INITIAL REPLY BRIEF

ORAL ARGUMENT SCHEDULED FOR APRIL 7, 2011

No. 10-1305

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

BUSINESS ROUNDTABLE and CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

Petition for Review of Final Rule of the
United States Securities and Exchange Commission

REPLY BRIEF OF PETITIONERS BUSINESS ROUNDTABLE and CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

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GLOSSARY

ABA	American Bar Association
Adopting Release	*Facilitating Shareholder Director Nominations*, 75 Fed. Reg. 56,668 (Sept. 16, 2010)
APA	Administrative Procedure Act, 5 U.S.C. §§ 551-559, 701-706 (and scattered other sections in Title 5 of the U.S. Code)
BRT	Business Roundtable
Commission, or SEC	Securities and Exchange Commission
Concept Release	*Concept Release on the U.S. Proxy System*, 75 Fed. Reg. 42,982 (July 22, 2010)
CII	Council of Institutional Investors
Investment Company Act of 1940, '40 Act, or ICA	Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq*.
ICI/IDC	Investment Company Institute/Independent Directors Council
Proposing Release	*Facilitating Shareholder Director Nominations*, 74 Fed. Reg. 29,024 (June 18, 2009)
Profs.	36 *Amici* Law Professors
Proxy Access Rules, or Rules	Rule 14a-11 and its related amendments
Securities Exchange Act or Exchange Act	Securities Exchange Act of 1934, 15 U.S.C. §§ 78a, *et seq*.

STATUTES AND REGULATIONS

The text of relevant statutes and regulations is set forth in the Addendum to the Opening Brief of Petitioners.

SUMMARY OF ARGUMENT

The SEC has adopted new Rules that enable a select number of large shareholders to use the company's proxy to campaign for board of directors positions. Record evidence showed these campaigns will cost the company (and ultimately shareholders) as much as $14 million in direct costs alone. The SEC did not dispute that estimate and made no estimate of its own, despite its statutory duty to "apprise itself of the economic consequences of [its] regulation[s]." It did repeatedly speculate that these and other costs "may" be less "to the extent" that certain conditions obtain, but did not estimate the likelihood of those conditions. Record evidence showed they are highly unlikely. The Commission repeatedly attributed the Rules' costs to existing state law, statements it now characterizes as mere idle observations.

The SEC's brief tacitly concedes that the shareholders most likely to use the Rules are union and government pension funds. These funds, while not typically cited for sound financial management, have a history of using shareholder activism to pursue non-investment-related objectives that depart from other shareholders' interests. (Mutual fund advisers—who are widely trusted for their financial management—have opposed the Rules.) In response to commenters' suggestion that *shareholders* be permitted to decide whether to adopt an "access" mechanism that enables a handful of specially-interested shareholders to impose millions of dollars

on the rest, the Commission stated that proxy access is a shareholder "right"—even though it is a privilege, not a right, granted by the Rules to a select few shareholders in derogation of the right shareholders *do* have under state law to decide for themselves whether to allow access.

The Commission's claim to be furthering shareholder rights while actually abridging them is characteristic of an arbitrary rulemaking where the Commission's explanations repeatedly conflicted with its action: A rule to facilitate state law rights requirements frustrates them; a rule to give shareholders control strips it away; a rule to facilitate contested elections will—when convenient to an economic analysis—be less accessible than supposedly "prohibitively expensive" proxy contests.

The Rules violate not only the APA, but also the First Amendment by forcing corporations to carry the campaign-related speech of others who necessarily oppose the company's position, even when that speech is false and misleading. Unable to justify this intrusion using settled First Amendment doctrine, the Commission likens it to SEC disclosure requirements (which require corporations to make accurate statements about themselves to facilitate the purchase and sale of stock) and rests its case on *dicta*, in a footnote, of a Supreme Court plurality opinion. The Commission was obligated to tailor its rules to avoid impinging on con-

stitutional rights, but—having concluded that First Amendment rights were not implicated—it did not take them into account at all when crafting its Rules.

"[W]here [an agency] has relied on multiple rationales . . . and we conclude that at least one of the rationales is deficient, [this Court] will ordinarily vacate the order unless we are certain that [the agency] would have adopted it even absent the flawed rationale." *Nat'l Fuel Gas Supply Corp. v. FERC*, 468 F.3d 831, 839 (D.C. Cir. 2006). The Commission's reasoning here was deficient in numerous respects and vacatur is appropriate.

ARGUMENT

I. THE COMMISSION'S COST-BENEFIT ANALYSIS IS FUNDAMENTALLY FLAWED

A. The Commission Repeatedly Shrank From Its Obligation To Determine The Economic Consequences Of Its Action.

In *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) ("*Chamber I*"), the Commission declined to estimate certain regulatory costs because, it said, it did not know the means that mutual funds would use to satisfy its rule. In remanding, this Court responded: "That particular difficulty may mean that the Commission can *determine only the range* within which a fund's cost of compliance will fall . . . but . . . it does not excuse the Commission from its statutory obligation to *determine as best it can* the economic implications of the rule it has proposed." *Id.* at 143 (emphases added). Similarly, last year this Court vacated a Commission regulation of an annuity product already regulated by the

states because, the Court explained, the Commission failed to make a "*finding*" on the "existing level of competition in the marketplace under the state law regime." *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2009). The Commission erred because it "did not *assess the baseline level* of price transparency and information disclosure under state law." *Id.* (emphases added).

The rulemaking here has the same deficiencies. The Commission made no finding or estimate of its own regarding election costs under the Rules, which commenters estimated would be the Rules' single largest direct cost. Instead, the Commission cited commenters' varied estimates and then opined that the costs "may" be higher or lower to "the extent that" certain conditions obtained. 75 Fed. Reg. 56,668, 56,770; Pets. Br. 19.

The Commission says that its many inconclusive statements about the effects the Rules "may have" warrant judicial deference because they are "predictive judgments." SEC Br. 36-37. In fact, they are neither: The Commission made no prediction and failed to exercise its judgment. It made no "finding" regarding costs, *Am. Equity*, 613 F.3d at 178, nor even "determine[d]" the "range" in which they would fall. *Chamber I*, 412 F.3d at 143. To make a "predictive judgment," an agency must "exercise its expertise to make tough choices about which of the competing estimates is most plausible, and to hazard a guess as to which is correct, even if . . . the estimate will be imprecise." *Pub. Citizen v. Fed. Motor Carrier*

Safety Admin., 374 F.3d 1209, 1221 (D.C. Cir. 2004). When this Court said that the Commission must "apprise itself . . . of the economic consequences of a proposed regulation," *Chamber I*, 412 F.3d at 144, it meant something more than the agency must merely cite commenters' estimates, provide no estimate of its own, and opine that *whatever* the costs, they are worth it.

Altogether, the Commission projected no fewer than 25 times in the Adopting Release that certain consequences would result "***to the extent that***" certain pre-conditions obtained—but then failed to exercise its "judgment" to "predict" whether those pre-conditions ***would*** obtain. *See*, *e.g.*, 75 Fed. Reg. 56,668, 56,765, 56,766-67, 56,770 (emphasis added). This practice is repeated throughout the SEC's Brief at 18, 19, 38, 40, 41, 48, and 49. To say an event will occur "to the extent" a condition obtains is, necessarily, to call for an assessment of the likelihood of that condition. The statement "to the extent pigs have wings they could fly" does not invite the conclusion that pigs fly; it invites consideration of whether pigs have wings. The Commission repeatedly identified things it should estimate and substantiate, yet did not proceed to do so.

B. The Commission Minimized The Rules' Adverse Consequences.

The Commission repeatedly and erroneously minimized the costs its Rules would impose.

1. Issuer opposition to access candidates

The Adopting Release said that direct campaign costs under the Rules "*may* be limited by two factors": "*the extent that* the directors' fiduciary duties prevent them from using corporate funds to resist shareholder director nominations for no good-faith corporate purpose" and "*the extent that* directors determine not to expend such resources . . . and simply include the shareholder director nominees" in the proxy. 75 Fed. Reg. at 56,770 (emphases added).

Petitioners' Opening Brief showed that in fact, board members will conclude that their fiduciary duties *require* them to oppose access candidates. The ABA Committee on Federal Regulation of Securities agreed. CRI 517 (ABA) at 35; Pets. Br. 19-20. Moreover, as the Rules will operate in practice, a nominee will be an access candidate only if the board, in the exercise of its fiduciary duties, has first reviewed the nominee and determined to nominate another candidate instead, fully recognizing that a contested election will result. Pets. Br. 43-45. In these circumstances, it is preposterous to suppose that directors who passed over an access candidate in favor of their own candidate would promptly do an about-face and decide that—in the Commission's words—they have "no good faith purpose" to support the candidate they just exercised their fiduciary duties to select. *Id.* at 44-45.

The Commission claims that the ABA letter said only that boards *may* oppose nominees. SEC Br. 41. That is incorrect: the ABA stated its expectation that

access nominations "will result in elections that are as hotly contested as traditional proxy contests" due in part to directors' fiduciary duties. CRI 517 (ABA) at 35. More to the point, the Commission still does not explain how a board could be so conflicted about its duties that it would force a contested election and then leave its candidate out to dry for fear that it has "no good faith purpose" to support her.

As for a company's possible decision as a matter of choice not to expend resources to support its own candidate, the Commission suggests a board might do so because the access nominee is "an unobjectionable alternative," or has no reasonable chance of winning. SEC Br. 40. Neither of those rationales is supported by record evidence or stated in the Adopting Release; they may not be offered to justify the Rules now. *SEC v. Chenery Corp.*, 318 U.S. 80, 87 (1943). Moreover, it is fanciful to suggest that a company would knowingly trigger a contested election by declining to make the access nominee its own candidate, and then would sit back quietly and assume victory as a nominee supported by substantial shareholders leveled the criticisms of incumbent leadership that are part and parcel of a contested director election.

2. Improper attribution of the Rules' costs to state law, or to company choice in response to the Rules

At critical points in its analysis, the Adopting Release attributed the Rules' costs to pre-existing state law rights or to choices companies would make in response to the Rules. For example, it stated: "We believe it is *important* to note

that these costs [of shareholder nominations causing board distraction and loss of shareholder value] are associated with the traditional State law right to nominate and elect directors, and *are not costs incurred for including shareholder nominees for director in the company's proxy materials*." 75 Fed. Reg. at 56,765 (emphases added). Similarly, after saying that corporations "may" spend millions to defeat access candidates, the Commission said "These solicitation costs are not, *however*, costs *required* under our rules." *Id.* at 56,770 (emphases added).

This mis-attribution of costs proximately caused by its Rules constituted a clear failure by the Commission to "apprise itself . . . of the economic consequences of [its] regulation." *Chamber I*, 412 F.3d at 144. The Commission claims, however, that in making these statements it was only "correctly recogniz[ing]" or making a "correct observation" about state law and actions issuers would take, rather than attributing the Rules' costs in whole or in part to those causes. SEC Br. 37, 39. But an agency cannot repeatedly include something among a handful of factors in an economic analysis, and then claim it did not affect the outcome. That is particularly the case when the agency characterizes the factor as "important," and consistently raises it when discussing the Rules' costs, but never when assessing their purported benefits. Pets. Br. 33. Moreover, the Commission could not have been clearer than when it stated that certain costs "are as-

sociated" with state law rights "and *are not costs incurred*" due to proxy access. 75 Fed. Reg. at 56,684 (emphasis added).

"Where [an agency] has relied on multiple rationales" and "at least one of the rationales is deficient," this Court "will ordinarily vacate the order unless [it is] certain that [the agency] would have adopted it even absent the flawed rationale." *Nat'l Fuel Gas Supply Corp.*, 468 F.3d at 839. This Court cannot be "certain" that the Commission's mis-attribution of costs to state law was mere harmless error.

3. Frequency of election contests

Determining the frequency of contests under the Rules was essential to assessing the Rules' economic effects. Petitioners' Brief demonstrated a fundamental flaw in the Commission's frequency analysis: The *raison d'etre* of the Rules is that they are a more accessible, less costly means of putting forward director candidates compared to traditional proxy contests, which supposedly are "prohibitively expensive." 75 Fed. Reg. at 56,755; CII Br. 9. Yet to estimate the frequency of election contests under the Rules, the Commission *began with the premise* that using the Rules would be more difficult than conducting a proxy contest. Pets. Br. 14-16, 35-39.

The Commission's Brief does not defend this analysis so much as obscure it; accordingly, the method by which the Commission estimated the frequency of election contests must be reiterated: In the Adopting Release, the Commission dis-

carded its original method for estimating frequency (which yielded a much higher rate) and premised its new estimate on two data points, explaining: "After further consideration, we believe that a better indicator of how many shareholders might submit a nomination is ***the number of contested elections*** and ***board-related shareholder proposals*** that have been submitted to companies." 75 Fed. Reg. at 56,743 (emphases added). Then, in the same paragraph, the Release enumerated only the restrictions the Rules place on access to the proxy, without taking account of the ways the Rules achieve their intended purpose of facilitating contested elections—*e.g.*, shifting costs to other shareholders, and special new rules facilitating the formation of nominating groups. *Compare* SEC Br. 11-12 (claiming that "the cost savings resulting from Rule 14a-11 could mitigate 'collective action' and 'free-rider' problems, which can discourage an individual shareholder from . . . nominat[ing] and elect[ing] it own director candidates," and enumerating numerous reasons nominating shareholders would find proxy access preferable and more accessible); CII Br. 9 ("[c]ompeting with incumbents through a traditional proxy contest is rarely an alternative").

The Commission protests that this frequency analysis appeared in the portion of the Release addressing the Paperwork Reduction Act. SEC Br. 42. However, it is the *only* frequency analysis in the Release, and the Commission does not dispute that determining the frequency of election contests was essential to ascer-

taining the Rules' "economic consequences." *Chamber I*, 412 F.3d at 144. To the extent the Commission means that it *did not* consider frequency when considering "broad" issues beyond the Paperwork Reduction Act, its error was only more serious.

The Commission claims that its "frequency estimate expressly accounts for both individual and shareholder groups." SEC Br. 45. That is not correct. As seen in the third column at 75 Fed. Reg. at 56,743 and the first column on the following page, when determining how frequently access contests would occur relative to traditional proxy contests the Commission considered *only* the Rules' restrictions on use. In footnote 805 the Commission estimated that 75 percent of access contests would be triggered by groups, but it never considered whether the increased ease of forming groups would increase the frequency of access contests.[1]

The Commission also cannot defend the second data point used to estimate frequency, the number of "board-related shareholder proposals" historically submitted under Rule 14a-8. That class of proposals—summarized in SEC Br. 44-45—excluded many other board proposals that are also "indicator[s] of shareholder

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[1] The Commission's *amici* unwittingly confirm how formidable groups will be formed to use the Rules. In coordination with *amicus* Council of Institutional Investors, 14 government pension funds with assets exceeding $950 billion came together to file the brief. (CII's 13-person board includes 6 members affiliated with union pension funds, but no union fund joined the brief.) CII Br. 1; *see* also note 3 below.

interest in using Rule 14a-11," *id.* at 44, including 17 proposals that were made for the very purpose of enabling access nominees. Pets. Br. 37 & n.6.

4. Costs resulting from unintended uses of the Rules

Petitioners showed that the principal users of the Rules would be special interest investors such as union and government pension funds, who would use access to obtain concessions from companies, and to mount "soapbox" campaigns where there was no serious intent that the candidate win. Pets. Br. 10-12, 16-20, 39-42; *see also* CRI 320 (NERA/Jonathan Macey) at 12, 23; CRI 629 (BRT) at 2 n.1 (citing Marleen O'Connor, *Labor's Role in the Shareholder Revolution,* in *Working Capital: The Power of Labor's Pensions* 71 (2001) (touting the use of shareholder proposals to "gain access to 'behind the scenes' meetings with managers" in which "it is commonly understood . . . that unions may discuss labor issues as well . . . . If these negotiations proceed favorably, the notion is that the union will withdraw its shareholder proposals.")).

The Commission nowhere disputes that the Rules will predominantly be used by union and government funds, nor that those funds often pursue non-investment-related objectives that conflict with other shareholders' interests. (For a recent example of such conduct, see *Raise My Company's Taxes*, Wall St. J. (Jan. 12, 2011), describing a shareholder proposal by the pension fund for AFSCME, a government workers' union, which objected to a company minimizing its tax li-

abilities. Government workers may want companies to pay higher taxes; the rest of shareholders do not.)

The Commission also effectively concedes that the Adopting Release failed to *expressly* discuss union and government funds and their shareholder activism, as well as the use of access as "leverage" or a bully pulpit to impose costs short of actual election. SEC Br. 23. Yet it was incumbent on the SEC to pause, consider, and address the wisdom of a costly rule that would be used mostly by investors with special interests known to depart from other shareholders', and that was not expected to be used—or even supported —by most respected investors, including mutual fund advisers. *See* CRI 595 (CII) at 2 (mutual funds unlikely to use the Rules because they "rarely if ever sponsor shareowner resolutions").[2]

The Commission claims, however, that it addressed commenters' concerns indirectly. First, it cites its observation that costs resulting from special interest investors "***may*** be limited ***to the extent that*** the ownership threshold and holding requirement allow the use of the rule by only holders who demonstrated a significant, long-term commitment to the company." SEC Br. 48 (quoting 75 Fed. Reg. at 56,766, emphases added). That is non-responsive, however, because union and

[2] The Commission's *amici* suggest that Petitioners' *amicus* Investment Company Institute ("ICI") favored adoption of the Rules. CII Br. 23. In fact, ICI opposed Rule 14a-11 and supported letting *shareholders decide* whether to adopt an access regime through Rule 14a-8. CRI 389 (ICI) at 1-3.

government funds are commonly long-term index investors, are recognized to act for reasons other than maximizing investment returns, and were a principal focus of commenters' concern. CRI 83 (CII) at 4 (CII members are "long-term, passive investors"); Leo E. Strine, Jr., *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 CRI 320 (BRT) at 102) (union and government funds "often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest").[3]

Second, the Commission says it "never stated that shareholders seeking to use such leverage would be dissuaded by the negative effects of their actions on board efficiency. Instead, the Commission observed that other potential costs—such as those of election contests—'may be offset to the extent that shareholders understand' the board's scarce resources." SEC Br. 49, quoting 75 Fed. Reg. at 56,765. This (elusive) reasoning confirms Petitioners' points: If nominating

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[3] CII, whose members are predominantly government and union funds, adopted a position on proxy access in 2008 with holding requirements similar to the Rules' final requirements: 3 percent of shares for at least 2 years. CRI 83 (CII) at C.1. CII explained that "the uniform five percent threshold contained in the Commission's 2007 proposals would largely be unattainable for Council members." *Id.* So, CII members plainly expect to be able to achieve proxy access under the Rules as finally adopted—which of course is why they avidly support them. Indeed, CII's comment letter identified various circumstances in which a 3 percent threshold could be met by even a small number of CII members. *Id.*

shareholders would not be dissuaded by the negative impact of their actions, they will not be deterred by concern with scarce board resources. Rather, a shareholder seeking to pressure a company will regard a board's scarce resources as a reason its pressure may succeed.[4]

* * *

Proxy access has been among the most controversial regulatory issues in the Commission's history because particular classes of institutional investors believe it will give them a radically less expensive, more accessible means of changing corporate conduct, whereas issuers strongly oppose access candidacies because of the cost and disruption it is believed they will cause. The Commission erred seriously in cost-justifying these Rules by marginalizing and even ignoring those powerful contending forces.[5]

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[4] The Commission states that directors' fiduciary duties would prevent them from acceding to a shareholder demand to avoid a costly election contest. SEC Br. 48. That is wrong: Directors will feel compelled to capitulate if the election would impose costs greater than the demand presented by the shareholder.

[5] *Amici* claim that the experience in other countries shows that the Rules will not impose the costs that Petitioners identify. CII Br. 15-16. However, the Commission did not rely on the design or consequences of proxy access regimes in other countries to assess the consequences of its Rules; the non-U.S. experience cannot be cited in the Rules' defense now. Moreover, significant differences exist between regulation of corporate governance in the U.S. and statutes and practices in other countries. *See, e.g.*, Companies Act, 2006, c. 46, § 338 (U.K.) (generally allowing only a group of shareholders holding at least 5 percent of shares to make any shareholder proposal to the company).

II. IT WAS ARBITRARY FOR THE COMMISSION NOT TO LET SHAREHOLDERS DECIDE WHETHER TO ADOPT AN ACCESS MECHANISM

As explained in Petitioners' Opening Brief, the Commission arbitrarily rejected alternatives to the Rules that would have empowered shareholders to decide for themselves whether and on what terms to allow proxy access, thereby averting costs that the Commission admitted *could* result from its Rules. Pets. Br. 21, 46-47.

Because the Commission's cost assessment was flawed, it must conduct a new one and reconsider whether the costs are such that shareholders should have a say in whether to adopt an access mechanism. However, the Rules' compulsory proxy access regime must also be vacated for the separate and independent reason that the Commission repeatedly advanced rationales for its action that conflict with the objective it claimed to further.

1. The Rules enable shareholders to "'effectively participat[e] in governing the corporation,'" the Commission asserts. SEC Br. 30 (quoting 75 Fed. Reg. at 56,680 n.96). However, on such important governance questions as whether to have an access regime and what its requirements should be, the Rules strip shareholders of the authority they currently have under state law.

2. The Rules enable shareholders "'to *control the corporation* as effectively as they might have by attending a shareholder meeting,'" the Commission

asserts. SEC Br. 25 (emphasis added, citation omitted). At the majority of public corporations—which are incorporated in Delaware—shareholders currently can decide to adopt no access regime or a more limited one than the Rules require. That control is stripped by the Rules.

3. "[T]he Rules' 'net effect' will be to expand shareholder choice, not limit it,'" the Commission claimed in the Adopting Release. Pets. Br. 50 (quoting 75 Fed. Reg. at 56,673). That claim is plainly incorrect for reasons just given, and is abandoned in the Commission's brief.

4. The Commission and its *amici* argue that proxy access is a "legal right" and it would be "without precedent" if "Federal securities law rights" could be "'restrict[ed]'" by other shareholders. CII Br. 25, 26 (quoting 75 Fed. Reg. at 56,672; 56,759). That argument fails for several reasons. First, it is circular: Federal proxy access is new, and it is a basic part of establishing a new "right" to determine who may exercise it and in what circumstances.

Second, proxy access is not a "right," it is a privilege granted to a select few at the expense of the majority's state law right to reject an access regime. Moreover, the Commission's rationale for conferring this privilege on the select few is not to advantage those particular shareholders, but to further the interests of all. Accordingly, the Commission's stated concern not to "diminish the ability of shareholders to vote for nominees put forth by other shareholders," SEC Br. 26, is

misplaced if the majority of shareholders do not want to vote for the nominees of special interest investors.[6]

Finally, the First Amendment interests discussed in Section V below are a further compelling reason that the Rules' compulsory access requirement must be vacated. The Commission asserted that control of the proxy "'derives from the shareholders,'" 75 Fed. Reg. at 56,674 (quoting *Pac. Gas & Elec. Co. v. Pub. Util. Comm'n*, 475 U.S. 1, 14 n.10 (1986)), yet never considered whether in light of First Amendment values shareholders should have a say before a handful among them hijack corporate resources to voice special interest agendas. The Court should vacate the Rules so the Commission may consider its action in light of these constitutional concerns in the first instance. Pets. Br. 60; *see AFL-CIO v. FEC*, 333 F.3d 168, 175 (D.C. Cir. 2003) ("[W]e do not accord the Commission deference when its regulations create 'serious constitutional difficulties.'").

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[6] *Amici* err in protesting that one "generation" of shareholders cannot "disenfranchise" another. CII Br. 26. Many shareholder decisions alter the bundle of rights that future shareholders enjoy, subject to those shareholders' ability to offer different proposals in the future. *Amici* also err in claiming that at some companies, supermajority voting requirements would prevent shareholders from adopting an access regime. *Id.* In fact, proposals to remove supermajority requirements have been largely successful, as well as shareholder proposals that needed to pass with a supermajority. CRI 629 (BRT) at 6-8.

III. THE COMMISSION NULLIFIED STATE LAW

The Commission contends that "the rules defer[ ] to the state law that created" rights to nominate and elect directors. SEC Br. 31. But the State of Delaware has explained that the Rules "fundamentally alter the policy of stockholder choice embodied in" Delaware law, "prevent[ing]" shareholders "from exercising their Delaware law right to adopt an alternative to proxy access." DE Br. 2, 7.

States such as Delaware provide the right to nominate and elect directors as part of a broader legal backdrop of "company-by-company flexibility" that "gives stockholders the ability to decide whether and when stockholders would be granted . . . a right of [proxy] access." DE Br. 1-2; *see* CRI 68 at 6. The Commission arbitrarily selected one state-law right and gave it a status not accorded by Delaware itself, disregarding the interlocking rights and obligations that Delaware has put in place as part of its overall "enabling" approach toward corporate law. It is therefore ironic that the Commission repeatedly blamed the Rules' costs on state law, while simultaneously nullifying state requirements that constrain those costs.

Petitioners explained that the Commission could have addressed some of the state-law problems with its Rules by exempting Delaware corporations. Pets. Br. 52. The Commission does not respond to that point.

IV. THE RULES ARBITRARILY INCLUDE INVESTMENT COMPANIES

Investment companies are materially different than other public companies and are subject to more stringent federal regulatory requirements. Petitioners and their *amici* demonstrated that the Commission gave insufficient weight to these differences in deciding to cover investment companies under Rule 14a-11. Pets. Br. 53-55; ICI/IDC Br. 4-9.

In response, the Commission's brief essentially repeats the error of the Adopting Release by reasoning as follows: Directors of investment companies have heightened responsibilities under the Investment Company Act ("ICA"). Therefore, the Commission reasons, shareholders' ability to nominate those directors can be no less important than at public companies, and the Rules should apply equally to investment companies.

That analysis overlooks two important points. First, nominating and electing directors at annual meetings plainly is not as important to protecting shareholder interests at investment companies as at operating companies, because state law does not require investment companies to hold annual meetings. (Operating companies must.) It is no response to say, as the Commission does at 52, that *when* investment companies hold shareholder meetings, shareholders should have the same proxy access as at operating companies. The absence of an annual meeting requirement for investment companies embodies a difference in shareholders' role

generally, which the Commission did not confront in its Adopting Release nor in its Brief.

Second and related, the special role that mutual fund directors exercise toward the investment adviser is already addressed by expanded responsibilities and special independence requirements imposed by the ICA and SEC regulations. Pets. Br. 23-24. The Commission could not identify these directors' responsibilities as a reason for regulation, without first "assessing" whether the shareholder interests underlying those responsibilities were already vindicated by the existing "baseline" of statutory and regulatory restraints. *Am. Equity*, 613 F.3d at 178. Yet it repeatedly did just that. For example, after observing that the ICA provides "'additional' safeguards 'beyond those required by state corporate law,'" making fund directors' duties a "'cornerstone'" in protecting against conflicts of interest, the Commission's brief states: "Thus"—that is, because of the heightened ICA requirements—"the protections of the ICA do not reduce the importance of rights to nominate and elect directors . . . ." SEC Br. 51-52. That reasoning is backwards, and squarely conflicts with *American Equity*. *See also id.* at 52-53, citing directors' "annual approval of advisory contracts" as a *reason* for regulation, even though "the ICA requires shareholder votes on the terms and approvals of investment advisory contracts." *Id.* Such granular shareholder oversight does not exist for operating companies.

Similarly, in declaiming that "the protections of the ICA affect neither the specific state law [nomination] rights furthered by the rule . . . nor their interaction with the proxy process," SEC Br. 52, the Commission overlooks its claim that operating companies would benefit under the Rules from supposed improved director performance. If directors' performance at investment companies *already* is boosted by the ICA's heightened requirements, then the benefit to be gained from the Rules must be less than at operating companies.

Petitioners' brief showed that while using such flawed reasoning to impose proxy access on investment companies, the Commission attributes the resulting costs to state law. Pets. Br. 32-33; ICI/IDC Br. 18, 22-23, 25, 29, 30. The Commission scarcely disputes the error: The Adopting Release "noted that any consequent effects on competition and efficiency *ultimately derived* from the state-law right to nominate," the brief admits, but the Release still "*fully considered* the potential effects on efficiency and competition for investment companies." SEC Br. 54 (emphasis added). However, this Court cannot presume that an agency has "fully" considered the effects of its actions when it attributes those effects "ultimately" to state law rather than to its own action, which is the proximate cause. *Supra* at 8-10.

The Rules' costs for investment companies include impairment of the "unitary" or "cluster" boards that enable one group of directors to serve as the board for

multiple funds. *See* Pets. Br. 24, 55; ICI/IDC Br. 19-22. Acknowledging these potential costs, the Commission suggested that non-conforming directors sign confidentiality agreements so they could receive information on funds for which they are not a director. SEC Br. 55. There is no rational basis to suppose that a dissident director would, without additional consideration, voluntarily sign a confidentiality agreement that imposed the needed restrictions and subjected her to legal action for a breach. The Commission dismisses such objections as "speculative," yet a legal memorandum to that effect was submitted in the rulemaking. CRI 648 ("Memorandum Re: Use of Confidentiality Agreements for 'Non-Conforming' Directors"). Recognizing the weakness of its reasoning, the Commission asserts for the first time that a confidentiality agreement "could be made a condition of board membership." SEC Br. 55. It cites no record evidence to that effect, and may not base its action on reasons not given at the time. *Chenery Corp.*, 318 U.S. at 87.

V. THE RULES VIOLATE THE FIRST AMENDMENT

By compelling companies to carry and fund third-party speech that they disagree with—even speech that is false and misleading—the Rules regulate the content of speech and are subject to strict scrutiny. Pets. Br. 55-56 & n.13. The Commission does not attempt to defend the Rules under that demanding standard,

but argues instead that the Rules do not implicate the First Amendment, or pass some form of relaxed scrutiny. It is wrong on both counts.

1. Strict scrutiny applies to content-based regulations of speech except in rare circumstances involving lesser-protected categories of speech, such as commercial speech. *United States v. United Foods, Inc.*, 533 U.S. 405, 409-10 (2001). The Commission does not seriously contend that the speech in issue here is commercial, nor could it, since the speech does not "propose a commercial transaction." *Id.* at 409.

Instead, the Commission contends, *first*, that lesser scrutiny applies to "disclosure under the securities laws." SEC Br. 64. The Rules do not involve mere "disclosure," however, as the Commission admitted during the rulemaking. *See* 75 Fed. Reg. at 56,674 & n.56 (explaining that the Commission has authority to adopt Rule 14a-11 because its "authority is *not* limited to regulating disclosure") (emphasis added). The disclosure cases cited by the Commission involve "regulat[ion of] what sellers of securities may write or publish about their wares," to protect buyers and sellers from false or misleading information. *Paris Adult Theatre I v. Slaton*, 413 U.S. 49, 64 (1973). The Commission cites two decisions condoning the regulation of "corporate proxy statements." *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 456 (1978); *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 758 n.5 (1985). The statements in those cases—which did not concern the se-

curities laws—trace to *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), which involved a proxy solicitation alleged to be materially misleading because it did not disclose a conflict of interest. *Id.* at 384 n.6.

Indeed it makes a mockery of federal disclosure laws to contend that mandated publication of false and misleading campaign rhetoric is a disclosure requirement. The Rules also are entirely different than laws requiring disclosure to the government so it can discharge its "essential operations," the subject of this Court's recent decision in *Full Value Advisors, LLC v. SEC*, __ F.3d __, 2011 WL 339210 (D.C. Cir. Feb. 4, 2011). *Compare* Profs. Br. 4 n.5 (a company's shareholders can "number in the millions").

The Commission errs, *second*, in suggesting that its "comprehensive regulation of . . . securities" consigns all speech about corporate governance to reduced First Amendment protection—or no protection at all. In *SEC v. Wall Street Publishing Institute, Inc.*, this Court said only that "[s]peech relating to the *purchase and sale* of securities" is subject to lesser First Amendment scrutiny. 851 F.2d 365, 373 (1988) (emphasis added). The Court added that it would be "impermissibl[e]" for the Commission to "be drawn into the arena encompassing content regulation" of speech. *Id.* at 375.

The Commission has stepped well beyond its customary role of regulating the accuracy of statements in connection with the purchase and sale of securities,

undertaking instead to adjust the balance of power in speech during corporate elections—a departure so substantial that the Commission sought special statutory authorization for some form of "access" rule. It cannot invoke courts' statements about the regulation of "'the exchange of information *about securities*'" as historically practiced, *Full Value,* __ F.3d __, at *6 (emphasis added), to immunize a new, very different regulation. For the same reason, constitutional review of this compelled speech will not shake the edifice of existing securities laws and corporate regulation generally. Profs. Br. 10-11.[7]

2. The Commission errs in suggesting that corporate proxy materials constitute "internal" speech subject to reduced First Amendment protection. SEC Br. 60-63. A speech by an employer to its employees is "internal" to the company, but "an employer's free speech right to communicate his views to his employees is firmly established." *NLRB v. Gissel Packing Co.*, 395 U.S. 575, 617 (1969). This Court likewise has observed that "the interest of a corporation in communicating with and soliciting its shareholders and employees" is "sheltered within the First Amendment by the Supreme Court." *Int'l Ass'n of Machinists & Aerospace Workers v. FEC*, 678 F.2d 1092, 1114 n.96 (D.C. Cir. 1982) (*en banc*), *aff'd*, 459 U.S.

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[7] It is of no moment that corporate proxy materials may not be "'core political'" speech. SEC Br. 65. *Compare United Foods*, 533 U.S. at 410 ("no basis" under Court's precedents to compel sponsorship of advertising for mushrooms).

983 (1982). The Commission's statement that gigantic financial institutions like its *amici* are not "third parties" relative to a company they invest in is obviously incorrect.

Unable to defend its action within settled parameters of First Amendment doctrine, the Commission leans heavily on *dicta* in a footnote to a plurality opinion. *See* SEC Br. 61-63. However, "it is rather implausible that the Supreme Court, in dicta—not to mention in a footnote—meant to overrule *sub silentio* the holdings in" other cases. *In re Sealed Case No. 98-3077*, 151 F.3d 1059, 1064 (D.C. Cir. 1998); *cf. Ctr. for Biological Diversity v. U.S. Dep't of Interior*, 563 F.3d 466, 481 (D.C. Cir. 2009) (Sentelle, C.J., joined by Ginsburg, J.) (even "considered *dicta* of the Supreme Court" is regarded only as "forceful, . . . not binding").

In any event, the *dicta* in *Pacific Gas* is inapposite. The plurality characterized Rule 14a-8 as "limit[ing] *management's* ability to exclude some shareholders' views from corporate communications." 475 U.S. at 14 n.10 (emphasis added). That was permissible, it suggested, because management's interest in the proxy "derives from the shareholders." *Id.* The Rules here override shareholders' ability to control unwanted third-party speech. Having displaced the shareholder supremacy that was the *dicta*'s rationale, the Commission can no longer rely on the *dicta* itself. Second, *Pacific Gas* said that Rule 14a-8 is "speech by a corporation to it-

self," *id.* (emphasis omitted), whereas the Commission has insisted that its new Rules confer rights to shareholders "*individually*, not in some aggregated capacity." 75 Fed. Reg. at 56,673 (emphasis added). Speech that is a shareholder's "right" cannot also be the company's chosen speech.

The Commission's *amici* argue that "state and federal law traditionally have granted shareholders *individual* rights with respect to their company." Profs. Br. 4 (emphasis in original). That is different from a shareholder right to act *as* the company. The only example *amici* give of that—derivative actions—are a rare exception in which shareholders act in lieu of directors whose "malfeasance" is thought to prevent them from "'faith[fully]'" acting on the company's behalf. *Id.* at 5. Such actions—which are subject to stringent pleading standards, a motion to dismiss, and, hence, judicial review before they may proceed—are an exception to the bedrock principle that directors, not shareholders, act for the company and manage its assets. *See* Fed. R. Civ. P. 23.1; Del. Ch. R. 23.1; *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).[8]

[8] Contrary to the suggestion in Professors' Brief at 5, requiring an entity to provide a forum for its members to meet, speak, and vote is not the same as requiring the entity to fund and transmit speech by third parties it disagrees with. *Cf. Citizens United v. FEC*, 130 S. Ct. 876, 904-08 (2010) (government may not infringe First Amendment rights to address purported distortion in campaign-related speech).

The *Pacific Gas dicta* is inapposite for the additional reason that the Rules differ significantly from Rule 14a-8. The Rules require a company to carry and fund speech whose content it *necessarily* opposes, since the board will already have declined to make the access candidate the company nominee, selecting another candidate whom the access nominee opposes. Pets. Br. 44. A Rule 14a-8 proposal, by contrast, does not necessarily require a company to "foster[ ] . . . an ideological point of view" it finds "unacceptable." *Wooley v. Maynard*, 430 U.S. 705, 715 (1977). Moreover, the burdens imposed by Rule 14a-8 proposals—which often are non-binding (CRI 320 (BRT) at 78)—are far less than the burdens under the Rules discussed above.

3. Even if relaxed scrutiny did apply, the Rules would fail First Amendment review. The Commission says it "rationally rejected" less intrusive alternatives (Br. 67), but "rationality" is not the test. The Supreme Court has "made clear" that if the government "could achieve its interests in a manner that does not restrict speech, or that restricts less speech, [it] must do so." *Thompson v. W. States Med. Ctr.*, 535 U.S. 357, 371 (2002) (explaining *Central Hudson* test). The government has the burden of "justif[ying]" such a restriction. *Id.* at 373 (internal quotation marks omitted). Here, the Commission summarily concluded that First Amendment interests were not implicated (Pets. Br. 58-59) and never considered them again even as it rejected less burdensome alternatives, including reliance on

the Delaware model, Rule 14a-8, or an opt-out. At minimum, the Commission must address these First Amendment interests on remand after the Rules are vacated.

CONCLUSION

For all the above reasons, the petition should be granted.

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 6,933 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word using 14-point Times New Roman font.

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CERTIFICATE OF SERVICE

I hereby certify that on this 10th day of February, 2011, I electronically filed the foregoing Reply Brief of Petitioners Business Roundtable and Chamber of Commerce of the United States of America with the Clerk of Court for the United States Court of Appeals for the District of Columbia Circuit by using the appellate CM/ECF system. I also hereby certify that I caused 5 copies to be hand delivered to the Clerk's Office.

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