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Fifth Circuit – Securities and Administrative Law Update

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Fifth Circuit Finds SEC’s “About-Face” On Proxy-Firm Disclosure Rule Arbitrary And Capricious

***National Association of Manufacturers v. SEC*, No. 22-51069** – Decided June 26, 2024

A unanimous Fifth Circuit panel vacated the SEC’s 2022 rescission of its 2020 proxy firm disclosure rule because the SEC failed to explain why the factual findings that supported the 2020 Rule were incorrect.

“[T]he 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. Second, the agency failed to provide a reasonable explanation why these risks were so significant under the 2020 Rule as to justify its rescission.”

JUDGE JONES, WRITING FOR THE COURT

Background:

Shareholders of public companies are generally permitted under state law and SEC rules to vote on a variety of corporate-governance issues during shareholder meetings. Most shareholders do not attend these meetings in person, so they cast their votes by proxy. Institutional investors, who own a sizeable percentage of public company stock, vote in thousands of these meetings. They often retain proxy firms, such as Institutional Shareholder Services and Glass Lewis, to provide research and to advise them on how to vote.

SEC rules relating to proxy regulations, among other things, prohibit persons who solicit proxies from making misstatements or omissions of material fact in their solicitations and require such persons to furnish the targets of their solicitations with proxy statements containing certain disclosures. But proxy firms are also eligible for exemptions from these rules if they comply with certain conditions, and the business models of proxy firms rely on the availability of such exemptions.

Over the years, as proxy advisors grew in influence, however, concerns emerged about their practices. The proxy advisor market is "effectively a duopoly, because two firms . . . control roughly 97% of the market," and "[i]nvestors, registrants, and others" began questioning the "accuracy of the information and the soundness of the advice that proxy firms provide" to shareholders and complaining about potential conflicts of interest and "the proxy firms' unwillingness to engage with issuers to correct errors." *Nat'l Ass'n of Manufacturers v. SEC*, No. 22-51069, 2024 WL 3175755, at *1 (5th Cir. June 26, 2024).

To address these and other concerns, the SEC undertook "nearly ten years of study and collaboration with all interested parties spanning two presidential administrations." *Id.* at *2. This effort culminated in 2019, with the SEC's proposal of a new rule that imposed additional conditions on the availability of exemptions for proxy firms. Importantly, amongst other requirements, the proposal required that proxy firms "provide registrants"—including public companies—"time to review and provide feedback on the advice ***before*** it is disseminated to the proxy firm's clients." *Id.* (cleaned up) (emphasis added). The rule's purpose was to ensure the reliability and accuracy of the proxy firms' advice by allowing a registrant an opportunity to correct any inaccuracies before dissemination. During the SEC's 60-day comment period, however, some commentators expressed concern that the rule would delay and undermine the independence of the proxy firms' advice.

When it adopted the rule in 2020 (the "2020 Rule"), the SEC addressed those concerns by requiring proxy firms (1) to provide their advice to registrants "***at or prior to***" the time they give their advice to their clients and (2) to allow their clients to see any written statements the registrant provided about the advice before the shareholder meeting. *Id.* at *3 (emphasis in original). Between the time the SEC finalized the rule and the date that proxy firms were required to comply with the new conditions, there entered a new SEC administration.

In November 2021, after all the SEC's collaboration and deliberation, and just days before proxy firms were required to comply with the 2020 Rule, the new administration of the SEC published its proposal to rescind the 2020 Rule. It did so only after the new SEC chairman took office, held a closed-door meeting with the opponents of the 2020 Rule, suspended its enforcement, and directed his staff to reconsider the regulation in full. In July 2022, over the dissent of two commissioners, the SEC formally rescinded the 2020 Rule, citing the same “timeliness” and “independence” concerns that the agency previously concluded the 2020 Rule was designed to address—all without explaining its change in position. *Id.* at *4.

Issue:

Is it arbitrary and capricious for an agency to reject its previous factual findings without explaining why those findings were incorrect?

Court's Holding:

Yes. An agency must provide a detailed explanation when rejecting prior factual findings.

What It Means:

- The Fifth Circuit’s decision makes clear that, although a new administration may rescind prior rules, the agency must adequately explain any departure from its prior factual findings. Litigants seeking to challenge an agency’s flip-flop should pay careful attention to the agency’s justification for the change—particularly when it involves contradicting prior agency fact finding.

- The Fifth Circuit’s decision also underscores courts’ refusal to credit agency litigation positions or other post hoc rationalizations for an agency’s change in position: “[I]n reviewing an agency’s action, we may consider only the reasoning articulated by the agency itself; we cannot consider *post hoc* rationalizations.” *Id.* at *8 (cleaned up).

- The Fifth Circuit also confirmed that the “default” remedy when “an agency rule violates the APA” is “vacatur”—indeed, a court “shall—not may—hold unlawful and set aside [such] agency action.” *Id.* at *9 (cleaned up). Accordingly, successful challenges to any agency’s rule will generally result in the rule being set aside.

- This case was one of many challenges relating to SEC rulemaking regarding the regulation of proxy advisory firms. For instance, the D.C. District Court recently held, regarding another part of the 2020 Rule defining “solicit,” that “the SEC acted contrary to law and in excess of statutory authority when it amended the proxy rules’ definition of ‘solicit’ and ‘solicitation’ to include proxy voting advice for a fee.” *ISS Inc. v. SEC*, No. 19-CV-3275, 2024 WL 756783, at *2 (D.D.C. Feb. 23, 2024), *notices of appeal filed*, Nos. 24-5105, 24-5112 (D.C. Cir.). And the Western District of Texas previously held that the SEC’s suspension of the 2020 Rule was unlawful because it was done without notice and comment. *NAM v. SEC*, 631 F. Supp. 3d 423 (W.D. Tex. 2022).

- Future SEC rules directed at proxy firms will likely continue to face challenges in court. The proxy advisor industry is also likely to continue to face challenges over the issues that led to the 2020 Rule. Moreover, corporations, investors, and proxy advisors will need to work to address these concerns in an often politicized corporate governance environment.

Gibson Dunn Appellate Honors

The Court’s opinion is available here.

Gibson Dunn’s lawyers are available to assist in addressing any questions you may have regarding developments at the U.S. Supreme Court. Please feel free to contact the following practice group leaders:

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