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Proxy Access Rule: Appeals Court Rejects SEC Regulation

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In an important victory for free enterprise, a unanimous panel of the U.S. Court of Appeals for the D.C. Circuit has struck down the regulatory hijacking of corporate board elections. Authorized by the Dodd–Frank statute, the so-called proxy access rule crafted by the Securities and Exchange Commission (SEC) was deemed to be "arbitrary and capricious" in a rebuke by the court. The opinion, penned by Judge Douglas H. Ginsburg, also chastised the commission's rulemaking process as "opportunistic" and underscored the government's duty to conduct credible analyses of regulatory costs rather than simply hyping unsubstantiated benefits.

The proxy access case is particularly consequential, as the SEC and at least 10 other agencies prepare to unleash hundreds of new and very costly regulations under Dodd–Frank.[1] At least three other SEC rules have been invalidated for similar reasons in recent years, and several new commission regulations issued under Dodd–Frank could also face scrutiny for substandard economic analyses.[2]

Subsidizing Dissidents. The proxy access rule, adopted by the commission in August 2010, requires publicly traded corporations and investment firms to disseminate information—at company expense—about board nominations made by shareholders.

As part of their fiduciary duties to a corporation, incumbent directors nominate board candidates for election at annual shareholder meetings. Prior to the election, information about these nominees is distributed to shareholders, along with a proxy statement and proxy voting card for those not attending the meeting. Under the proxy access rule, companies would be forced to also prepare and distribute information on nominations made by an individual shareholder or a group of shareholders and list those nominee(s) on the proxy voting card. The directors would also be required by their fiduciary duty to expend considerable funds to defeat shareholder nominees they deemed as unsuitable for advancing the best interests of all shareholders.

The rule was slated to take effect in November 2010 but was suspended by the SEC after the U.S. Chamber of Commerce and the Business Roundtable filed a legal challenge in September 2010.

SEC's Regulatory Opportunism. The SEC asserted that the proxy access rule could create "potential benefits of improved board and company performance and shareholder value" sufficient to "justify [its] potential costs."

The court found otherwise: "By ducking serious evaluation of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily."

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The ruling, issued on July 22, also castigated the commission for eagerly embracing and extrapolating from studies that supported the rule while wholly dismissing those that cast doubt on its utility. Indeed, much of the SEC reasoning for the regulation amounted to mere speculation, the court concluded. Even when empirical evidence was readily available, the commission neglected to quantify benefits or costs—a failure constituting "statutory neglect," the court found.

Unfortunately, such analytic sloppiness is hardly unusual among regulatory agencies in general and the SEC in particular. For example, the commission recently issued complex regulations to control financial institutions as directed by Dodd–Frank. But officials calculated only a minuscule portion of the total burden. Costs related to the internal company time required to comply with three of the regulations—some 317,926 hours—were not included in the SEC's cost estimate, although they may constitute three-quarters of the total man-hours required to comply.

Unlike the budgetary accounting of direct tax revenues, Washington does not track the total burdens imposed by its expansive rulemaking. Even when agencies do estimate the impacts of their own rules, costs are routinely minimized. Nor do agencies always analyze the costs of proposed rules. Twelve of the 75 major regulations adopted by the Obama Administration through the end of March 2011 did not include quantified costs.

Constraining Corporate Governance. By forcing firms to subsidize shareholder candidates in competition with board nominees, the government significantly distorted corporate control of board elections—thus terminating a fundamental prerogative of corporate management and stockholders. This unilateral restructuring of corporate authority paid no heed to the preferences of shareholders. In effect, creation of a proxy access right catapulted the interests of a single shareholder or small group of shareholders over the majority of shareholders.

As noted by commissioner Kathleen L. Casey, who opposed the regulation:

> Rather than presuming, as corporate law does, that companies and their shareholders are generally capable of privately ordering their affairs based on their unique individual circumstances, the rules presume that shareholders are incapable of determining the director election procedures that are in their best interests.[3]

Indeed, the commission maintains that proxy access expands shareholder choice. On the contrary, a government mandate on board elections constrains shareholders far more than it frees them. And rather than allow corporate officers and shareholders to customize election procedures to their unique circumstances—as most state law allows—the proxy access dictate ignores the vast differences among firms.

Special Interest Access. The regulation, not surprisingly, has been long sought by unions, pension funds, and other special interests groups seeking leverage to secure corporate concessions—particularly those that would advance their cause over shareholder value. The real beneficiaries are activists and special interest groups that would manipulate proxy access to focus attention on social and political causes at the expense of the legitimate business concerns of the stockholders.

Indeed, the rule recasts the relationship between directors and shareholders as primarily adversarial. According to Casey, activists assiduously promote such a power struggle:

> I believe many activists will concede that their interests in proxy access do not lie solely in the ability to successfully place a nominee on a company's board of directors; instead, the

1. See Diane Katz, "Dodd–Frank: One Year Later," Heritage Foundation *WebMemo* No. 3320, July 25, 2011, at *http://www.heritage.org/Research/Reports/2011/07/Dodd-Frank-Wall-Street-Reform-and-Consumer-Act-One-Year-Later*.
2. Under the Securities Exchange Act, the commission is held to a higher standard than other financial regulatory agencies and must consider whether a regulatory action will promote "efficiency, competition, and capital formation."
3. Commissioner Kathleen L. Casey, statement at open meeting to adopt amendments regarding "Proxy Access," August 25, 2010, at *http://www.sec.gov/news/speech/2010/spch082510klc.htm* (July 26, 2011).

proxy access right is also an important means of obtaining leverage to seek outcomes outside of the boardroom that may otherwise not be achievable—outcomes that are often unrelated to shareholder value maximization.[4]

Power Grab. The SEC could seek a rehearing of the case before the entire appeals court or request a review of the decision by the U.S. Supreme Court. The more responsible action would be for the commission to refrain from its proxy access power grab and recognize that Americans will benefit far more from free enterprise than incessant unwarranted government interference in corporate matters.

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4. *Ibid.*