id.*

1. Consideration of Costs and Benefits

The Commission acknowledged that companies might spend significant sums of money to fight shareholder-nominated board candidates.[77] However, the Commission argued that these costs would be limited by a couple of factors. First, to the extent that managers have a fiduciary duty to desist from expending company funds to fight shareholder nominees for "no good-faith corporate purpose," the managers may elect to simply include the nominees on the proxy material.[78] Second, the requirements that a shareholder or shareholder group must collaborate in order to qualify to nominate a candidate would limit the number of nominees for a board to contest.[79]

The Commission did not seem to dispute the cost figures for conducting a proxy fight, which were submitted by various commenters.[80] The Petitioners argued that the Commission failed its duty by neither endorsing the figures provided nor providing its own estimate.[81] In any event, the Commission suggested that they might be "discretionary" costs because Rule 14a-11 imposed no obligation upon any company board or executive to fight a shareholder

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[77] 75 Fed. Reg. 56770 (Sept. 16, 2010) ("[B]oards may be motivated by the issues at stake to expend significant resources to challenge shareholder director nominees . . . . We therefore recognize that . . . it can reasonably be expected that the boards of some companies likely would oppose the election of shareholder director nominees.").

[78] 75 Fed. Reg. 56770; *see also* 75 Fed. Reg. 56668–01 n. 1011. The Commission also sought to distinguish between costs that the company would incur by including a shareholder candidate without a fight, such as printing and mailing new proxy materials and costs that are borne by the company to fight that same candidate. 75 Fed. Reg. 56770 n. 1011.

[79] 75 Fed. Reg. 56770.

[80] *Id.*

[81] Petr's Opening Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *39 (Feb. 25, 2011) (No. 10-1305) (citing *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005), asserting that while the Commission cited some of the figures submitted by commenters, but not endorsing them or providing their own, the Commission failed a basic "statutory obligation to do what it can to apprise itself . . . of the economic consequences of a proposed regulation.").

nominee.[82] The Petitioners argued, and the court agreed, that the Commission's assertion that companies would simply choose not to oppose a shareholder nominee was speculation.[83] The opinion pointed to comments submitted to the Commission during the comment period.[84] One comment from the American Bar Association said that companies would be, in fact, compelled to resist shareholder nominees.[85] The Commission used the complete opposite rationale to justify the rule, reasoning that shareholders would face resistance from management if they tried to institute a proxy access policy under current laws.[86] The Commission said that "companies . . . could frustrate shareholder efforts to establish procedures for shareholders to place board nominees in the company's proxy materials by *litigating* the validity of a shareholder proposal establishing such procedures, or possibly repealing shareholder-adopted bylaws establishing such procedures."[87] The conflict in logic is quite apparent as the Commission basically states that boards both will and will not be compelled to resist shareholder-nominated director candidates.

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[82] 75 Fed. Reg. 56770 ("Some commenters, in fact, characterized the costs incurred . . . as discretionary because Rule 14a-11 itself does not require such efforts."). *Id.*

[83] Bus. Roundtable v. SEC, 647 F.3d 1144, 1150 (D.C. Cir. 2011); *see also* Pet'r's Final Br., Bus. Roundtable, 2011 WL 2014800, at *19 ("the Commission cited no basis that the companies would opt to 'simply' include access candidate material . . . without mounting strenuous opposition.").

[84] *Bus. Roundtable*, 647 F.3d at 1150.

[85] *Id.* (citing a letter sent to the Commission during the comment period by Jeffrey W. Rubin, Chair, Comm. On Fed. Regulation of Sec., Am. Bar. Ass'n, to SEC 35 (Aug. 31, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-456.pdf (stating that if nominee of the shareholder or shareholder group is "determined . . . not to be as appropriate a candidate as those to be nominated by the board's independent nominating committee . . . , then the board will be compelled by its fiduciary duty to make an appropriate effort to oppose the nominee . . . ")). *See also* Pet'r's Final Br., 2011 WL 2014800, at *19–20 (citing a very similar comment from the American Bar Association).

[86] 75 Fed. Reg. 56672 (Sept. 16, 2010).

[87] *Id.* (emphasis added). The Commission was expressing concern that not all states have incorporation laws like Delaware's, which provide forums for shareholders to nominate directors. *Id.* Also inadequate were opportunities provided by company bylaws because the board may put up significant obstacles, such as litigation, to avoid a shareholder's proxy access policy being passed. *Id.*

The court agreed that the Commission "relied upon insufficient empirical data" to conclude that Rule 14a-11 would improve the performance of company boards and increase company value for shareholders by facilitating the election of shareholder nominees.[88] The court also noted that the Commission cited numerous compelling studies submitted by commenters that forecast reduced performance of boards with dissident members, but then came to the conclusion that Rule 14a-11 would increase board performance and shareholder value.[89] For example, a report submitted by NERA Economic Consulting stated that "[t]he benefits predicted by the SEC will be at best small, and possibly prove to be costly rather than beneficial."[90] The report cited three benefits forecasted by the Commission and rated them "from small to simply implausible."[91] First, the report stated that the only direct savings to shareholders, $18,000 in postage and printing costs, represented about two percent of the estimated costs that a company would incur as a result of having a shareholder nominee on the ballot.[92] Secondly, the report noted that the while the Commission touted increased transparency and better informed voting, they did not make any attempt to quantify this benefit.[93] Third, despite the great weight of evidence indicating reduced board performance in these scenarios, the Commission hypothesized that board performance would be increased by the mere presence of shareholder nominated directors, or at least because directors would work harder at their jobs in order to stay in their positions.[94] The report also stated that firms where a

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[88] *Bus. Roundtable*, 647 F.3d at 1150–51.

[89] *Id.*

[90] ELAINE BUCKBERG, PH.D. & JOHATHAN MACEY, REPORT ON EFFECTS OF PROPOSED SEC RULE 14A-11 ON EFFICIENCY, COMPETITIVENESS AND CAPITAL FORMATION 22 (NERA Economic Consulting Aug. 17, 2009), *available at* http://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf (Dr. Buckberg is the Senior Vice President of NERA; Professor Macey is a Sam Harris Professor of Law, Corporate Finance & Securities Law at Yale Law School).

[91] *Id.* at 22.

[92] *Id.*

[93] *Id.*

[94] *Id.* at 22–23.

dissident director was elected underperformed their peers by nineteen to forty percent during the two years following the election.[95]

The court found that the Commission "completely discounted" those studies and chose to rationalize Rule 14a-11 based on two "relatively unpersuasive studies."[96] The first was the *Cernich* study, which focused on "hybrid boards"–boards with some dissident directors.[97] The second study was on the effects of proxy contests on shareholder value in general.[98] The Commission actually noted that the *Cernich* study was limited[99] and that the findings of the study related to the creation of shareholder value were "difficult to interpret."[100] Nonetheless, the Commission decided Rule 14a-11 would still improve board performance and shareholder value.[101] This was in light of its substantial cost and the fact that the Commission itself referred to its evidence in support of the rule as "at best 'mixed' empirical evidence."[102]

The opinion found further fault where the Commission sourced the costs and benefits of the rule to companies, shareholder value, and the economy as a whole.[103] The Petitioners argued that the Commission often dismissed or discounted the costs of Rule 14a-

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[95] *Bus. Roundtable*, 647 F.3d at 1151.

[96] *Id.* (Stating that the Commission relied "exclusively and heavily" on these two studies, the first being CHRIS CERNICH ET AL., EFFECTIVENESS OF HYBRID BOARDS (IRRC INSTITUTE FOR CORPORATE RESPONSIBILITY May 2009), *available at* www.irrcinstitue.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf (may have to alternately click on download link *available at* http://www.irrcinstitute.org/projects.php?project=36)). The second study is J. Harold Mulherin & Annette B. Poulsen, *Proxy Contest & Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279 (1998).

[97] *Bus. Roundtable*, 647 F.3d at 1151.

[98] *Id.*

[99] *Id.* (citing 75 Fed. Reg. 56668 n. 911).

[100] *Bus. Roundtable*, 647 F.3d at 1151.

[101] *Id.* (citing 75 Fed. Reg. 56761). The Commission also reasoned that the presence of Rule 14a-11 would improve board performance and shareholder value by causing boards to be more responsive, and thus better; it would also improve, of course, the actual election of dissident shareholders. *Bus. Roundtable*, 647 F.3d at 1151.

[102] *Bus. Roundtable*, 647 F.3d at 1151.

[103] *Id*.

11 as costs that were already borne under state laws.[104] Conversely, when considering benefits enjoyed while using the rule, it counted them as *new* benefits gained under the rule.[105] The court cited the Commission's allocation of negatives, such as distraction to management and the loss of time the board may devote to long term planning, as being associated with the long-standing *state law right* that shareholders have to nominate and elect dissident directors.[106] The court found that the Commission's logic was illogical and stated that its use in economic analysis was "unacceptable."[107]

Another example of unsubstantiated conclusions and inconsistent allocation of costs and benefits is the Commission's theory that the rule would increase shareholder value because of "better decision-making" arising from increased board transparency.[108] Rule 14a-11 provided that if a company negotiated

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[104] *Id.*

[105] *Id.* An additional example of the Commission's analysis style is the stated assertion that boards may reexamine their procedures for shareholders to nominate a director candidate. 75 Fed. Reg. 56765. The Commission concluded that boards may incur costs resulting from a re-evaluation of these policies, but then dismissed these costs as only being limited "to the extent that the new rules improve the overall efficiency of the director nomination process and lead to improvements in the existing procedures for director nominations." 75 Fed. Reg. 56765 (Sept. 10, 2010). The Commission's reasoning was that where those types of costs existed, they would be attributed to something else, or at the very least those costs would only be linked to a rule where the rule resulted in an improvement to shareholders.

[106] *Bus. Roundtable*, 647 F.3d at 1151. Petitioners pointed out the Commission, in considering the benefits of the rule, "did not once state that they arose from state law." Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *33.

[107] *Bus. Roundtable*, 647 F.3d at 1151 (the court analogized this type of logic to the logic the Commission relied on, and the court rejected, in *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005), stating the "rule would not create 'costs associated with the hiring of staff because boards typically have this authority under state law,' and assuming that 'whether a board is authorized by law to hire additional staff in no way bears upon' the question whether the rule would '*in fact cause* the fund to incur additional staffing costs.'") (emphasis added).

[108] 75 Fed. Reg. 56765 (Sept. 16, 2010) ("The additional communication between a board and the company's shareholders may lead to enhanced transparency into the board's decision-making process, more effective monitoring of this process by shareholders, and, ultimately, a better decision-making process by the board.").

with a nominating shareholder or group and the board agreed to include the nominee, the nominee would count towards the 25% maximum dissident director limit under 14a-11.[109] Of course, this calculation assumes, against the evidence, that the board would negotiate with nominators and include their nominee. This figure also assumes the negotiations would result in increased board transparency and that this transparency would be beneficial. Finally, the Commission did not give any reason why the shareholder's increased influence over the board would result in better value. No evidence was provided to support the theory that shareholder expertise in a given industry is superior to that of the management. In his scholarly article on the role of institutional investors in corporate governance, prominent securities attorney and corporate analyst Robert Vanecko states that "[i]ncreased activism by American institutional investors is unlikely to improve corporate performance because American institutional investors do not have the expertise to monitor and discipline management."[110] He goes on to point out that many public pension funds "act like politicians rather than investors," especially with politically charged issues, and that "[p]ublic pension funds are typically directed by politicians."[111]

Ruling that the Commission acted arbitrarily and capriciously by using these rationalizations to promulgate Rule 14a-11 was a solid response by the Court and in accordance with precedent from recently decided cases.[112] It is a well-known axiom in law that it is not enough to point to a condition, like a state law right that could *possibly* result in a cost, as the *actual reason* a cost being incurred. The Commission's conclusion, that costs may be avoided simply by a

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[109] *Id.*

[110] Robert G. Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 NW. U. L. REV. 376, 406 (1992) (referring to American investors specifically because institutional investors in some other countries he discusses have much more business experience in the industry in which they invest, whereas it is uncommon in the U.S.).

[111] *Id.* at 413.

[112] *See Chamber of Commerce*, 412 F.3d at 143 (stating that whether state law authorized an additional expenditure did not bear upon whether the rule would in fact cause additional expense); American Equity Life Insurance Co. v. SEC, 613 F.3d 166, 178 (D.C. Cir. 2010) (stating that even if costs are "associated" with state law rights, the Commission still has an obligation to assess and consider the "economic implications" of the rule).

board not objecting to a candidate or shareholders not using the rule, was wishful thinking. The assertion that a board would have no good faith purpose for opposing a dissident candidate presupposes dissident candidates will be equally or better qualified than the candidates a board nominates. The Petitioners pointed out numerous sources of opposing data, such as the American Bar Association letter from Jeffrey Rubin, concluding that a board has a fiduciary duty to oppose less suited candidates; the *Cernich* study, which predicted poorer performance by dissident boards; numerous comments from business leaders; and the off-point studies that the Commission chose to rely on.[113] While discussing shareholder proposals that could affect director positions, Professor David Porter stated that such proposals "could be viewed as extremely threatening by the directors" and that they might "fight the[m] . . . tooth-and-nail."[114]

Further, the Commission did not dispute the substantial cost figures given for the cost of proxy fights, but it did not accept them as reliable either. There is no way of knowing what the Commission believed the costs to be, except that the Commission determined 14a-11 would increase shareholder value and that its benefits would justify the costs. As the Petitioners pointed out, it made little sense for the Commission to consider limited use of the rule as a basis to assess the rule's cost; speculating on *overall* limited use does nothing to address the cost each time the rule is used.

Considering all these points, it is readily apparent that the court was correct to decide that the Commission failed to consider the rule's effect on efficiency, competition, and capital formation. Even if it had an estimate, how could the Commission properly

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[113] *See generally* Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800 (Feb. 25, 2011) (No. 10-1305).

[114] David P. Porter*, Institutional Investors and Their Role in Corporate Governance: Reflections By a "Recovering" Corporate Governance Lawyer*, 59 CASE W. RES. L. REV. 627, 663–64 (2009). Professor Porter describes a scenario where institutional shareholders propose a measure that, if approved, would require board members to get a majority vote to maintain their seat; this proposal is analogous to the present case in that both relate to shareholder proposals which could threaten a company with losing its board member. *Id.* (David P. Porter is an Adjunct Professor of Law at Case Western Reserve University School of Law and a retired partner of the Cleveland Office of Jones Day, where he worked from 1981-2008).

consider costs of the rule when it was brushing significant costs aside (regardless of the amount it estimated the costs to be) as not attributable to the rule?

2. Shareholders with Special Interests

The court next addressed the Petitioners' argument that the Commission failed to consider an important problem which could arise from use of Rule 14a-11, specifically how special interests such as unions, government pension funds, and hedge funds would use Rule 14a-11 to further their own narrow interests at the expense of shareholders as a whole.[115] The Petitioners argued that the Commission received substantial commentary arguing that unions and other special interests would use the rule to gain concessions that did not increase shareholder value.[116] In the adopting release, the Commission pointed to comments it received regarding issues on independent board chairman, majority voting, and cumulative voting as a way to demonstrate the "degree of interest in using Rule 14a-11" by inferring interest in these issues to predict interest in using 14a-11.[117] The Petitioners contended that the study which the Commissioners relied upon "unwittingly confirmed the role unions and government funds would play under the rules" by pointing out that the study showed that two-thirds of all those proposals were submitted by union and government funds.[118] Petitioners bolstered this argument by pointing to the *Georgeson* Report used by the Commission, which showed that out of thirty-nine proposals to adopt majority voting requirements for directors, thirty-eight were from

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[115] *Bus. Roundtable*, 647 F.3d at 1151. Petitioners argued that the Commission neglected its duty, "entirely fail[ing] to consider an important aspect of the problem . . . ." *Id.* (citing *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983)).

[116] *Bus. Roundtable*, 647 F.3d. at 1151–52.

[117] 75 Fed. Reg. 56743 n. 804 (Sept. 16, 2010).

[118] *See* Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800 at *39–40 (stating that the Commission "unwittingly confirmed the role unions and government funds would play under the rules" and referencing a report relied upon by the Commission that estimated that two-thirds of shareholder proposals related to independent board chairmen, majority voting, and cumulative voting were brought by union and government pension funds).

union and government funds.[119] Likewise, they were responsible for twenty-three out of twenty-seven shareholder proposals to require an independent chairman.[120] Indeed, in the adopting release the Commission referred to "shareholders who link the recent financial crisis to a lack of responsiveness of some boards to shareholder interests."[121] This list included eighteen individuals or entities, ten being union or government pension funds.[122]

The court, agreeing with the Petitioners that unions and other special interests would be most likely to use Rule 14a-11, noted the Commission's acknowledgement[123] that companies and shareholders would be injured if special interests used Rule 14a-11, but came to the "conclusion that 'the totality of the evidence and economic theory' both indicate the rule 'has the potential of creating the benefit of improved board performance and enhanced shareholder value.'"[124]

The Commission reasoned that these costs may be limited by the parts of the rule that limited shareholder or group eligibility, such as the requirement to hold three percent of the company's voting stock for at least three years, and would limit use of the rule to those who had a long-term commitment to the company.[125] In other words, the Commission believed the rule would be used by shareholders who are interested in shareholder value.[126] They also reasoned that shareholders are aware of the valuable and limited time board

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[119] *Id.* at *40 (citing the *Georgeson* Report (2010) considered by the Commission at 75 Fed. Reg.56743 n. 804) (Georgeson, Inc. is a major provider of strategic shareholder consulting services). The *Georgeson* Report is available at http://www.georgeson.com/usa/acgr.php.

[120] *Id.*

[121] 75 Fed. Reg. at 56670 (Sept. 16, 2010).

[122] *See id*. at n. 29.

[123] *Bus. Roundtable*, 647 F.3d at 1152 (the court noted that the Commission did not consider the problem *in haec verba* (meaning "in these words" or that something is recited in the exact language)).

[124] *Id.* (citing 75 Fed. Reg. 56761).

[125] *Bus. Roundtable*, 647 F.3d at 1152. The Commission reasoned that other protections existed and cited that in addition to the narrowing of potential nominating entities, the provision allowing only one dissident director on the board or twenty five percent of the board, whichever is greater, via Rule 14a-11 would also limit a degradation in board effectiveness. 75 Fed. Reg. 56766 (Sept. 16, 2010).

[126] 75 Fed. Reg. 56766 (Sept. 16, 2010).

members have and that shareholders would be loath to waste board time on a distracting proxy fight.[127] In addition, the Commission believed that the company's shareholders could be alerted to candidates who may not have shareholder value in mind, giving them the information to make an informed vote.[128] The Commission further concluded that once a dissident director was elected, the director's fiduciary duty would prevent him or her from taking any action that benefitted a special interest at the expense of the shareholders.[129]

The Petitioners argued that the Commission failed to address concerns that the rule would impose burdens on companies, regardless of whether the dissident nominee is elected, due to the cost of succumbing to demands that have nothing to do with shareholder value, threatening a nomination for use as leverage to extract concessions from the company, or the cost of opposing and defeating the dissident nominee.[130] The court echoed multiple commenter's remarks, stating that "as more than one commenter noted, 'public and union pension funds' are the institutional investors 'most likely to make use of proxy access.'"[131] However, it did not express complete

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[127] 75 Fed. Reg. 56765 (Sept. 16, 2010) ("The cost also may be offset to the extent that shareholders understand that the board's time and other resources are in scarce supply and will take these considerations into account in deciding to nominate directors, recognizing that the cost of a distracted board may not justify pursuing their own specific concerns.").

[128] *Bus. Roundtable*, 647 F.3d at 1152.

[129] 75 Fed. Reg. 56766 (reasoning that a dissident director, once elected, would have the same fiduciary duties as the other board members).

[130] *Bus. Roundtable*, 647 F.3d at 1152. Petitioners asserted that the Commission never used the word "union" (except where they listed their submitted comments) throughout the final rule despite the great amount of comments received related to shareholder activism by unions and other special interests. Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *41. Petitioners further argued that the Commission's argument that shareholders would not wish to waste the valuable time of board members was exactly why threatening a proxy fight could be used as leverage by activist shareholders. *Id.*

[131] *Bus. Roundtable*, 647 F.3d at 1152 (citing a letter from Jonathan D. Urick, Council of Institutional Investors, to SEC (Jan. 14, 2010) at 2, *available at* http://www. cii.org/UserFiles/file/resource% 20center/correspondence/2010/1–14–10% 20Proxy% 20Access% 20Comment% 20Letter.pdf [hereinafter Urick Letter] (expressing support for Rule 14a-11 while acknowledging that it would impose costs upon companies)).

ease of use by pension funds and unions. The comment said that because of diversification policies, almost all institutional investors, and even larger funds, hold only small interests in public companies.[132] Assuming this is generally accurate, these special interests would need to collaborate in order to qualify to use Rule 14a-11. However, a study of the fifty largest companies, as determined by market capitalization, indicates this would not involve much collaboration, if any.[133] Of the fifty companies that the top five institutional investors most commonly invested in, the aggregate amount of outstanding shares they owned ranged from 7.6% to 33.5%.[134] In almost all of the fifty companies they most commonly invested in, the percentage was in the upper teens or twenties.[135]

Despite the Commission's responses that the rule would promote use by investors interested in shareholder value, the court agreed with the Petitioners that the Commission, at the very least, failed to respond to numerous concerns regarding use of Rule 14a-11 by activist institutional shareholders.[136] The opinion highlighted the Commission's failure to respond to numerous and serious comments that unions, along with state and local governments, often have special interests in jobs that may far outweigh any interest in share value.[137] For example, in his article, Vice Chancellor Leo Strine opined that "unlike the individual investors whose capital they use to wield influence, institutional investors and their advisors bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than on long-run growth."[138] In

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[132] Urick Letter, *supra* note 131, at 2.

[133] *See* Elaine Buckberg, Ph.D. & Johathan Macey, *Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation*, NERA Economic Consulting (Aug. 17, 2009) at 25–26, available at http://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf.

[134] *Id.*

[135] *Id.*

[136] *Bus. Roundtable*, 647 F.3d at 1152.

[137] *Id.*

[138] Leo E. Strine, *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006) (cited in Pet'r's Final Br., 2011 WL 2014800, at *10, *17, *40 (No. 10-1305)). (Chancellor Leo E. Strine is the Chancellor of the Delaware Court of Chancery (he was Vice Chancellor during the comment period), a Law Dragon, a Robert B. and Candace J. Haas Lecturer on Law at Harvard Law School,

another scholarly article submitted to the Commission, Professor Stephen Bainbridge wrote: "the two classes of institutions most likely to make significant use of those powers—union and state and local employee pension funds—are precisely the classes most likely to misuse those powers in the pursuit of private benefits."[139] Bainbridge concluded that the involvement of active investors in company management will contradict "the very mechanism that makes the widely held public corporation practicable: namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors."[140] Naturally, there was great concern that special interests could be expected to pursue self-interested objectives which would likely cause companies, at a loss to the economy as a whole, to spend significant sums of money and time to fight dissident nominees regardless of whether the nominee could win.[141]

In her legal article provided to the Commission on the role of labor in corporate governance, Marlene O'Connor stated that "unions have devised innovative strategies to use shareholder rights to exercise unprecedented power over managers."[142] O'Connor also wrote that while most unions limit their influence to "so-called" governance practices that promote shareholder value, she pointed to

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and an Adjunct Professor of Law at both the University of Pennsylvania and Vanderbilt University Law Schools).

[139] Stephen M. Bainbridge, *Director Primacy And Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1751 (2006). (Stephen Bainbridge is the William D. Warren Distinguished Professor of Law at UCLA where he primarily teaches corporate law).

[140] *Id.* at 1749.

[141] *Id.* (citing as an example the Detailed Comments of Business Roundtable on the Proposed Election Contest Rules and the Proposed Amendment to the Shareholder Proposal Rule 102 (August 17, 2009), *available at* http://businessroundtable. org/uploads/hearings-letters/downloads/BRT_Comment_Letter_to_SEC_on_File_No_S7–10–09.pdf ("state governments and labor unions . . . often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest" (citing Strine, *supra* note 138, at 1765)). *See also Georgeson* Report, *supra* note 119 (stating that the level of dissident success during elections has dropped to 31%).

[142] Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J 97, 110 (2000) (cited in Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *10, *17, *40, *45).

the AFL-CIO's steps to "develop a worker-shareholder view of the firm to account for the needs of workers more directly"[143] and cited the AFL-CIO's increased practice of organizing other union pension funds to amass large groups of shareholders in order to coordinate their voting power.[144]

Under Rule 14a-11, nominating shareholder(s) were required to certify that they were not "holding the company's securities with the purpose, or with the effect, of changing control of the company or to gain a number of seats on the board of directors that exceeds the maximum number of nominees that the company may be required to include under Rule 14a-11."[145] It is no wonder that this provision did not sway the court to rule for the Commission. As explained above, a shareholder does not have to be seeking control of the company in order to cause significant cost and disruption. Nor can a simple pledge by a nominating investor, claiming to harbor no *intent* to effect control of the company, be reassuring to the management or the remainder of shareholders who will bear the burden of a proxy fight. As Strine points outs, institutional investors do not "owe fiduciary duties to the corporations whose policies they seek to influence."[146] While counting the percentage of dissident shareholders on a board is fairly simple, proving intent is difficult.

Petitioners pointed to recent examples of union pension fund activism at shareholders' expense using a Wall Street Journal article regarding the financial advisory firm, Lazard Ltd.[147] The American Federation of State, County, and Municipal Workers (AFSCME)

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[143] *Id.* at 97.

[144] *Id.* at 110.

[145] 75 Fed. Reg. 56675 (Sept. 16, 2010).

[146] Strine, *supra* note 138, at 1765.

[147] *See* Pet'r's Initial Reply Br., Bus. Roundtable v. SEC, 2011 WL 758644 (Feb. 25, 2011) (No. 10-1305) (citing *Raise My Company's Taxes*, WALL STREET JOURNAL (Jan. 12, 2011), *available at* http://online.wsj.com/article/SB10001424052748703779704576073980682909272.html.). The article refers to AFSCME's pressure against not only Lazard, but other companies, to include in annual reports information about risks that are created by the company's efforts to reduce their tax owed to federal, state, and municipal entities. The article quotes AFSCME's "director of capital strategies" that AFSCME is "trying to challenge the assumption that everyone makes that it's always better for shareholders to pay as little taxes as you can." *Id.*

pension plan invests in Lazard stock.[148] AFSCME, whose 1.6 million members receive their income and pension plans through taxes, sent a letter to Lazard arguing that tax regulators "may 'challenge'" Lazard's tax avoidance and minimization structure.[149] To protect against what AFSCME apparently assumed to be a threat to shareholders, even though it cited no wrongdoing of Lazard, it called on Lazard to detail its tax strategy in the annual report.[150] The inference and assumption AFSCME made is that it is improper to consider tax minimization to always be in the best interest of shareholders.[151] Lawfully minimizing any expense is not a concept that should require justification or explanation. Nor should a company have to make public its strategy, which affects its competitiveness, simply to placate a special interest. The seemingly obvious interest AFSCME has in companies not avoiding taxes lies in increasing tax revenues to ease pressure on governments to reduce expenditures on salaries and pension benefits, both of which directly affect AFSCME's narrow interests.

To exercise influence over a company's management, a special interest group does not need to effect control of the company. It is enough just to exert undue pressure. Rule 14a-11 would have provided that fulcrum. For every expense or burden the management faces, its fiduciary duty will compel it to evaluate the cost of the response and the practicability of that response. The greater the cost or burden, the greater the likelihood that that board will give something up because the cost of resisting the burden may be greater than the cost itself. Naturally, it could be nearly impossible to

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[148] *Id.*

[149] *Id.*

[150] *Id.* (also warning Lazard and other companies that AFSCME was pushing for regulations to force them to publish company tax strategy in their annual reports).

[151] Pet'r's Initial Reply Br., Bus. Roundtable v. SEC, 2011 WL 758644 (2011). *See also Shutting Up Business – Now Unions Are Turning to Shareholder Proposals to Limit Political Speech*, WALL STREET JOURNAL, (Dec. 28, 2011), at A14, *available at* http://online.wsj.com/article/SB10001424052970204224604577030260580411048.html (discussing efforts by major unions to force companies to disclose their political donations in order to facilitate the unions' ability to stop company contributions to political causes that the unions do not agree with).

entirely measure the long-term effects when compared with all the other factors that affect a company's performance.

The court determined that the Commission should have given greater consideration and further explanation to those concerns, stating, "by ducking serious evaluation of the cost that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily."[152] The Circuit ruled appropriately, as the Commission left unaddressed serious effects 14a-11 could have upon shareholders. The Commission failed to "examine the relevant data and articulate a satisfactory explanation for the facts found and the choice made."[153] Because of this, the Commission failed to apprise itself of the relevant information necessary to balance the cost of the rule against its benefits. Accordingly, the rule was found to be arbitrary and capricious.

3. Frequency of Election Contests

The court took note of the number of estimated election contests that would involve 14a-11. When the Commission first proposed the rule they estimated that 269 companies would use Rule 14a-11 each year to propose nominees.[154] When the Commission published the adopting release, it revised the figures to a total of fifty-one companies, citing the more restrictive change in eligibility requirements set forth in the adopting release as the reason for the change.[155] The Petitioners argued that such a drastic change was unreasonable given that the Commission stated that the ownership threshold it adopted makes it possible for "a significant number of shareholders either individually or a number of shareholders . . . [to] satisfy the holding requirement."[156] The Petitioners further argued that the Commission failed to reconcile the apparent inconsistency that such a significantly smaller group of eligible shareholders or shareholder groups would somehow attain the claimed benefits of Rule 14a-11, as opposed to traditional proxy contest methods, if it

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[152] Bus. Roundtable v. SEC, 647 F.3d 1144, 1152 (D.C. Cir. 2011).

[153] *See* Motor Vehicle Mfrs. Ass'n v. State Farm Auto Ins. Co., 463 U.S. 29, 43 (1983).

was so much harder to qualify for eligibility to use 14a-11.[157] Petitioners premised this argument on the Commission's reliance on the "frequent" use of "direct printing and mailing cost savings" when tallying the benefits of 14a-11.[158]

The court agreed with the Commission that the total number of shareholder attempts to nominate directors may be higher with 14a-11, but that revising the estimate from 269 to 51 was not arbitrary and capricious.[159] The Commission argued, in contrast to 14a-11's three year/three percent requirement, that "[o]ne who has owned a single share for one day can start a traditional proxy contest . . . ."[160] Even with 14a-11 in place, shareholders would still have traditional proxy contest methods available as before.[161] That the total number of efforts by shareholders to nominate dissident directors will be higher when shareholders have two ways to nominate a director, rather than one, is a reasonable conclusion.[162] Absent dramatic extremes in the requirements to use 14a-11, it would

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[154] *See* Proposing Release, SEC, 74 Fed. Reg. 29024, 29064 (June 18, 2009). The Commission estimated that 208 companies under the Exchange Act and 61 registered investment companies would receive Rule 14a-11 nominations. *Id.*

[155] *Bus. Roundtable*, 647 F.3d at 1152–53. The Commission stated in the Adopting Release that the estimated number of companies eligible to make nominations under Rule 14a-11 would decrease to 51, 45 Exchange Act companies and six registered investment companies. 75 Fed. Reg. 56743–44. The Commission further stated this decrease was due to the heightened requirements to be eligible under 14a-11 such as the three year holding and three percent ownership requirements. *Id.* at 56744.

[156] Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800 at *36 (emphasis removed) (citing 75 Fed. Reg. 56692).

[157] *Bus. Roundtable*, 647 F.3d at 1153; *see also* Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *36–37; *see also* 75 Fed. Reg. 56756 (Sept. 16, 2010).

[158] *Bus. Roundtable,* 647 F.3d. at 1153 (citing 75 Fed. Reg. 56756).

[159] *Bus. Roundtable*, 647 F.3d at 1153.

[160] Respondent's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014799 (Feb. 25, 2011) (No. 10-1305).

[161] *Bus. Roundtable*, 647 F.3d. at 1153. Nominations can be conducted under traditional methods such as those available under state law, or under 17 C.F.R. § 240.14a–8, which permits a wide variety of shareholder proposals and requires lesser eligibility requirements; Rule 14a-8 is not challenged in this case, but is referenced throughout the releases and briefs as another shareholder proposal method.

[162] *Bus. Roundtable*, 647 F.3d. at 1153.

likely be difficult to predict with any specificity what difference changes to the qualification requirements would have on the number of nominees produced exclusively from the new rule.

Next, the court determined that the Commission acted arbitrarily when balancing the cost and benefits of using Rule 14a-11 as related to the total number of proxy contests initiated under *all* methods available to shareholders.[163] Petitioners argued that the Commission neglected to estimate how many proxy contests, as defined by those which would otherwise occur under the traditional methods currently available, would be replaced by those under Rule 14a-11.[164] Pointing to a failure to adequately inform themselves of the *net effect* on the number of total director proxy contests, the court stated that, although the Commission foresaw beneficial results because Rule 14a-11 would "mak[e] election contests a *more* plausible avenue for shareholders to participate,"[165] without this "crucial datum,"[166] the Commission had no way of knowing whether the rule would result in enough contests to be of net benefit—assuming that it becomes a net benefit at some point.[167] What the APA required from the Commission was an analysis of what the expected increase in shareholders would be. It would do little good to impose Rule 14a-11 upon the investing public without knowing how many Rule 14a-11 nominations occurred relative to traditional methods. If the number of times Rule 14a-11 would be used approximated a decrease in the use of methods already available, then the Commission would have arbitrarily placed another regulation with little to no net benefit.

The court found the Commission's analysis of the estimated rate of the use of Rule 14a-11 was "internally inconsistent" and thus arbitrary.[168] In the adopting release, the Commission forecast savings to shareholders using Rule 14a-11 because it imposed the cost of printing and mailing proxy material directly onto the company, and this shift would naturally spur nominations that were

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[163] *Id.*

[164] *Id.*

[165] *Bus. Roundtable*, 647 F.3d at 1153 (citing 75 Fed. Reg. 56761 (Sept. 16, 2010)) (emphasis added).

[166] *Id.*

[167] *Id.*

[168] *Id.*

otherwise foreclosed due to those costs.[169] The court pointed to letters the Commission used to support its theory, which stated that approximately fifteen percent (several hundred) of companies listed on the stock exchanges expected to receive a nomination (recall that the Commission revised its estimate to fifty-one) for directors under 14a-11.[170] The court agreed with the Petitioners that the Commission projected frequent use of the rule when tallying the benefits.[171] This estimate was a contradiction of the lower estimate the Commission gave when projecting Rule 14a-11's *total costs* at other parts in the release, particularly when calculating costs of solicitation and campaigning.[172]

B. Application of the Rule to Investment Companies

At this stage the court already determined that Rule 14a-11 was arbitrary and capricious. Still, the court took up the Petitioners' concerns regarding the application of the rule to investment companies in the event that 14a-11 is modified and re-imposed.[173] The court echoed the Petitioners' point that investment companies are already covered by the various other laws that afford investors protections not available to shareholders of regular stock owned companies, such as the Investment Company Act (ICA).[174] The Commission argued that the ICA provides a "panoply" of protections to shareholders of investment companies, but reasoned – as it did in its adopting release – that the ICA only provides added protections to state corporate laws.[175] It next argued that the ICA does not deal

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[169] *Id. See also* 75 Fed. Reg. 56756 (Sept. 16, 2010).

[170] *Bus. Roundtable*, 647 F.3d at 1153–54. One comment the Commission relied on is a letter based on the Proposal and a survey of company directors. *See* 75 Fed. Reg. 56756 n. 872 (letter from Kenneth L. Altman, President, The Altman Group, Inc., to SEC (Jan. 19, 2010) at 3, *available at* http://www.sec.gov/comments/s7–10–09/s71009–605.pdf).

[171] *Bus. Roundtable*, 647 F.3d at 1154.

[172] *Id.* at 1150–51, 1154.

[173] *Id.* at 1154.

[174] *Id.* (using as an example 15 U.S.C. § 80a-13(a), which requires a vote by the majority of shareholders to change a fund's "sub classification").

[175] *See* Respondent's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014799, at *51 (Feb. 25, 2011) (citing 75 Fed. Reg. 56684 & n. 141).

with state law proxy access rules or a shareholder's ability to nominate a director under state laws, a fact that the Commission discussed in the Adopting Release as well.[176] To further justify the application, the Commission referred to the substantial responsibilities of investment-company boards, such as the approval of advisory contracts.[177] Petitioners pointed out that the ICA actually *does* require shareholder approval of advisory contracts.[178]

As previously explained, investment companies are often governed by unitary or cluster boards.[179] In responding to comments the Commission received espousing the efficiencies gained by boards governing multiple funds as well as the threat to efficiency under Rule 14a-11, the Commission acknowledged that the rule may decrease efficiency due to disrupted board structures.[180] Dismissing the Commission's argument that the "policy goals and the benefits of the rule justify these costs,"[181] the court stated that it "erroneously attributed" the costs to existing state law rights.[182] The Commission also determined that the costs of Rule14a-11 would be lower for investment companies as there are fewer institutional investors able to meet the three-year holding requirement.[183] Further, there would not be as many opportunities for director elections because not all states require an annual board meeting.[184]

Another theory the Commission advanced was that disruptions to unitary or cluster boards could be avoided by using confidentiality agreements.[185] In response to this, the Petitioners

[176] *Id.* at *52 (citing 75 Fed. Reg. 56,684; 56,763; 56,766).

[177] *Bus. Roundtable*, 647 F.3d at 1154–55 (citing 75 Fed. Reg. 56684).

[178] *Id.* at 1154–55 (citing 15 U.S.C. § 80a-15(a), and analogizing to *American Equity Investment Life Insurance Co. v. SEC*, 613 F.3d 166, 178–79 (D.C. Cir. 2010), finding the Commission's analysis incomplete for failure to determine whether protections existed under another regulatory regime and thus failing to consider the benefits of the rule and promotion of efficiency).

[179] *Id.* at 1155 (citing Rubin, *supra* note 85, at 61–62).

[180] *Bus. Roundtable*, 647 F.3d at 1155 (citing 75 Fed. Reg. 56684).

[181] 75 Fed. Reg. 56684 (Sept. 16, 2010).

[182] *Bus. Roundtable*, 647 F.3d at 1155.

[183] *Id.* (citing 75 Fed. Reg. 56,685 (Sept. 16, 2010)).

[184] *Id.* (citing 75 Fed. Reg. 56685).

[185] *Id.* (citing 75 Fed. Reg. 56685); *see also* Respondent's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014799, at *55–56 (responding that confidentiality

argued that the Commission received numerous comments explaining that "directors would have no obligation to sign such agreements and the agreements would not prevent the loss of attorney-client privilege."[186] The Commission's final rationale was that shareholders could avoid or acquiesce to any cost increases or efficiency reductions if they chose not to elect the dissident director once they were provided with warnings that electing the director may result in increased costs and a disruption of the board structure.[187]

Holding that the Commission acted arbitrarily, the court described the Commission's application of Rule 14a-11 to investment companies as "unutterably mindless."[188] The court found that the Commission's rationale in applying the rule to investment companies was akin to the same logic rejected in earlier parts of the case—that the rule was economically justified because it would only burden shareholders if it was actually used.[189] Ultimately, it held that the Commission failed to sufficiently consider whether the application of 14a-11 to investment companies was necessary given the requirements and protections already imposed under the ICA.[190]

This was an accurate response by the court. The Commission's assertion that the ICA does not govern proxy access the same way that Rule 14a-11 will is insufficient, especially since the Commission acknowledged that significant protections exist for shareholders of investment companies. One of the central tenets offered in justification of Rule 14a-11 was that boards would be more accountable to shareholders, a far broader goal than shareholder oversight of "advisory contracts." Even if it is true that the net of state and federal regulations covering investment companies is similar to that covering operating companies, it does not mean that state laws addressing proxy access are insufficient simply because the ICA does not specifically cover proxy access. The burden is still

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agreements could be made a condition of appointment; that the Petitioners' assertion that dissident directors would not sign the agreement because it was voluntary is speculative; and that concerns that a confidentiality agreement might be too broad to be enforced was unsupported).

186 Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *55.

187 *Bus. Roundtable*, 647 F.3d at 1155 (citing 75 Fed. Reg. 56684).

188 *Id.* at 1155–56.

189 *Id.*

190 *Id.* at 1156.

on the Commission, as the court pointed out, to "'determine whether, under the existing regime, sufficient protections existed' to advance the stated benefits of the rule and to promote efficiency."[191] Given the issues related to the costs of Rule 14a-11, it seems the Commission fell quite short of justifying the costs of the rule against its benefits.

While the Commission argued that the Petitioners had no solid basis for contending that directors would not voluntarily sign a confidentiality agreement, it missed the mark because it would not be adequate even if the Commission had been correct. Given the costs and burdens that Rule 14a-11 would likely impose, requiring a confidentiality agreement seems insufficient. A dissident shareholder could exert great pressure on a board even without getting elected and there is always the chance that the director could simply refuse to sign the agreement after he won. At that point, the *horse has left the barn* and remaining at issue will be whether the company is supposed to hold another costly election, keep the seat empty until the next election, bring in the second place candidate, or reinstate the previous director. These possibilities may be somewhat more remote and even repairable through adjusting the rule. On balance, it seems that the Commission did not give much serious consideration to how the rule applies to investment companies, and this was arbitrary and capricious.

C. The Rule Precluded Shareholders From Forming Their Own Shareholder Nomination Procedures Under State Laws

To prevent future conflict and economize judicial, Commission, and commenter resources, the court should have addressed the Petitioners' claim. The Petitioners' (including the State of Delaware's amici) argument was that the Commission arbitrarily rejected proposals calling for Rule 14a-11 to permit the shareholders of individual companies to decide whether to enact dissident nomination mechanisms.[192] Bolstering the Petitioners'

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[191] *Id.* at 1155 (citing *American Equity Investment Life Insurance Co. v. SEC*, 613 F.3d 166, 178–79 (D.C. Cir. 2010)).

[192] *Bus. Roundtable*, 647 F.3d at 1149. Petitioners argued that 14a-11 imposed a proxy access mechanism that shareholders would be stuck with, without giving them the opportunity to seek such corporate policies under their current state

claim, the State of Delaware, as amicus curiae, argued that its own securities laws would be at odds with Rule 14a-11.[193] Delaware's argument was bolstered by support from its bar association, warning of "significant" stripping of rights currently available to shareholders.[194] The Commission responded that 14a-11 actually helped promote state law policies of shareholder nomination rights and that it did not contradict state laws because Rule 14a-11 would not apply if a company's governing documents or the applicable state laws *entirely* "'prohibit shareholders from nominating candidates for the board of directors.'" [195] The Commission added that a company or state could change the terms of its nomination procedure, so long as any shareholder or group meeting the 14a-11 requirements could still submit a nominee.[196]

The court certainly could have addressed the Petitioners' argument as it could very well come up during a future rulemaking session. The Commission basically asserted that since Rule 14a-11 did not prohibit other avenues for shareholders to nominate directors, it did not conflict with shareholder's state law rights.

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rights. Pet'r's Opening Br., Bus. Roundtable v. SEC, 2010 WL 5116461, at *46–47. Petitioners pointed out that 14a-11 left shareholders with no way to modify, repeal, or broaden the ability of shareholders to nominate and elect director candidates. *Id.* Petitioners further argued that the Commission inconsistently and incorrectly concluded that 14a-11 protected a shareholder right granted under federal law, but then apparently found that only certain shareholders had this right. *Id.*

[193] Final Br. of the State of Delaware, Bus. Roundtable v. SEC, 2011 WL 2014797, at *2. Delaware argued that 14a-11 is "completely contradictory to Delaware's newly adopted statute governing proxy access." *Id.* It reasoned that 14a-11 took away the shareholder rights of Delaware companies by disregarding the State's law permitting shareholders to determine their own company's bylaws as provided under Delaware law. *Id.* at *1–2. *See also* Delaware General Corporation Law, DEL. CODE ANN. tit. 8, §§ 112, 113 (West 2012). *See also* Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *51 (citing a comment submitted to the Commission from the Delaware State Bar Association warning that "[r]ule 14a-11 would deprive stockholders and boards of directors of significant rights and powers under state law").

[194] Pet'r's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014800, at *51.

[195] Respondent's Final Br., Bus. Roundtable v. SEC, 2011 WL 2014799, at *31–32 (emphasis added).

[196] *Id.* at *32.

Equally flawed was the Commission's argument that Rule 14a-11 is not contradictory to state law shareholder rights because it does not apply to a company where the bylaws or state laws prohibit shareholder nomination of director candidates. In order to avoid the rule altogether, a company or state would have to ban shareholders from nominating directors, an obvious burden to expect a shareholder to accept. Not only did this provision fail to increase shareholder access under state laws, it forced states, companies, and shareholders to choose whether to accept Rule 14a-11 or completely rid themselves of any shareholder rights to nominate a director candidate.

V. IMPACT

The judges of the D.C. Circuit have again prevented an arbitrary and capricious rule from being foisted onto the public's shoulders. If upheld, Rule 14a-11 would have served little purpose other than providing a means through which certain shareholders can exercise their personal interests at the expense of the remaining shareholders. While it is possible to do this under the traditional methods if an election is won and the insurgent directors win a vote for reimbursement, it generally must be done initially at the expense and inconvenience of the dissenting shareholders.

Another positive impact of this case is that it refines the Commission's rulemaking methods in light of Dodd-Frank.[197] The Commission will have to readjust its idea of what sort of federal regulations must be in place in order for shareholders to be adequately represented on company boards, to the extent that they should be. Unfortunately, the court's decision not to rule on whether shareholders were already sufficiently protected under existing state laws and proxy access rules leaves the Commission the opportunity to pursue another rule like 14a-11. It is difficult to say whether the Commission will do so. From the information provided by the court and parties to this case, combined with information available from other sources, it looks like it will be very difficult for the Commission to formulate another rule that is similar in any

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[197] *See* Casey, *infra* note 198.

meaningful way to Rule 14a-11 without getting the same response from the courts.

A future rule with the same stated goal as 14a-11 is nonetheless a reality. In her statement during the announcement of the adopting release, Commissioner Kathleen Casey stated that the Commission incorrectly believed it was putting this issue to bed by issuing Rule 14a-11.[198] She was clearly correct, as the rule is now null. The issue is not at rest. Commissioner Elisse Walter subsequently stated that the Commission was finally adopting "the first effective mechanism to facilitate shareholder nomination and voting rights."[199] Despite this case, there is little question that the Commission believes that it needs to institute a rule to further facilitate shareholders' state law right to nominate and elect directors. After the court's ruling, Chairman Schapiro released a statement declaring

> I firmly believe that providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets . . . I remain committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.[200]

As the court stated, the Petitioners and the authors of their supporting amicus curiae briefs made it quite clear that shareholders can either exercise sufficient influence over companies, or divest themselves of the company. Rather than seek to layer on additional proxy access rules, the Commission will need to more diligently improve its oversight capabilities provided under current laws. After all, the Commission failed to establish why shareholders were not being adequately protected. If shareholders are not satisfied with a

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[198] Kathleen L. Casey, *Commissioner, Speech at SEC Hearing* (Aug. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch082510klc.htmI.d.

[199] Elisse B. Walter, *Commissioner, U.S. Sec. and Exch. Comm'n, Speech by SEC Commissioner: Opening Statement at the SEC Open Meeting Speech at SEC hearing* (Aug. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch082510ebw.htm.

[200] *See* Schapiro Press Release, *supra* note 6.

current board of directors, they have the power (which they often exercise) to nominate a new director if the bylaws provide for it. They also have the power to vote with their feet, or choose not to purchase the stock in the first place.

The Commission's rules will continue to be deemed arbitrary and capricious if it continues to insist that a minority of shareholders can impose substantial proxy contest expenses upon the rest of the shareholders, to say nothing about the consequences of a candidate's election. Of course, if a candidate is elected, it is apparently what the shareholders *en masse* wish, and they will reap the rewards or negative consequences accordingly. Indeed, efficient market theories seem to indicate that this is already happening to the extent shareholders want.

Public sentiment seems to indicate a growing desire for more accountability of company managers. As discussed earlier, shareholders are left with fewer methods of nominating directors, but that does not mean that shareholders may not exercise the extensive rights that they already have. Because of the direct and indirect costs to companies, combined with the obvious potential (and probability) for abuse by special interests, the vacation of Rule 14a-11 has likely left shareholders better off than they would have been with it. More does not necessarily equal better.

VI. CONCLUSION

Society must balance the rights and privileges it grants to individuals. Congress enacted the APA to prevent the government from usurping these rights, regardless of whether they are purportedly enacted to protect people's rights. By vacating Rule 14a-11, the court has prevented an abuse of the Commission's regulatory power in the name of shareholders' rights. Moreover, the opinion gives guidance to the Commission as to its powers, responsibilities, and expectations under Dodd-Frank. If the Commission chooses to exercise its rulemaking authority to promote another rule designed to facilitate shareholder nomination of director candidates, it will have to do so within the constraints of this precedent.