Labaton Keller Sucharow

Investor Alert

Circuit Split Emerges in SEC Proxy Advice Reform

This Investor Alert serves as an update to Labaton Keller Sucharow's previous Investor Alert following a recent decision by the Sixth Circuit Court of Appeals. The ruling establishes a Circuit split concerning amendments to the Securities and Exchange Commission's ("SEC") rules governing proxy voting advice.

Background of the 2020 Rules and the SEC's 2022 Recission

On July 13, 2022, the SEC voted to adopt amendments to its rules governing proxy voting advice,[1] voting to partially rescind a set of rules enacted during the Trump administration (the "2020 Rules"). The 2020 Rules increased restrictions on proxy voting advice businesses ("proxy advisory firms"), which advise institutional investors on how to vote their shares in a proxy contest.[2] Specifically, on July 13, 2022, the SEC rescinded and eliminated the following 2020 Rules:

- Requiring proxy advisory firms to make their voting recommendations available to the registrant / public company no later than when the advice is disseminated to the proxy advisory firm's clients (*i.e.*, institutional investors); and
- Requiring proxy advisory firms to notify institutional investors of a company's written response to the proxy advisory firm's recommendation in advance of the shareholder meeting.

Institutional investors and proxy advisory firms expressed concern that the independence of investors' votes were jeopardized by the 2020 Rules since "proxy advisory firms ***may feel pressure to tilt voting recommendations in favor of management*** more often, to avoid critical comments from companies that could draw out the voting process and expose the [proxy advisory] firms to costly threats of litigation."[3] There were also concerns from proxy advisory firms of the potential for increased compliance costs for, and increased delays associated with, the delivery of the proxy recommendations since proxy advisory firms' recommendations needed to be provided to public companies "at or prior to"[4] the time they were given to proxy advisory firms' clients. These two risks were known as the "risks to timeliness and independence"[5] and were a major driver of the SEC's decision to rescind the 2020 Rules.

[1] SEC, *SEC Adopts Amendments to Proxy Rules Governing Proxy Voting Advice* (July 13, 2022).

[2] *Id.*

[3] Rosemary Lally, *Leading Investor Group Dismayed by SEC Proxy Advice Rules*, COUNCIL OF INSTITUTIONAL INVESTORS (July 22, 2020), (emphasis added).

[4] *Nat'l Ass'n of Mfrs. v. SEC*, 105 F.4th 802, 808 (5th Cir. 2024).

[5] *Id.* at 812 (5th Cir. 2024).

The Fifth Circuit Vacates the SEC's Recission

On June 26, 2024, the Fifth Circuit Court of Appeals in *National Association of Manufacturers v. SEC* vacated and remanded the SEC's recission of the 2020 Rules. By a 3-0 vote, and under a *de novo* review, the Court held that the SEC's "explanation" for the recission of the 2020 Rules was "arbitrary and capricious and therefore unlawful."[6]

The Fifth Circuit cited the relevant legal standard under the Administrative Procedure Act ("APA"), finding that courts must "hold unlawful and set aside agency action that is 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.'"[7] The Fifth Circuit then cited Supreme Court precedent, which held that "[t]he APA's arbitrary-and-capricious standard requires that agency action be reasonable and reasonably explained."[8] And citing the seminal *FCC v. Fox Television Stations, Inc.* Supreme Court case, the Fifth Circuit found that when a "'new policy rests upon factual findings that contradict those which underlay its prior policy,' a more detailed explanation is required."[9]

The Court found that, under this caselaw, the SEC acted arbitrarily and capriciously in two ways. "First, the agency failed adequately to explain its decision to disregard its prior factual finding that the notice-and-awareness conditions posed little or no risk to the timeliness and independence of proxy voting advice."[10] "Second, the agency failed to provide a reasonable explanation why these risks were so significant under the 2020 Rule[s] as to justify its recession."[11]

In other words, the Fifth Circuit found that because the SEC's *new* policy (*i.e.*, the recission) hinged upon factual findings that contradicted its prior policy (*i.e.*, the 2020 Rules), a detailed explanation and justification was warranted. According to the Court, such an explanation for the switch was not provided.

Further, as to the timeliness concerns, the Fifth Circuit found that it is "wholly implausible that the 2020 Rule[s'] contemporaneous-disclosure requirement would pose a threat to the timely delivery of proxy voting advice," as "[t]he advice could be delivered at the usual time; it simply had to be delivered to registrants as well."[12] As to the concerns of independence, the Fifth Circuit found that the raised concerns were "*post hoc* rationalizations," and that in the SEC's recission in 2022, "the SEC nowhere explains how a drawn-out voting process would affect the independence of proxy voting advice."[13]

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[6] *Id.* at 806.

[7] *Id.* at 810 (citing 5 U.S.C. § 706(2)).

[8] *Id.* at 810 (citing *FCC v. Prometheus Radio Project*, 592 U.S. 414, 423 (2021)).

[9] *Id.* at 811 (quoting *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515-16 (2009)).

[10] *Id.*

[11] *Id.*

[12] *Id.* at 813.

[13] *Id.* at 814.

The Sixth Circuit Upholds the SEC's Recission

On September 10, 2024, the Sixth Circuit Court of Appeals in *Chamber of Commerce v. SEC* affirmed the Middle District of Tennessee's grant of summary judgment in favor of the SEC on the SEC's recission of the 2020 Rules.[14] The Sixth Circuit's decision sharply contrasts with the reasoning and holding of the Fifth Circuit's decision in *National Association of Manufacturers*—establishing a Circuit split on the SEC's recission of the 2020 Rules.

The Honorable Julia S. Gibbons, writing for the majority, and under *de novo* review, found that the SEC's recission in 2022 "satisfied" the Supreme Court's requirements concerning agency decision-making.[15] Specifically, the Sixth Circuit found under a detailed analysis that:

> The Commission candidly recognized that the 2022 Rescission constituted a shift from the approach it had taken in 2020. And it acknowledged that although the SEC had previously found that the benefits of the 2020 Rule outweighed its costs, it now "weigh[ed] these competing concerns differently." 2022 Rescission, 87 Fed. Reg. at 43175. The Commission also identified "good reasons" for the change in position. *Fox*, 556 U.S. at 515, 129 S.Ct. 1800. It stated that it reconsidered its prior rulemaking due to [proxy advisory firms'] clients' concerns that the Notice-and-Awareness Conditions "would have adverse effects on the cost, timeliness, and independence of proxy voting advice." 2022 Rescission, 87 Fed. Reg. at 43,169. The Commission further noted that it was no longer convinced that the prevalence of errors in proxy voting advice justified the Notice-and-Awareness Conditions, but that to the extent there were errors, rescinding the Conditions would not affect companies' ability to "identify [ ] issues and respond [to proxy voting advice] using pre-existing mechanisms." *Id.* at 43,176. Finally, the Commission fully explained why it believed that rescinding the Notice-and-Awareness Conditions would ameliorate burdens on [proxy advisory firms] without negatively impacting the quality of proxy advice or efficiency of the proxy system. ***Its thoughtful and thorough explanation of these considerations was "hardly arbitrary and capricious."*** *Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1038–39 (D.C. Cir. 2012) (finding the repeal of a regulation was not arbitrary and capricious where the agency explained that the prior rule "did not sufficiently account for" countervailing factors and that the amended rule "promotes, to a greater extent, [its] statutory directive" (cleaned up)).[16]

The Sixth Circuit found that several courts have recognized that an "agency may 'reevaluat[e]' its position with respect to the weight it assigns to countervailing facts without making new factual findings," and that "that is precisely what

[14] *Chamber of Com. v. SEC*, 2024 WL 4132206 (6th Cir. Sept. 10, 2024).

[15] *Id.* at *6.

[16] *Id.* (emphasis added).

occurred here."[17] According to the Sixth Circuit, "[t]he Commission struck a balance between regulatory burdens and benefits when it promulgated the 2020 Rule[s], ***and it thought better of that same balance when issuing the 2022 Recission***. . . . The APA does not authorize us to second-guess that policy choice."[18]

Contrary to the approach taken by the Fifth Circuit, the Sixth Circuit rejected the notion that there were factual inconsistencies between the 2020 Rules and the recission in 2022. According to the Sixth Circuit, there were no "contradictory factual findings" that occurred between the two policies, rather, there were "differing judgments on the value of [proxy advisory firms'] self-regulation."[19] Because the recission in 2022 did not rest upon factual findings contrary to the findings contained in the 2020 Rules, the SEC was "not required to provide a more thorough explanation under *Fox*."[20] "In sum, the 2022 Recission was not arbitrary and capricious because the Commission acknowledged that it was changing course, provided good reasons for the change, and explained why it believed that its new rule struck a 'different and improved policy balance.'"[21]

Implications

It is not immediately clear what the next steps are and whether the SEC will be able to enforce the recission of the 2020 Rules, given the split in authority. The parties indicated they likely will continue to litigate the issue, with the Chamber of Commerce stating, "[w]e continue to weigh all legal options to challenge the SEC's illegal rollback."[22] The SEC, in turn, stated that it was "pleased that the Sixth Circuit confirmed that the Commission's rulemaking was consistent with its legal obligations."[23] If either *National Association of Manufacturers* or *Chamber of Commerce* is appealed to the Supreme Court, there is a good chance that the Supreme Court will review the decisions given the split in authority. Indeed, it has been reported that the Supreme Court fills the majority of its docket (often up to 70%) with cases that involve splits in authority among the Circuit Courts of Appeal.[24] But, while there is a technical Circuit split here, the operative question is whether the Supreme Court will find the issue important and ripe enough to warrant its review.[25]

[17] *Id.* at *7 (citing *Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1038 (D.C. Cir. 2012)).

[18] *Id.* (emphasis added) (citation omitted).

[19] *Id.* at *8.

[20] *Id.* (citing *Fox*, 556 U.S. at 515).

[21] *Id.* (citing 87 Fed. Reg. at 43170).

[22] Douglas Gillison, *In Battle Over Proxy Rules, Appeals Court Sides with US SEC*, REUTERS (Sept. 11, 2024).

[23] *Id.*

[24] Congressional Research Service, *The United States Courts of Appeals: Background and Circuit Splits from 2023* at 8 (Apr. 1, 2024).

[25] *Id.*

Labaton Keller Sucharow's lawyers are available to address any questions you may have regarding these developments. Please contact the Labaton Keller Sucharow lawyer with whom you usually work or the contacts below.

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