

## SEC PROXY REGULATION: STEPS TOWARD MORE EFFECTIVE STOCKHOLDER PARTICIPATION

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In the modern corporation, stockholders' meetings have become largely a formality. The hundreds of stockholders cannot hope to attend the meeting in person. Their only opportunity for effective participation in corporate affairs lies in the exercise of their right to vote by proxy. If that opportunity is not afforded, they are prevented as a practical matter from expressing their will as proprietors of the corporation, and control of the corporation by management is complete.

Prior to 1934, the proxy machinery had in many instances degenerated into a device for the perpetuation in office of the management group and the ratification of its policies. Particularly in the larger corporations, the stockholders, the legal owners, had almost no voice in management.<sup>1</sup> The general practice was for management, charging the corporate treasury,<sup>2</sup> to solicit proxies giving the proxy-holder broad, discretionary powers. In some cases the proxies were good for a number of years.<sup>3</sup> Ordinarily, the proxy authorized some person or persons to vote the stockholders' shares to elect a board of directors and to take any other action considered "desirable." Too frequently the owner of the shares was given no assurance that the items mentioned (that is if

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1. The problem is analyzed in BERLE & MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 80-90, 139, 207, 244-5 (1932); SEC, *REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES*, pt. VII, pp. 67, 135, 233 *et seq.* (1938). See also BURNHAM, *THE MANAGERIAL REVOLUTION* (1941), esp. c. VII; Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

2. Such a charge was upheld in *Bounds v. Stephenson*, 187 S.W. 1031 (Tex. Civ. App. 1916); *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 20 Del. Ch. 78, 171 Atl. 226 (1934). See also *Lawyers' Advertising Co. v. Consolidated Railway Lighting & Refrigerating Co.*, 187 N.Y. 395, 80 N.E. 199 (1907). Note, 53 HARV. L. REV. 1165, 1167, 1168 (1940); Comment, 33 ILL. L. REV. 914, 917 (1939).

3. In a number of states proxies are limited in duration to eleven months from the date of execution unless the stockholder specifies a longer period. *E.g.*, CAL. CORP. CODE § 2226 (Deering, 1949); CONN. GEN. STAT. § 5161 (1949); N.Y. GEN. CORP. LAW § 19; OHIO GEN. CODE § 8623-53 (Page, 1949); PENN. STAT. ANN. tit. 15, § 2852-504 (Purdon, 1938). Some jurisdictions place a maximum time limit upon the validity of proxies. *E.g.*, CAL. CORP. CODE § 2226 (Deering, 1949) (7 years); PENN. STAT. ANN. tit. 15, § 2852-504 (Purdon, 1938) (3 years).

any were mentioned) in the notice of meeting were the only ones the management expected to bring up for consideration at the meeting. Usually the stockholder was simply invited to sign his name and return his proxy without being furnished the information essential to the intelligent exercise of his rights of franchise.<sup>4</sup>

State statutes<sup>5</sup> provided few, if any, requirements that adequate information be given stockholders,<sup>6</sup> and the decisional law was not much more stringent in this regard.<sup>7</sup> Moreover, the proxies were often stated to be irrevocable, although they are actually a form of agency agreement and therefore ordinarily revocable by either party unless coupled with an interest.<sup>8</sup> They were an inverted type of agency, however, for the agent prescribed his powers for the principal. And, although the proxy holder was said to be under a fiduciary duty to the stockholder,<sup>9</sup> in reality he gave his primary allegiance to management.<sup>10</sup>

4. See 10 SEC ANN. REP. 51 (1944).

5. The common law did not recognize the validity of corporate proxies. By the late eighteenth and early nineteenth centuries, however, corporate charters permitted vote by proxy. Today all states but two, Texas and Iowa, expressly recognize the right to vote by proxy, and in those two states the privilege is recognized by "custom," or, if permitted, by charter or by-law. *Axe, Corporate Proxies*, 41 MICH. L. REV. 38, 46 (1942).

6. Statutes commonly require notice of meetings. In some the purposes of the meeting must be disclosed. See, e.g., N.Y. STOCK CORP. LAW art. 5, § 45; OHIO GEN. CODE § 8623-44 (Baldwin, 1949). But this requirement is usually satisfied by a brief statement that by-laws are to be amended, or officers elected. See Note, 53 HARV. L. REV. 1165, 1166 (1940).

7. Judicial requirements of adequate disclosure are based primarily upon the proxy's agency relationship with the stockholder. The proxy may not use his powers for self aggrandizement without full disclosure to his principal. *Rice & Hutchins v. Triplex Shoe Co.*, 16 Del. Ch. 298, 147 Atl. 317 (1929); *Blair v. F. H. Smith Co.*, 18 Del. Ch. 150, 156 Atl. 207 (1931). Proxies have been characterized as "limited" and "general." The authorization of a "limited" proxy is analogous to the creation of a special agency. It may be exercised on a specific subject only and not on other matters about which the stockholder-principal has not been notified and has therefore not authorized. A "general" proxy, however, is similar to a general agency and gives the holder the right to represent his principal on all matters of ordinary business. This is the rule irrespective of whether the business was disclosed to the stockholder, in the absence of fraud. The courts have construed the term "ordinary business" broadly. It does not include, however, authorization in connection with "extraordinary" business, such as the sale of the entire assets, voluntary liquidation, or recapitalization. Comment, 33 ILL. L. REV. 914, 917 (1939); *Axe, Corporate Proxies*, 41 MICH. L. REV. 38, 249 (1942); Note, 53 HARV. L. REV. 1165 (1940). Despite the stockholder's right of full disclosure in some cases, the difficulty of enforcing his right by trial is obvious.

8. *Axe, Corporate Proxies*, 41 MICH. L. REV. 38, 258 (1942). Irrevocable proxies are apparently prohibited by statute in New York and Pennsylvania. N.Y. STOCK CORP. LAW art. 5, § 47; N.Y. GENERAL CORP. LAW § 19; N.Y. PENAL LAW § 668; *Re Germicide Co.*, 65 Hun. 606, 20 N.Y. Supp. 495 (1892); PENN. STAT. ANN. tit. 15, § 2852-504 (Purdon, 1938).

9. *Blair v. F. H. Smith Co.*, 18 Del. Ch. 150, 156 Atl. 207 (1931); *cf. United Milk Products Corp. v. Lovell*, 75 F.2d 923 (6th Cir. 1935); SEC REPORT, *op. cit. supra* note 1, pt. VII, p. 8; *Axe, Corporate Proxies*, 41 MICH. L. REV. 38, 248 (1941); Comment, 33 ILL. L. REV. 914, 915-16, 920 (1939).

10. "Legally, the proxy is an agent for the shareholder; and necessarily under a

It thus became increasingly apparent that in order for the stockholder to express adequately his desires as a legal owner, the proxy machinery must more nearly approximate the individually attended stockholders' meeting. Stockholders voting by proxy must be afforded adequate knowledge of the corporation's financial condition and of the issues to be decided at the stockholders' meeting.<sup>11</sup> They must have an opportunity to express clearly their desires to those acting as proxies for them. And if an individual stockholder or group of stockholders outside of management wishes to raise an issue before the meeting, they must have an opportunity to reach other stockholders via the proxy device.

Congress attempted to achieve these results through Section 14 of the Securities Exchange Act of 1934, as implemented by the proxy regulations which the SEC was authorized to prescribe. The SEC, "listed" companies,<sup>12</sup> and the investing public have now had two years of experience with the Commission's current regulations.<sup>13</sup> It is the purpose of this article, as a third "proxy season"<sup>14</sup> under the new rules is opening, to review briefly the development of proxy regulation and to interpret the current regulations, especially in the light of the experience of the past two years. In addition, an evaluation will be made of proposals for further effectuating the policies underlying regulation of the proxy device.

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duty of fidelity to him. Factually, he is a dummy for the management, and is expected to do as he is told. Indeed, proxies are often clerks in the management, perhaps assisted by the company's attorney. The vote when mobilized really represents the will of the Directors." BERLE & MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 245 (1932).

11. The Senate Committee report on Section 14 of the Securities Exchange Act stated in part: "In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the matters for which authority to cast his vote is sought." SEN. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934). See also H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934).

12. A "listed" company may be defined, for purposes of this article, as a firm or other business association which has one or more classes of its non-exempted securities listed and registered pursuant to Section 12 of the Securities Exchange Act of 1934, 48 STAT. 881, 892 (1934), 15 U.S.C. §§ 78a, 78l (1946) (hereinafter referred to as the Exchange Act) on a "national securities exchange."

13. The revised Regulation X-14 became effective December 18, 1947, but it was optional with persons making a solicitation whether to follow the old or new regulations with respect to any solicitation commenced prior to February 15, 1948. Further amendments to the revised Regulation became effective on December 15, 1948. See Exchange Act Release No. 4185 (Nov. 5, 1948).

14. The "Ides of March" has more than a Shakespearian significance, not only to the tax lawyer, but also to the corporation or securities lawyer, for approximately 72 per cent of all proxy statements filed with the SEC during any year are for stockholder meetings held in the now-at-hand three-month period of March through May. 13 SEC ANN. REP. 41 (1947).

## CONGRESSIONAL AUTHORITY AND THE SEC REGULATIONS

Section 14 consists of two paragraphs. Paragraph (a) authorizes the Commission to prescribe rules and regulations concerning the solicitation of proxies, consents, or authorizations in respect of any non-exempt<sup>15</sup> security listed and registered on a national securities exchange.<sup>16</sup> Acting pursuant to the rule-making power thus granted, the Commission has promulgated Regulation X-14 governing the form and content of proxy ballots and proxy statements. The Commission has not, however, directly exercised its rule-making power under paragraph (b).<sup>17</sup> This paragraph reflects an awareness of the fact that a great many securities are carried for customer-stockholders in so-called "street" form, commonly in broker-dealers' names. As a result, before the Securities and Exchange Act, the customer-stockholders sometimes did not even receive notice of the stockholders' meeting much less any essential information or an opportunity to vote. This dilemma has been largely removed, however, through the promulgation of remedial rules by the New York Stock Exchange, which is supervised by the Commission under general power granted by Section 19(b) of the Act.<sup>18</sup>

Complementing the Exchange Act authority to formulate proxy

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15. The term "exempted security" is defined in Section 3(a)(12) of the Exchange Act.

16. Section 14(a) reads: "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

17. Section 14(b) provides: "It shall be unlawful for any member of a national securities exchange or any broker or dealer who transacts a business in securities through the medium of any such member to give a proxy, consent, or authorization in respect of any security registered on a national securities exchange and carried for the account of a customer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

18. The New York Stock Exchange's Rules 870 and 872 provide in part: "Rule 870. No member firm shall give a proxy to vote stock registered in its name, except as required or permitted under the provisions of Rule 872, unless the firm is the beneficial owner of such stock." "Rule 872. A member firm shall give a proxy for stock registered in its name, at the direction of the beneficial owner. . . ." Rules 870 through 875 relate generally to proxies and proxy material, and are followed by a schedule of solicitation charges, exclusive of postage, approved by the Exchange's Board of Governors. See *NEW YORK STOCK EXCHANGE DIRECTORY AND GUIDE*, E-555-7. The Philadelphia-Baltimore Stock Exchange has comparable rules. While only three other exchanges, Boston, Los Angeles, and San Francisco, have proxy rules and their rules permit their members to execute proxies without restriction, the various regional exchanges as a matter of practice or custom ordinarily follow the policy expressed in the rules of the New York Stock Exchange if they have not adopted rules of their own.

rules for "listed" companies are Sections 12(e) of the Public Utility Holding Company Act of 1935, and 20(a) of the Investment Company Act of 1940.<sup>19</sup> These sections are applicable, irrespective of listing, to electric and gas public utility holding companies and their subsidiaries registered under the Holding Company Act, and to investment companies registered under the Investment Company Act.<sup>20</sup> Pursuant to Section 12(e) the Commission has adopted Rule U-62 relating to solicitations in connection with a reorganization or other transaction which is the subject of an application or declaration under the Holding Company Act. Rule U-61 relates to all other proxy solicitations and affords information to investors in registered utilities through the mechanism of Regulation X-14.

The Commission has proceeded carefully in its development of rules which would place the solicitation of proxies on a more sound and equitable basis than had existed prior to July 1, 1934, the effective date of the Exchange Act. The first set of rules, seven in number and designated Rules LA1 through LA7, was not adopted until September 24, 1935.<sup>21</sup> Although the LA rules are no longer in effect, they are of far more than passing interest because they established an effective, three-way regulatory pattern still discernible in the current proxy rules.

First, solicitors had to furnish a "brief description" of the matters intended to be considered in the exercise of the proxy, together with the action proposed to be taken by the holder of the proxy.<sup>22</sup> Names of nominees for officers or directors could be omitted. However, the rules did provide for notice to stockholders if a director opposed manage-

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19. Section 12(e), Public Utility Holding Company Act of 1935, 49 STAT. 803, 824 (1935), 15 U.S.C. §§ 79, 791(e) (1946) (hereinafter referred to as the Holding Company Act); Section 20(a), Investment Company Act of 1940, 54 STAT. 789, 822 (1940), 15 U.S.C. §§ 80a-1, 80a-20(a) (1946) (hereinafter referred to as the Investment Company Act). Reference may also be made to Section 11(g) of the Holding Company Act, and Rules U-60 and U-62 to U-65 for special proxy rules applicable to plans of reorganization under the Holding Company Act. See also Holding Co. Act Release No. 7020 (Dec. 2, 1946) for an "order" entered under 12(e) directing Standard Gas and Electric Company to furnish two stockholders a stock list.

20. If an investment company owning securities of a company subject to the proxy regulation should solicit its own security holders for proxies authorizing the investment company to solicit proxies from other holders of the portfolio company's securities, the result would be a "solicitation on a solicitation" both of which would apparently be subject to the proxy rules.

21. See Exchange Act Release No. 378 (Class A), containing the text of the rules and companion Release No. 378 (Class B), consisting of a statement by the Commission, both dated Sept. 24, 1935.

22. LA1 defined the term "solicitation" to include generally any communication or request for a proxy, consent, or authorization, or the furnishing of any form of proxy, whether or not the form was in blank. Compare definition in present X-14A-1.

ment in certain instances.<sup>23</sup> The limited information afforded in the LA rules by the identification and certain "brief description" provisions was required to be furnished irrespective of whether the solicitation was on behalf of management or outsiders, although the security holder was required to be advised whether the proxy was solicited by management. Secondly, the rules placed upon management the duty of mailing proxy material to record owners upon the request of a security holder, if the management was also engaged in soliciting proxies. The third principal feature of the LA rules was a provision making it unlawful to employ materially false or misleading statements in connection with solicitations.<sup>24</sup>

Although the Commission realized that the LA rules were neither specific nor comprehensive enough to supply holders with the information necessary to formulate an informed decision on how to cast their votes, it was felt that further experience was needed before a more adequate set of rules could be adopted.<sup>25</sup> Nearly three years after the promulgation of the LA rules, the Commission announced rules of a more positive nature.<sup>26</sup> The revision, designated Regulation X-14, had as its keystone an important new requirement that a "proxy statement" must be sent to each person whose proxy was solicited.<sup>27</sup> Another significant new provision required that the security holder be

23. LA3(a)(2) If either management or its opposition engaged persons for compensation to solicit on their behalf, that fact and the name of the paid solicitor's principal was required to be furnished. LA3(a)(4).

24. LA4. The rule made it unlawful to employ fraud in seeking proxies, consents, or authorizations in respect of non-exempt, listed securities. This provision was not unlike the mail fraud statute, 35 STAT. 1130 (1909), 18 U.S.C. § 338 (1946).

25. 10 SEC ANN. REP. 51 (1944).

26. Exchange Act Release No. 1823 (Aug. 11, 1938). The regulation was announced August 11, 1938, and became effective October 1, 1938. See Dean, *Non-Compliance With Proxy Regulations*, 24 CORNELL L.Q. 483 (1939): Comment, *Regulation of Proxy Solicitation by the Securities and Exchange Commission*, 33 ILL. L. REV. 914 (1939).

27. Former X-14A-1 and present X-14A-3. Then, as now, there was no requirement that all security holders be solicited. Some, none, or all may be solicited, but those solicited must receive a proxy statement. While the requirement that a solicited investor be furnished an informative "proxy statement" was novel, it had a precedent in Section 5(b) of the Securities Act of 1933, 48 STAT. 74 *et seq.*, 15 U.S.C. § 77 *et seq.* (1946) (hereinafter referred to as the Securities Act), which makes it mandatory that a prospectus of defined content be delivered in connection with the sale to investors of securities registered under that Act. In addition to expanding the limited informational requirements of the LA rules, the first X-14 also stipulated that the proxy statement meet prescribed legibility standards (former X-14A-3 and present X-14A-5(d)), that it set forth the power of the security holder to revoke his proxy and the rights of dissenters (former and present Schedule 14A, Items 1 and 2 of same schedule), that it disclose the expenses of the solicitation (Schedule 14A, former and present Item 3), and that it provide in certain instances various financial data (former Schedule 14A, Items 9(e), 10(f), 11(b), 11(c)(2), and compare present X-14A-3(b) and Item 15, Schedule 14A).

afforded the opportunity to direct how his vote should be cast on *each* of the matters to be considered.<sup>28</sup> When the solicitation covered the election of directors, the new regulation stipulated that the proxy statement must include information in regard to each nominee.<sup>29</sup> The original X-14 also added other important provisions.<sup>30</sup>

The regulation was amended in certain details in 1940 after one year of operation,<sup>31</sup> the principal change being a requirement that the proxy, proxy statement, and other proxy soliciting material be filed with the Commission at least 10 days before the beginning of the solicitation.<sup>32</sup> A second group of amendments to Regulation X-14 was adopted in 1942.<sup>33</sup> As in the instance of the 1940 amendments, they did not constitute a general revision of the regulation, but they did effect five substantive changes suggested by additional experience with the regulation.<sup>34</sup>

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28. Former X-14A-2 and present X-14A-4(b).

29. Former Schedule 14A, Item 6, and compare present Items 6 and 7.

30. See, *e.g.*, the exemptions provided in former X-14A-7(a), (b), (d) and (e). Compare present X-14A-2.

31. Exchange Act Release No. 2376 (Jan. 12, 1940). See Bernstein & Fischer, *The Regulation of Proxy Solicitation by the Securities and Exchange Commission*, 7 U. OF CHI. L. REV. 226 (1940).

32. Former X-14A-4(b). See Release No. 2376, *supra* note 31, at 7-8. The previous rules did not require the filing of the proxy material until solicitation had started. Consequently companies were considerably embarrassed when required under the anti-fraud and other proxy rules to send out supplemental material to correct deficiencies which the Commission's staff could have pointed out in advance had it had an opportunity to examine the material before it was mailed. Exchange Act Release No. 1823 (Aug. 11, 1938); *cf.* Dean, *supra* note 26, at 483. The ten-day waiting period, during which proxy material is processed, and which may be shortened by the Commission upon a showing of unusual circumstances, has virtually eliminated this difficulty. 10 SEC ANN. REP. 51 (1944); Bernstein & Fischer, *supra* note 31, at 237. See present X-14A-6. Other new matter inserted in Regulation X-14 by the 1940 amendments included provisions supplementing the remuneration disclosure requirements, provisions amplifying the disclosures of nominees' securities holdings, amendments to the requirement for communication to security holders of matters which minority groups have indicated that they will propose at the meeting, and a provision expanding the definition of the term "solicitation". Exchange Act Release No. 2376, pp. 2-6, 9, 11-12, (Jan. 12, 1940).

33. Exchange Act Release No. 3347 (Dec. 18, 1942).

34. 10 SEC ANN. REP. 52 (1944). The requirement concerning information regarding remuneration and securities ownership of corporate managers was amplified, and provision was made for a brief statement of the principal occupation of all directors, and a resumé of the business experience of new candidates. (Former Items 5 and 7, Schedule 14A, and compare present Items 6 and 7 of Schedule 14A). The company's annual report was required to accompany or precede management proxy statements if directors were to be elected. (Former X-14A-1(b) and compare present X-14A-3). Security holders opposing management were afforded not more than 100 words in the management proxy statement, if timely notice was given management. (Former X-14A-7 and present X-14A-8). The exemption which was granted proxy solicitations made without use of the mails or of interstate commerce was abolished. (Exchange Act Release No. 3347,

In 1947 and 1948 further revisions of Regulation X-14 were effected. The more important among the 1947 amendments<sup>35</sup> were the relaxation of the officers' individual remuneration disclosure provisions to reach only those of the three highest paid officers whose aggregate remuneration exceeded \$20,000 each per annum,<sup>36</sup> and provision for the filing of follow-up or additional soliciting material, in general, at least two days, Saturdays, Sundays and holidays excluded, prior to its use.<sup>37</sup> The 1948 amendments, which became finally effective December 15, 1948,<sup>38</sup> included provisions to the effect that no proxy could confer authority to vote at any annual meeting other than the one next following the solicitation,<sup>39</sup> that the proxy would be voted and in accordance with the choice indicated by the security holder,<sup>40</sup> that the floor on remuneration disclosures be raised from \$20,000 to \$25,000 per annum,<sup>41</sup> and that indebtedness to the issuer and its subsidiaries of directors, officers, nominees, and also their associates be disclosed, unless it arose in the ordinary course of business or did not exceed \$1,000.<sup>42</sup>

The current Regulation X-14 still reflects the three-way treatment first applied to proxy regulation by the former LA rules. To be sure, the limited information requirements have been expanded considerably, particularly the list of specifications under Schedule 14A. The security holders communication provisions have been enlarged, an alternative technique added by rule X-14A-8, and the fraud prohibition has been elaborated upon. However, the basic approach remains the same and represents normal growth toward enabling the security holder to act more intelligently upon the matter for which his vote or consent is sought.

#### COVERAGE

Section 14(a) has almost as its sole touchstone of application the

supra note 33, at 1). And a new exemption permitted solicitations through newspaper advertisements similar to the "tombstones" of Securities Act § 2(10)(b). The 1942 proposal for amendments precipitated hearings on the revisions before a subcommittee on the House Committee on Interstate and Foreign Commerce in connection with a bill to repeal the revisions, but no further action was taken by Congress. See 10 SEC ANN. REP. 51-2 (1944).

35. See Exchange Act Release No. 3998 (Oct. 10, 1947), announcing the proposed revision, and Exchange Act Release No. 4037 (Dec. 17, 1947) reporting adoption of revisions.

36. Schedule 14A, present Item 7(a)(2). Reference hereinafter to the proxy rules are to the present rules, unless otherwise indicated.

37. X-14A-6(b).

38. See Exchange Act Release No. 4114 (July 6, 1948), and No. 4185 (Nov. 5, 1948).

39. X-14A-4(d)(2).

40. X-14A-4(e).

41. Schedule 14A, Items 7(a)(1) and (2). See also Item 7(f).

42. Item 7(d) and the instruction that follows it.



answer to the easy question, "is the security held by the person solicited registered on a national securities exchange?" If the security is registered on a national securities exchange, the proxy regulation applies, unless the security is an "exempted security," a term used in Section 14(a) itself, and defined in Section 3(a)(12) of the Exchange Act. Neither Section 14(a) nor X-14A-3 limits its jurisdiction to solicitations by use of the mails or through interstate commerce or by the facilities of a national securities exchange.<sup>43</sup> The regulation is applicable only with respect to solicitations in respect of the particular class of a company's securities which are listed. Non-listed<sup>44</sup> classes are not covered and remain outside the regulation even if they are convertible to listed securities.<sup>45</sup> Coverage vests when the security becomes "listed," and this occurs when the registration application filed under Section 12 of the Exchange Act becomes effective. Any solicitation after the application has become effective is covered by X-14A-3; any solicitation prior to the effectiveness is excluded. Until delisting<sup>46</sup> has become effective, there is coverage; afterwards there is none.

The coverage test is somewhat analogous with respect to companies amenable to X-14A-3 by virtue of Section 12(e) of the Holding Company Act, and Section 20(a) of the Investment Company Act. Just as

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43. Section 14(a) covers solicitations "by use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise." X-14A-7(a) of Regulation X-14, as promulgated in 1938, exempted solicitations other than through the mails, interstate commerce, or a national exchange. The exemption was eliminated in the 1942 amendment of the regulation. See note 34 *supra*. Constitutional questions may lurk in the phrase of Section 14(a) "or otherwise." See Bernstein & Fischer, *supra* note 31, at 241.

44. A *non-listed* security, one which is not listed or registered on any national securities exchange, is not to be confused with an *unlisted* security. *Unlisted* securities are of three types: (1) securities which have been admitted to unlisted trading privileges under X-12F-1 *et seq.* on a particular national securities exchange because of having previously been listed and registered on another such exchange (the proxy rules are applicable as to these); (2) securities which were admitted to unlisted trading privileges prior to the effective date of the Exchange Act, and are not listed or registered on any national securities exchange (the proxy rules are not applicable to these by virtue of X-12F-4(b)); and (3) securities which have been admitted to unlisted trading privileges as a result of their continuing to be available from a registration statement and periodic reports or other data filed under the Securities Act or the Exchange Act information substantially equivalent to that available in respect of listed securities (the proxy rules would be applicable to these). See § 12(f) of the Exchange Act.

45. On December 1, 1949, the Cleveland, St. Louis, and Minneapolis-St. Paul Stock Exchanges de-registered under Section 6 of the Exchange Act as a consequence of their merger into the Chicago Stock Exchange, which survived and changed its name to the Midwest Stock Exchange. Most companies registered on the non-surviving exchanges re-registered pursuant to Section 12, on form 8-C, with the Midwest Stock Exchange. A few, however, did not, and consequently their shares were delisted. Any solicitation for proxies after December 1, 1949, in respect of shares of the delisted companies is outside the scope of Section 14(a) and X-14A-3.

46. The Commission's rules concerning delisting are X-12D2-1 and 2.

coverage under the Exchange Act parallels listing, coverage of an electric or gas public utility company parallels registration under the Holding Company Act. The same may be said of an investment company in connection with Section 20(a) of the Investment Company Act. This Act, however, raises a problem in regard to when an existing company must register under the Act because it "proposes to engage" in investment company activities and therefore is bound by the proxy rules. Reference to Section 3(a) of the Investment Company Act will disclose that in three subparagraphs it defines an investment company for purposes of the Act. It will also be observed that each of the three subparagraphs, including Section 3(a)(3) which prescribes a partially quantitative test couched in terms of acquisition of "investment securities" having a value exceeding 40 per cent of total assets, embraces not only an existing investment company, but also a company that "proposes to engage" in such activities. Consequently, a person undertaking to organize a new company that "proposes to engage" in the investment company business must initiate registration under Section 8 of the Act before issuing any shares. It would also seem that an existing company which intends to engage in new activities which will constitute it an investment company necessarily "proposes to engage" in investment company activities, and must immediately register under Section 8. As an incident of registration the newly formed investment company would of course be subject to the proxy requirements of Section 20(a) and X-14A-3. It would seem to follow that the existing company that "proposes to engage" in investment company activities may also be covered by Section 20(a) and X-14A-3.<sup>47</sup>

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47. Portsmouth Steel Corporation, which held certain investment securities, proposed in November, 1949 to transfer its steel assets and coal subsidiaries to the Detroit Steel Corporation for Detroit shares. As a result of the proposed acquisition of Detroit shares, more than 40 per cent of Portsmouth's assets would consist of "investment securities" as defined in the sentence following Section 3(a)(3). It therefore appeared that Portsmouth proposed to engage in an investment company business, and that registration under Section 8 was required. Consequently, the proxy provisions of Section 20(a) and X-14A-3 would appear to have been applicable to the solicitation by Portsmouth and Otis & Co. (a registered broker-dealer, whose principals were also officers of Portsmouth) of proxies in favor of the proposed entry of Portsmouth into the investment company field and the resultant abandonment of its steel producing operations. Of course, it is often extremely difficult to ascertain subjective purpose. But the facts that Portsmouth and Otis & Co. solicited proxies in favor of the proposal, and that Portsmouth had consummated negotiations with Detroit, indicated circumstantially what was proposed, and that the result would be to constitute Portsmouth an investment company under Section 3(a)(3). It may be arguable whether the legislative purpose of the language "proposes to engage" was to reach an existing as well as a new company. A question may also arise as to whether a pleading directed to such a situation may properly charge violations of both the registration provisions of Section 8 and the proxy requirements of Section 20(a) in view of the circumstances that the company, though required to register under Section 8, is not literally a "registered investment company" within the language

In outlining the coverage of the regulations it is necessary to define the scope of the term "solicitation." An interesting case involving this question is *SEC v. Okin*.<sup>48</sup> Okin, a shareholder in the Electric Bond and Share Company, sent a letter to other security holders in which he did not solicit a proxy but in which he requested these holders not to sign any proxies for the company and to revoke any that they might already have signed. At the time of the mailing of Okin's letter, X-14A-1(2), defining "solicitation," did not expressly cover (as it has since the adoption of the 1942 amendments) "any request to execute or not to execute, or to revoke, a proxy."<sup>49</sup> But the Commission argued, and the Court of Appeals for the Second Circuit agreed, that "[t]o say that Okin's conduct did not involve the solicitation of proxies, consents, and authorization would be to exalt form over substance."<sup>50</sup> The letter "was a first step in an admitted program of requesting proxies."<sup>51</sup>

Of course, even under the amended definition, an informal letter to security holders, not accompanied by a proxy form and merely advising them of the progress of the company and its affairs, is not a solicitation, providing it is not used in anticipation of a possible proxy contest or to forestall anticipated negative votes.<sup>52</sup> But the furnishing of a form of proxy "under circumstances reasonably calculated to result in the procurement of a proxy" is a solicitation under the express terms of the

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of 20(a). However, if 20(a) is not charged the result may be to permit non-compliance with the proxy regulation by a company who has violated the registration section. Even if a 20(a) charge will not properly lie, it would seem that a Section 8 injunctive order should include as a remedial device a provision enjoining any proxy solicitation not made in compliance with the proxy regulation. See pages 669-70 *infra*. Little reason is apparent for narrow interpretation. It is interesting to note that the proxy material disseminated by Portsmouth and Otis & Co. fell far short of the standards of the Commission's proxy regulation, and was, therefore, in sharp contrast to the material distributed by Detroit, a listed company and therefore subject to the regulation. It will be interesting to observe what further experience may be gained in connection with the solicitation of proxies in favor of a plan, the effect of which is to change an existing company's operations to those of an investment company within Section 3(a) of the Investment Company Act. See Cleveland Press, Nov. 3, 1949, p. 29, col. 1, 2, and Jan. 3, 1950, p. 21, col. 1.

48. 132 F.2d 784 (2d Cir. 1943).

49. Cf. former Rule X-14A-8 and former Rule X-14A-9(b) (2). See also present Rule X-14A-1 defining, *inter alia*, "solicitation," particularly clause (2) of the definition.

50. See Opening Brief for the SEC, p. 9.

51. *SEC v. Okin*, 132 F.2d 784, 786 (2d Cir. 1943). The circuit court made no finding on the question whether under the circumstances Okin should have disclosed that he had acquired his 9,000 shares for \$9,000, suggesting that "it may depend upon why he bought his shares at the figure he did." The court also said, "We will not now decide whether a person buying into a company, merely to become an officer, can never be required to disclose what stake he has in it, if he chooses to go out after proxies." *SEC v. Okin*, 132 F.2d 784, 787 (2d Cir. 1943).

52. However, if there is no conduct which amounts to an invitation to security holders to request proxies and any request received for a proxy form is a spontaneous and isolated application, the furnishing of the form of proxy will not constitute a "solicitation."

third clause of the X-14A-1 definition, unless the proxy is furnished, as contemplated by the last sentence, "upon the unsolicited request" of the security holder.

Whether any given activity is a "first step" in a solicitation appears to depend under the *Okin* case upon the nature of the activity and the activity proposed.<sup>53</sup> If the activity should be followed by a proxy solicitation there would seem to be an additional basis for holding the activity to have been a "first step," and to have constituted a violation. A box-type advertisement addressed to security holders and urging formation of a stockholders committee;<sup>54</sup> a letter to shareholders asking their opinion on the advisability of forming a committee to select a slate of candidates for directorship; or a similar letter seeking support for, or opposing an amendment to the by-laws may be a "first step," and require compliance with the proxy regulations before use. It should be noted, moreover, that, since "solicitation" is defined in terms of "any request," either an oral or a written solicitation will constitute a violation, if made prior to the Commission's authorization to mail the proxy statement.<sup>55</sup>

#### *Exemptions from Coverage*

Rule X-14A-2 affords seven specific exemptions from the coverage provided in X-14A-3, and there are two additional exemptions found elsewhere in the Exchange Act Rules. Both of the latter spring directly from the statute itself. One, X-3A-12, makes somewhat clearer the scope of the term "exempted security" appearing in Sections 14(a) and 3(a)(12) of the Act. This rule operates to exempt any solicitation of proxies with respect to so-called "governments" and "municipals."

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53. Cf. Securities Act Release No. 474 (Feb. 5, 1936), which discusses the conditions under which a written communication constitutes a prospectus within the meaning of Section 2(10) of the Securities Act.

54. See Cleveland Plain Dealer, March 5, 1948, p. 12, col. 6-8 for ad pertaining to Alleghany Corporation. For an example of a box type ad constituting a "first step" in a solicitation of a proxy for the 1950 Kaiser-Frazer Corporation annual meeting and/or a "first step" in a solicitation of a consent or authorization relating to a pending federal court action against Kaiser-Frazer, see Detroit News, Jan. 17, 1950, p. 32, col. 7-9 (ad captioned, "Open Letter to Kaiser-Frazer stockholders.")

55. It should be observed also that the saving sentence appended to the solicitation definition, in addition to excepting the furnishing of a form of proxy to a security holder upon his request and the performance of acts required by management by the mailing-communications-for-security-holder provisions of X-14A-7, also excepts "the performance by any person of ministerial acts." Examples of permissive ministerial acts are the mailing of letters to stockholders merely announcing postponement of the meeting, change of the meeting place, and correction of a typographical error contained in a prior communication.

The other, X-12F-4(b), makes it plain that the proxy rules are not applicable to solicitations in respect of unlisted securities.<sup>56</sup>

The exemptions specifically provided by X-14A-2 are of four general types. There is an exemption available to all but management; an exemption for two special classes of security holders; an exemption for two types of securities even though they are not an exempted security as such, and, finally, a general exemption permitting a limited type of solicitation through newspaper advertisements.<sup>57</sup>

Interesting questions have been raised as to how one counts to ten in connection with the X-14A-2(a) exemption for solicitations "otherwise than on behalf of management . . . where the total number of persons solicited is not more than ten."<sup>58</sup> Keen enthusiasm for the exemption has sometimes impelled opposition groups to total each time ten persons have been solicited, and to start anew. The more sophisticated have suggested that each member of a non-management soliciting group gets ten tries. Still others, apparently forgetting either the abolition of the repealed exemption found in former Rule X-14A-7(a), or the word "otherwise" contained in Section 14(a) itself, have conceived that there is room under the rule for a "luncheon technique" or other oral or written solicitation not involving a use of the mails, instruments of interstate commerce, or a facility of a national securities exchange. These are all delusions. The computation is actually as easy as counting to ten, taking care to count, however, not merely each person who gives his proxy, but each person who is solicited either orally or in writing irrespective of whether he gives or refuses a proxy. Similarly, a non-management group as a whole gets ten solicitations; but the individual members of a given group do not each have ten thrusts. Any attempt at concerted efforts to "divide and conquer," either through solicitations by several individual members of one group or through the splitting up of a group into several groups, may be expected to be regarded as an overburdening of the exemption. While nice questions continue to arise, the *bona fides* of the parties remains the test, not only as to the computation aspect of the rule, but also as to whether the solicitation claimed to be exempt is actually "otherwise than on behalf of management."

Rules X-14A-2(b) and (c), broadly speaking, exempt solicitations by a person in respect of securities carried in his name or in the name of his nominee or held in his custody, or of which he is the beneficial

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56. Of course, if the unlisted security is the security of a registered gas or electric utility holding company or its subsidiaries, or a security of a registered investment company, the proxy regulation would nevertheless apply by force of Section 12(e) of the Holding Company Act or 20(a) of the Investment Company Act.

57. See X-14A-2(a), X-14A-2(b) and (c), X-14A-2(d) and (e), and X-14A-2(g).

58. In 1947, X-14A-2(a) increased to ten the nine solicitations previously contemplated by X-14A-8, its predecessor. See note 35 *supra*.

owner. These "personal" exemptions receive different treatment in the sense that the exemption based on beneficial ownership is complete and without qualification once the matter of beneficial ownership is determined, whereas the other personal exemptions are qualified in three important particulars.

The matter of beneficial ownership presents difficult questions of fact, but it is a question upon which some light has been shed by interpretations of Section 16(a) of the Exchange Act.<sup>59</sup> That Section requires that a "beneficial owner of more than 10 per cent of any class of any equity security (other than an exempted security) which is registered in a national securities exchange" report periodic changes in his beneficial ownership. The principal problems encountered in determining who are beneficial owners occur when legal title to securities is vested in wives and other family members or in partnerships, corporations (especially those used as personal holding companies or investment mediums), and inter vivos, testamentary or other trusts. The Commission has stated that if a person has benefits substantially equivalent to ownership, or has the power to vest or re-vest ownership in himself, he may be regarded as a beneficial owner of shares held in a husband's, wife's, or other family member's name.<sup>60</sup> Again, the Commission has stated that if one is a member of a partnership or interested in a corporation which is an owner of voting securities, or a settlor, trustee, or beneficiary of a trust similarly situated he may have beneficial ownership.<sup>61</sup> While these statements were made with reference to Section 16(a), they are at least helpful in construing X-14A-2(c), if not actually applicable by analogy. Thus a determination of beneficial ownership may be a mixed blessing, for while the ownership reporting requirement must then be considered, the X-14A-2(c) proxy exemption is gained.

The "personal" exemption which X-14A-2(b) affords solicitations in respect of securities carried in the solicitor's name or in his nominee's, contains an important qualification not present in the exemption for securities held in the solicitor's custody, namely, that voting trustees are precluded from the exemption through the parenthesis technique.<sup>62</sup> Some relief, however, may be available to voting trustees by the exemptions afforded through Rules X-14A-2(d) through (f), which exempt

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59. The term "equity security" used in Section 16(a) is defined in Section 3(a)(12) of the Exchange Act. And see rules under Section 16(a), namely, X-16A-1 through X-16A-7.

60. Exchange Act Release No. 175 (Class A) (April 16, 1935).

61. Exchange Act Release No. 1965 (Dec. 21, 1938).

62. X-14A-2(b) affords an exemption for "any solicitation by a person in respect of securities carried in his name or in the name of his nominee (otherwise than as voting trustee) or held in his custody. . . ."

certain solicitations involving securities subject to the Securities Act, Chapter X of the Bankruptcy Act, or the Holding Company Act.

Apart from the voting trustee problem, there are three qualifications to the availability of the "personal" exemption afforded with regard to securities carried in a solicitor's name, or in his nominee's name, or held in his custody. Parenthetically, it should be noted that, while not so limited, the exemption was probably cast with an eye on the circumstance that a great many securities are carried in the name of broker-dealers or in "street form" for the accounts of customers. Thus the exemption complements the proxy rules of the New York and other national securities exchanges.<sup>63</sup> And the exemption also recognizes that other registered owners whose names appear on the issuer's transfer books may be nominees, or even a nominee of a nominee *ad infinitum*. The first of the three limitations on the exemption disqualifies certain paid solicitors. But by virtue of its modifying clause such solicitors are disqualified only if the commission or remuneration received by them is given other than for reimbursement of "reasonable expenses." As in the instance of the "exchange" exemption contained in Section 3(a)(9) of the Securities Act, neither the X-14A-2(b) nor the 3(a)(9) exemption is lost, if otherwise available, merely because the paid solicitor is paid and is a solicitor. The term "reasonable expenses" contemplates merely mailing, out-of-pocket, and kindred sundry expense items. The second limitation provides for transmission of proxy soliciting material and requires the solicitor, if requested, to defray the expenses of transmitting the material. It again has particular reference to the proxy rules of the various national securities exchanges. The third limitation simply requires that the transmitter shall not himself engage in any solicitation as such. Thus his function is confined to that of transmitting the material he has received from an actual solicitor of the proxy.

Since a solicitation incident to the filing of a Securities Act registration statement, a plan of reorganization under the corporate reorganization provisions of Chapter X, or a Holding Company Act application and declaration is accomplished under the jurisdiction and supervision of either the Commission, a federal court, or both, they have been exempted by X-14A-2(d) through (f). The protection afforded by the various statutes and applicable regulations is considered to obviate any need for further controls through the proxy regulation.

The final exemption, X-14A-2(g), permits the use of certain newspaper advertisements in a solicitation. Without the rule it would be practically impossible to solicit through the medium of a newspaper advertisement for it would be necessary to print an entire proxy statement, a prohibitive expense in most instances. The exemption has as

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63. See note 18 *supra*.

its counterpart the so-called "tombstone" exception found in the Securities Act Section 2(10)(b) definition of the term "prospectus." Like the "tombstone" exception, so-called because of the brief scope of the permitted statement, the proxy "tombstone" exception limits the contents of the advertisement to one which "does no more than (1) name the issuer, (2) state the reasons for the advertisement, and (3) identify the proposal or proposals to be acted upon by the security holders."

The "tombstone" advertisement will necessarily be brief. Both the Securities Act and the proxy "tombstone" have been criticized on this count, especially since the three permissive items of the "tombstone" are ordinarily interpreted by the Commission to permit little more than identification of the general type found on their namesakes. However, a nationally known investment banking house recently conducted a survey which showed that an amazingly large percentage of readers of newspaper financial pages read and even remember the material carried in "tombstones," apparently because of their brevity.<sup>64</sup> Nevertheless, on the basis of preliminary discussions concerning the amendment of Section 2(10)(b) of the Securities Act, it appears that an expansion of its "tombstone" requirements is possible,<sup>65</sup> with perhaps a subsequent broadening of the proxy "tombstone" provisions.<sup>66</sup>

#### INFORMATION REQUIRED FROM COMPANIES SUBJECT TO REGULATION

Rule X-14A-3 provides that if companies subject to the act solicit proxies, they must, either concurrently with the solicitation or at a previous time, furnish security holders a proxy statement containing the information specified in Schedule 14A. The rule also requires such companies to provide security holders, in certain instances, with an annual report containing financial statements.

More specifically, X-14A-3(b) requires that an annual report con-

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64. Cleveland Plain Dealer, March 10, 1948, p. 15, col. 6. The survey was conducted by Lehman Brothers.

65. See Securities Act Release Nos. 3188 and 3244 (Jan. 17, 1947 and June 6, 1947, respectively).

66. A point commonly overlooked is that the proxy "tombstone" involves a solicitation within the meaning of the X-14A-1 definition of "solicitation." The "tombstone" is required, moreover, by the exemption's introductory language to inform "security holders of a source from which they may obtain copies of a proxy statement, form of proxy, and any other soliciting material." The solicitor employing the "tombstone" must, therefore, necessarily have a proxy, proxy statement, and other material, if any, available. Consequently, he must have first filed with the Commission and obtained its authorization to use his materials before his advertisement is published. Thus a security holder who has merely availed himself of the security holder proposal provisions of X-14A-8 and/or who has not filed a proxy statement cannot avail himself of the proxy "tombstone" exception. In short, the exemption embraces only the advertisement itself, and not the solicitation it contemplates.



taining financial statements must either precede or accompany a management proxy statement relating to an "annual meeting"<sup>67</sup> of security holders at which directors are to be elected. An opposition group, however, is not required to transmit an annual report or financials. Therefore, before the regulation was amended, an opposition group was able to start soliciting in favor of its slate of nominees, pursuant to its proxy statement, while management was waiting for its financials to be completed. By an amendment effective February 1, 1945,<sup>68</sup> the substance of the last sentence of the present rule X-14A-3(b) was added. The amendment permits management to solicit in advance of the availability of financials, if a solicitation is being made in opposition to management, provided that management's proxy statement includes an undertaking in bold-face type to furnish at least twenty days before the date of the meeting an annual report, with financials, to all persons solicited.

Occasionally the subject matter of a particular solicitation permits opposition groups to solicit proxies before management can prepare its proxy material even though neither annual reports nor financials are required of management. Various suggestions were received by the Commission in 1948 following the announcement of its proposal to amend the proxy rules with respect to this matter.<sup>69</sup> Among the suggestions was one to permit management to publish statements in response to solicitations in opposition before its material was ready. It was also proposed that management be allowed to omit from its proxy material any information not available at the time the solicita-

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67. The requirement pertaining to annual reports was qualified by the amendments adopted on December 17, 1947, and effective on February 15, 1948, to apply to an "annual" meeting. See Exchange Act Release No. 4037 (Dec. 17, 1947). Until the amendment, the rule required the sending of an annual report prior to special meetings where, for example, only one or two directors were to be elected to fill vacancies.

68. See Exchange Act Release No. 3652 (Feb. 1, 1945), and compare the former X-14A-1(b) with the present X-14A-3(b). It will also be noted that under X-14A-3(b) it is not necessary, as it was until the 1947 amendments, that annual reports sent by management in advance of its proxy statement contain a statement that proxies will be requested later. Compare the third last sentence of former X-14A-1(b) with present X-14A-3(b).

69. See Exchange Act Release No. 4114 (July 6, 1948), captioned "Notice of Proposal to Amend Proxy Rules." Since both the 1947 and 1948 proposals by the Commission for amendment contemplated certain expansions of the regulation's requirements, and were not confined to relieving restrictions, the proposals were both subject to the public notice requirements of Section 3 of the Administrative Procedure Act of 1946. 60 STAT. 238, 5 U.S.C. § 1003 (1946). Before this act, however, the Commission had made a practice of publicly announcing its proposals to change its rules. See Exchange Act Release No. 2376 (Jan. 12, 1940), which indicates that the Commission had also circulated its 1940 proposed amendments to the various national securities exchanges, to interested members of the bar and financial community, and to a number of professional organizations concerned with problems of corporate management.

tion is begun by the opposition.<sup>70</sup> Beyond this it was suggested that where the opposition has begun soliciting, the rules should be amended to reduce the ten-day waiting period.<sup>71</sup>

None of the three suggestions has been adopted. Adoption of the first two would practically result in the management's solicitation being virtually accomplished before all the facts pertinent to its solicitation had been filed with the Commission or made available to security holders. If this were to happen, it would be in conflict with the Rules' main purpose of affording adequate information to security holders. The third suggestion, that the waiting period be shortened, apparently ignores the closing words of X-14A-6(a) which provides for acceleration of the expiration of the waiting period by the Commission where good cause is shown. The rule establishes a procedure for meeting special situations which is more flexible and presumably more practical than a rigid rule. The Commission's practice, moreover, has been to grant acceleration freely where there is a contest.<sup>72</sup>

The first and second sentences of X-14A-3(b) require only that financial statements furnished security holders by management shall "in the opinion of management, adequately reflect the financial position and operations of the issuer." Financial statements, moreover, like the annual report, "may be in any form deemed suitable by the management." Consequently, the Commission's accounting rules,<sup>73</sup> governing the form and content of financial statements, are not applicable to financials disseminated in connection with proxy solicitations relating to annual meetings at which directors are to be elected. Similarly, the annual reports need not meet the standards prescribed by the Commission for annual reports required to be filed under Section 13(a) of the Exchange Act, Section 14 of the Holding Company Act, or Section 30(a) of the Investment Company Act. Indeed, the only affirmative requirement of X-14A-3(b) in regard to financials and annual reports used in connection with proxy solicitations is that they relate to the "last fiscal year."<sup>74</sup>

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70. While X-14A-5(b) permits subject matter, which from a standpoint of practical necessity must be determined in the future to be stated in terms of present knowledge and intention, and also permits information not known, and not reasonably ascertainable or procurable, to be omitted if a brief statement is made of the circumstances rendering the information unavailable, the rule is not regarded as applicable merely because management's material is not yet ready.

71. The ten-day waiting period is provided for in Rule X-14A-6(a).

72. See address by former Commissioner Robert K. McConaughy before the American Society of Corporate Secretaries, Inc., at the Harvard Club, New York, N.Y., Nov. 10, 1948, pp. 10-11.

73. Regulation S-X. Revision of this regulation is currently being given preliminary consideration by the Office of the Commission's Chief Accountant and by interested certified and public, independent accountants.

74. X-14A-3(b), first sentence. A definition of the term "last fiscal year" was

In addition to prescribing the time within which the management's annual report and financials must be filed with the Commission, X-14A-3(c) provides that these materials "shall be mailed to the Commission, solely for its information," and that they are "not deemed to be 'soliciting material' or to be 'filed' with the Commission or otherwise subject to this regulation or to the liabilities of Section 18 of the Act."<sup>75</sup> While the saving language is subject to two narrow exceptions, its general effect is to exculpate the annual report and its financials from the anti-fraud provision of X-14A-9. The rule not only spares management from anti-fraud action by the Commission, but it also excludes management from the civil liability and recovery provisions afforded investors by Section 18 of the Act. While exclusion from X-14A-3 has some precedent based on the Securities Act exemptions from its registration requirements,<sup>76</sup> there is no similar precedent for exclusion from fraud. The congressional grant of rule-making power to the Commission by Section 14(a) of the Exchange Act does not require any exclusion from fraud. None of the legislation administered by the Commission affords exemptions from fraud, except through certain purely jurisdictional exclusions in coverage sections. Although the X-14A-3(c) fraud exclusions appeared in the regulation for the first time in the 1947 amendments, the policy reflected is not new. They represent codification into the regulation of an administrative interpretation first announced on February 5, 1943.<sup>77</sup> This administrative interpretation was the ultimate result of one of the amendments proposed by the Commission in 1942. The effect of the amendment

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added to X-14A-1 by the 1948 amendments in order to make it more clear that the fiscal year referred to in X-14A-3(b) and elsewhere in the regulation is the last fiscal year of the issuer ending prior to the date of the meeting for which proxies are to be solicited. See Exchange Act Release Nos. 4114 and 4185 (July 6, 1948 and Nov. 5, 1948). The purpose of both X-14A-3(b) and X-14A-1 is to provide the security holder with reasonably current financial statements when they are required by the regulation. Financials covering a preceding fiscal year would commonly result in information so dated as to be practically useless.

In connection with its 1949 proxy solicitation, Affiliated Gas Equipment, Inc., of Cleveland, Ohio, considered as adequate financials contained in its January 13, 1949, prospectus filed under Section 10 of the Securities Act. Pursuant to Rule X-12B-35(a) and (b), the company included the financials in its April, 1949, Form 10 filed under Section 12 of the Exchange Act. The prospectus was incorporated by reference in the president's letter accompanying the proxy statement. However, the company undertook actually to deliver the prospectus containing the financials to stockholders who responded to the reference in the president's letter by requesting a copy. See 1949 proxy statement and material filed with SEC by Affiliated Gas Equipment, Inc. Photocopies of this and other proxy filings may be obtained from the Commission's Washington, D.C. office at the photocopying rates prescribed in Rule 121 (a) under the Securities Act.

75. X-14A-3(c), first sentence.

76. Compare Section 3(a), 4, and 17(c), with Section 17(a).

77. Exchange Act Release No. 3380 (Feb. 5, 1943).

would have been to require that all proxy statements relating to annual reports contain financial statements meeting the accounting requirements of Regulation S-X. The administrative interpretation followed a wave of adverse criticism culminating in congressional hearings concerning the Commission's proposed amendments.<sup>78</sup>

The two exceptions contained in X-14A-3(c) are as follows: one assures management of the fraud exemption, unless it specifically "requests" that it be subject to the fraud provisions and the other in effect warns management to take care in employing incorporations by reference in its proxy material lest it be deemed to have indirectly requested that it be compelled to satisfy the anti-fraud requirements. Obviously, the careful corporation or securities lawyer prepares and examines management proxy material with an eye on X-14A-3(c). It should, however, be said in fairness to the rule that its exemptions from fraud may not be as broad as they seem. The nature of a given item of business at an annual meeting at which directors are to be elected may well be such that it is very difficult in a contest to avoid language constituting an incorporation by reference in management proxy soliciting material which is "filed" with the Commission. Such language would, of course, subject management and its solicitors to administrative, criminal, or civil liability for fraud.<sup>79</sup>

#### *Informational Requirements of Schedule 14A*

The lack of substantive content in X-14A-6 is explained by the comprehensive requirements of Schedule 14A which detail the information required in a proxy statement.<sup>80</sup> Essentially the schedule has four parts: Items 1 through 5 specifying informational requirements applicable to proxy statements generally; Item 6 pertaining to the election of directors; Items 8 through 21 dealing with various additional proposed

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78. Exchange Act Release No. 3347 (Dec. 18, 1942).

79. With a view to avoiding incorporation, references to the annual report in the proxy statement sometime include language to the effect that the annual report is not a part of the proxy statement. See 1949 Parke Davis & Co. proxy statement.

Financials contained in annual reports, although commonly condensed considerably, are frequently the result of an independent audit by certified or public accountants and may be covered by an auditor's certificate. Thus the ultimate responsibility for false or misleading statements in the financials would in any event rest with the accounting fraternity. This circumstance would serve to spare management from liability based on the financials to the extent that they rely on their accountants, and would leave management liable only for its own acts for which they must expect to assume responsibility. The portions of the annual report, other than the financials, should present few problems. They consist ordinarily of the perennial president's letter, and descriptive information of the company's product and business, all matter well within the fair responsibility of management.

80. Structurally, Schedule 14A is incorporated into the regulation by the coverage rule. See X-14A-3(a).

action; and Item 7 calling for remuneration data in connection with solicitations relating to certain items of contemplated business. Each item requires in effect that a certain minimum of information be given to security holders in connection with the solicitation of proxies analogous to the registration requirements of the Securities Act.<sup>81</sup>

The information requirements of Items 1 through 5 may be summarized generally as comprehending disclosures regarding revocability of the proxy,<sup>82</sup> dissenters' rights of appraisal,<sup>83</sup> identity of the actual solicitor and the source of the funds used to pay the costs of solicitation, interest of the solicitor and others,<sup>84</sup> and ownership of voting securities.<sup>85</sup> Item 6, which specifies the information required in connection with an election of directors, merits, however, more than passing attention, *if for no other reason than because nearly 90 per cent of all proxy statements filed during a typical year, 1947, involved an election of directors.*<sup>86</sup> While the requirement of Item 6(a) embracing names of nominees and the duration of the term for which they are nominated is clear enough, portions of its import are not so obvious. For example, if less than the authorized number of directors is nominated, the reason for so proceeding should be stated.<sup>87</sup> Furthermore, if proxies are solicited to vote upon the classification of directors under a plan pro-

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81. See Securities Act § 7, and Schedule A. See also Commission's statement of purpose in Exchange Act Release No. 1350 (Aug. 13, 1947).

82. In effect Item 1 calls for information as to whether under the applicable law the proxy may be revoked, and the extent of any limitations upon revocation. Where, as in some states, revocation is dependent upon conformance with a specified statutory procedure, a specific statement of the procedure to be followed should be included in the proxy statement. See, e.g., OHIO GEN. CODE § 8623-53 (Page, Supp. 1949).

83. See Item 2 which is especially applicable where statutory mergers, consolidations, or transfers of assets are involved. Approximately 33 states have statutes affording dissenters appraisal rights in such situations. BALLANTINE, CORPORATIONS 700 (1946). See also Items 14 and 15. A letter or other solicitation urging dissenters to claim statutory appraisal rights is a solicitation of consent or authorization, and therefore a solicitation of a proxy, unless the applicable state statute requires the soliciting person to give notice and/or take the proposed action.

84. Item 4, in general, calls for information in connection with any matter to be acted upon other than elections to office, concerning "any substantial interest" direct or indirect (by security holdings or otherwise) of any of the following persons: (1) directors or officers, or the solicitor, if he is not acting in behalf of management, (2) nominees for directorships, or (3) associates of any of the foregoing. Formerly the item (designated Item 5(H)), reached "any interest," which was interpreted in Exchange Act Release No. 3385 (Feb. 17, 1943) to mean "any material interest."

85. Item 5, in addition to requiring in paragraph (d) information as to ownership of voting securities by more than 10 per cent owners, also encompasses data as to the number of voting securities outstanding and the number of votes they carry, the record date for purposes of eligibility to vote, and cumulative voting with respect to election of directors.

86. See 14 SEC ANN. REP. 38 (1948).

87. Cf. Rule X-14A-4(d)(1) providing that no proxy may confer authority to vote for the election of any person to any office for which a bona fide nominee is not

viding for terms of more than one year, the proxy statement must contain an explicit statement as to whether in filling vacancies occurring during the year, the directors are authorized to appoint directors for the remainder of the year.<sup>88</sup> Similarly, Item 6(b) pertaining to disclosure of an "arrangement or understanding" for election to office existing between a nominee and persons other than an officer or director acting solely in his official capacity, presents problems as to what constitutes a nominee a party to an "arrangement or understanding." If a nominee is proposed to be elected pursuant to an arrangement primarily between the issuer or its management, on the one hand, and one or more third persons, on the other, the nominee is deemed to be a party to the arrangement or undertaking, for it is unlikely that he is being nominated without his knowledge of and consent to the arrangement or understanding.<sup>89</sup> However, an arrangement for election incident to a contract for the nominee's regular employment with the issuer is within the exception afforded arrangements or understandings between a nominee and directors or officers acting in their official capacity with respect to the employment agreement.<sup>90</sup> The remainder of Item 6<sup>91</sup> is generally self-explanatory.<sup>92</sup>

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named. Consequently, the failure to name a nominee for a vacancy may result in the unopposed election of an opposition group's nominee.

88. The statement should also indicate whether the appointment power seats the director for a term which extends beyond the date of the next security holders' meeting, or is limited to the portion of the term falling between the appointment and the next annual meeting.

89. Where a person is to be put on the board pursuant to an arrangement or understanding entered into at some time in the past, it should be described if it continues to be operative with respect to the current nomination. It is common for underwriters to condition their underwriting of a public offering of securities upon, *inter alia*, their right to designate for inclusion in a management slate, a nominee for election to the board. See, for example, prospectus covering securities registered pursuant to Section 5 of the Securities Act issued by Roosevelt Oil & Refining Corporation on July 14, 1948 (cover page and page 18), and prospectus covering securities offered as exempt under Section 3(b) and Regulation A of the Act issued by H. D. Smith Manufacturing Corporation on May 3, 1949 (cover page and page 6).

90. See 1948 Howell Electric Company proxy soliciting material.

91. The term "associate" defined in Rule X-14A-1 and used in Items 4(d), 6(c) (4), 7(d) (4) (iii), 7(e) (3), 7(f) (4), 8, and 11(e), is given a triple effect for purposes of the regulation. In general, it reaches not only certain natural persons through clause (3) of X-14A-1, but also specified corporations and organizations (exclusive of the issuer in respect of which the proxy is solicited and its majority-owned subsidiaries) through clause (1) and designated trusts and estates through clause (2). Clause (1) sets up an officer or ownership test for corporations and organizations measured in terms of the holding of an office or having a partnership interest or owning a beneficial interest in 10 per cent or more of any class of equity security. The terms "majority-owned subsidiary," "officer," and "equity security" are defined in X-12B-2, X-3B-2, and Exchange Act § 3(a) (11), respectively.

Whether a trust or estate is an "associate" of a person within the meaning of clause (2) depends upon whether the person (a) has a "substantial beneficial interest" in the

Information in regard to remuneration of directors, officers, and certain others, and in regard to certain transactions between them and the issuer or its subsidiaries is required by Items 7 (remuneration), 9 (bonus and profit-sharing plans), 10 (pension and retirement plans),<sup>93</sup> and 11 (plans embracing options, warrants, or rights).

If any matters are to be considered within the ambit of Items 9 through 11, or within Item 6 (election of directors),<sup>94</sup> the proxy statement must contain information responsive to Item 7. This item com-

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trust, or (b) serves as a trustee or in a "similar fiduciary capacity." In determining what constitutes "substantial beneficial interest" reference to the discussion in SEC Exchange Act Release Nos. 175 (Class A) (April 16, 1935) and 1965 (Dec. 21, 1939) regarding "beneficial ownership," and SEC Exchange Act Release No. 3385 (Feb. 17, 1943) relating to "interest" may be helpful.

Clause (3) defines as an associate "any relative or spouse . . . having the same home." The term "relative" includes not only a blood relative but also a relative by marriage, for a mother-in-law "having the same home" has been deemed a relative and therefore an associate. See 1949 Monarch Machine Tool Co. proxy statement. However, the definition does not reach every "close family relationship," for the 1947 proposal to so broaden the definition was not adopted. See SEC Exchange Act Release Nos. 3998 (Oct. 10, 1947) and 4037 (Dec. 17, 1947).

92. While Item 6(c)(1) actually calls for a statement of the principal business of a nominee's employer, a statement of the principal business of the issuer is unnecessary, since it may be assumed that the security holders are aware of that fact. See 1948 Midland Steel Products Co. proxy statement. Insofar as Item 6(c)(3) and (4) entail consideration of what constitutes "beneficial ownership," reference may be made to the SEC Exchange Act Releases under § 16(a). In connection with Item 6(c)(3) a company undertaking an August 1948 solicitation used June 30, 1948, as the "most recent practicable date" for stating beneficial ownership. The stockholders' meeting was fixed for October 20, 1948, or three months and 20 days after the selected date. See 1948 Motor Products Corp. proxy statement.

93. Since the autumn of 1949 the application of Item 10 has broadened far beyond the consideration of plans to afford directors, officers, and salaried employees additional remuneration. Pension plans won for non-salaried industrial workers by organized labor are within the orbit of this item. The controversial cost aspect of such plans has been considered in the context of Item 10(b). As a result, the recent Bethlehem Steel Corporation proxy statement carried an estimate of the average annual payments to the company under the plan, assuming its continuance. Such an estimate is required even though the company may have the right to terminate the plan at will or after a specified period. In such a situation the proxy statement also should include the estimated cost which would be imposed on the company if the plan were currently funded for past services. Anticipated tax benefits may be indicated. In all instances the basis for the estimates should be given. See also the United States Steel Corporation and A. M. Beyers Company 1950 proxy statements. Accounting aspects of employees' pensions are discussed in 13 SEC ANN. REP. 128-9 (1947).

94. In the case of unincorporated, management investment companies, shareholders' action in voting upon a new management contract, or a renewal, pursuant to which the manager performs the functions usually performed by a board of directors of an incorporated investment company is in effect an election of directors and Item 7 is therefore applicable. See any proxy statement of National Securities and Research Corp., First Mutual Trust Fund, or Independence Fund.

prises six paragraphs,<sup>95</sup> but space limits this Article to a consideration of only a few of the problems arising thereunder. Questions arise under Item 7(a) (*viz.*, relating to remuneration of directors) with reference to so-called "deferred compensation plans" for the benefit of directors, officers,<sup>96</sup> and others. These plans provide generally that upon retirement of a director, officer, or other participant, he or his estate will receive a fixed amount annually for a specified number of years and that in return for the payments, he shall be available, throughout his lifetime, for consultation services. The estimated costs of these benefits should ordinarily be accrued periodically prior to retirement, and the amounts periodically accrued should, therefore, be disclosed in response to Item 7. Also, although the payment of nominal group insurance premiums need not be disclosed in Column 5 of Item 7(a) due to the difficulties of making computations,<sup>97</sup> estimates based on participation to the retirement age at present salary should be furnished in respect of pension or retirement plans.<sup>98</sup>

Remuneration<sup>99</sup> paid to a firm of which a director is a partner is of special interest to lawyers who have undertaken to serve as a director as well as to act as counsel for a client. The instruction to Item 7(a) permits a statement of the total amount paid to a partnership in lieu of a statement of the proportionate share of the director or officer, provided it is indicated in a footnote or otherwise that this procedure has been followed. It is not intended by the instruction, however, that the

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95. Items 7(a) and (b) are applicable to receipt of remuneration as fees, salaries, commissions, bonuses, shares in profits, pensions, retirement and similar plans; Item 7(c), to receipt of remuneration in the form of securities, options, warrants, rights, or other property, or through their exercise or disposition; Item 7(d), to remuneration in the form of indebtedness to the issuer; and Item 7(e), to remuneration from a "material interest" received in "any significant transactions." Item 7(f) (1) through (4) calls for remuneration information as to payments to certain affiliates, voting trustees of the issuer's securities, more than 10 per cent owners, and associates of such voting trustees or security holders, or any director or nominee, or of any officer specified in Item 7(b). Note the \$25,000 floor contained in Item 7(a) and (f).

96. The term "officer" is defined in X-3B-2; and see *Colby v. Klune*, CCH FED. SEC. LAW REP. ¶ 90,474 (2d Cir. 1949); Exchange Act Release No. 2687 (Nov. 16, 1940).

97. These payments need not be disclosed provided the amount of insurance coverage is nominal, for example, under \$5,000. If the group insurance is over \$5,000, a note to the Item 7(a) table that the designated persons are covered by group insurance, and giving the amount of the coverage is apparently sufficient without reference to the premiums.

98. These estimates may be footnoted to the effect that part of the sum is attributable to the employees' own contributions, if that is the fact. See SEC Exchange Act Release No. 3385, 3-4 (Feb. 17, 1943). See also 1949 Dresser Industries, Inc., proxy statement.

99. Brokers', accountants', and engineers' fees are also remuneration within the meaning of the Item. Where an issuer sells a product through others the commissions paid are remuneration, if title does not pass from the issuer to the marketing person or agent. Percentage bonuses for services rendered during the "last fiscal year" which are not payable until after the close of the fiscal year, should be included as "paid or set aside."



total remuneration paid the firm must be included either in the individual remuneration of any director or officer who is required to be named, or in the total remuneration shown for all directors and officers as a group.<sup>100</sup>

Item 7(c) (securities, etc., as remuneration) and 7(d) (indebtedness to issuer as remuneration) have significant implications from the standpoint of the recapture provisions of Section 16(b) for the reason that a gain subject to recapture is viewed as "remuneration" and as "indebtedness" within the meaning of the items. A director or officer who has realized within six months a so-called "short-swing" profit may have obtained the gain either "from the issuer . . . in the form of securities," or from others as a result of trading.<sup>101</sup> In the interest of avoiding the precipitation of litigation, the Commission does not require a specific reference to Section 16(b) as such. It is sufficient in the instance of profits from options, warrants or rights, to disclose the name of the officer, or director, the dates of the transaction, and a statement of the facts necessary to compute profits. However, if the profit realized resulted from transactions in securities other than options, warrants or rights, that is to say, from trading, additional data is required. Such data must include a statement that the profit is recoverable by the company, and indicate whether the company intends to initiate action.<sup>102</sup>

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100. If the total amount paid the partnership exceeds \$25,000, the name of the firm and the amount received must be disclosed under Item 7(f), but in such case no reference need be made in the response to Item 7(a) to the data given under Item 7(f). If, on the other hand, the amount paid the partnership does not exceed \$25,000, but the aggregate remuneration of the director or officer including the payment to the partnership, does exceed \$25,000, the answer to Item 7(a) should be footnoted to show the name of the partnership, the amount paid, and the nature of the services for which the payment was made. In those cases in which the remuneration of the director or officer, including the total amount paid the partnership, does not exceed \$25,000, it is sufficient to furnish the data reached by Item 7(e) in regard to transactions between the issuer and the partnership. It will also be noted that Instruction 2 requires that the total amount paid to the firm be included in determining whether or not a director or officer received remuneration in excess of the \$25,000 figure in Item 7. However, if the only remuneration paid in addition to the payment to the partnership is nominal directors' fees, the latter need not be included in the computation to determine whether Item 7(a) is applicable to the officer or director. But if the partnership or other recipient of remuneration is reimbursed for expenses incurred, the total payment, and not merely the fee itself, must be compared with the \$25,000 figure.

101. Under the instruction to Item 7(d) short-swing trading resulting in profits of \$1,000 or less may be excluded.

102. See 1949 National Gypsum Co. proxy statement. Item 7(e) contains two phrases in particular which present definition problems. They are, "material interest" and "ordinary course of business." For an interpretation of "material interest" see SEC Exchange Act Release No. 3385 (Feb. 17, 1942). The phrase "ordinary course of business" presents specialized questions of fact and is dealt with on a case by case basis. If "ordinary course of business" problems concern matters of confidential nature see Rule X-24B-2 affording confidential treatment to such information filed with the Commission.

Items 12 through 15 may conveniently be considered together, since the financial statements called for by Item 15 must be furnished in connection with the authorization or issuance of securities otherwise than for exchange, the modification or exchange of securities, or the effecting of mergers, consolidations and transfers of assets within the meaning of Items 12, 13, and 14, respectively. Although the three individual items present frequently recurring problems and provide for specially prescribed data, the provisions of Item 15 requiring financials are probably of greatest importance.<sup>103</sup> The most significant aspect of the requirement of Item 15 with respect to financial statements is the contrast that it affords with the provisions of X-14A-3(c) regarding the financials furnished in annual reports incident to the election of directors. Unlike the latter rule which permits financials "deemed suitable by the management," Item 15 calls for balance sheet and profit and loss information which must substantially meet the standards for form and content of financial statements prescribed by Regulation S-X.<sup>104</sup> If, however, the financials contained in the annual report (sent to security holders because an election of directors is also an item of business) are prepared substantially in accordance with the standards of Regulation S-X, as modified by Item 15, they may be incorporated by reference under the express provisions of Item 15(d). Some latitude from the general requirements of Item 15 is obtained by paragraph (c), which permits omission of financials "not material for the exercise of prudent judgment in regard to the matter to be acted upon." The final sentence of the paragraph defines the quoted phrase to include "the usual case . . . involving the authorization or issuance of common stock, otherwise than in exchange," but makes it clear that if the authorization or issuance of senior securities is involved financials are for obvious reasons required.<sup>105</sup>

The remaining items of Schedule 14A, Items 8 and 16 through 21, relate to selection of auditors;<sup>106</sup> acquisition or disposition of property;

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103. During the typical year of 1947 a total of 292, or 17 per cent, of the proxy statements filed concerned proposals within the scope of Items 12, 13, or 14. 13 SEC ANN. REP. 39 (1947).

104. If the proposal is one within the scope of Item 14(b), the financials, however, need not be certified, but must otherwise meet the balance sheet and profit and loss requirements of Regulations S-X. Schedules, other than schedules of supplementary profit and loss information, may also be omitted. See Items 15(a) and 15(b).

105. Where the action proposed is a stock-split, or a change from no par to par value stock, financials are not required. The proxy statement need carry only a summary of the equity section of the balance sheet on an "as is" and "pro-forma" basis. See 1948 McCord Corporation and Union Investment Company proxy statements.

106. Item 8, dealing with the selection of auditors, recognizes the practice in many jurisdictions of submitting to stockholders the matter of choosing outside accountants to prepare the annual audit. See 13 SEC ANN. REP. 39 (1948); SEC v. Transamerica Corporation, 163 F.2d 511 (3d Cir., 1947), *cert. denied*, 332 U.S. 847 (1948).

restatement of accounts; action with respect to reports;<sup>107</sup> matters submitted to stockholders although not so required;<sup>108</sup> amendment of the charter, by-laws, or other documents;<sup>109</sup> and the manner of stating all other items of business to be submitted to the security holders.<sup>110</sup>

#### *Form, Content and Filing of the Proxy Statement*

The form, content, and mechanics of filing the proxy statement and other soliciting material is dealt with in X-14A-4, X-14A-5 and X-14A-6. Certain paragraphs of these three Rules, however, touch on related substantive matters of considerably more than mere formal significance. For example, X-14A-4(a)(1) requires that the form of proxy must indicate in bold face type whether or not the proxy is solicited on behalf of management. Prior to the adoption of the 1948 amendments, it had not always been clear that a given solicitation was not being conducted on behalf of management. To avoid the possibility of misleading security holders, the amendment was adopted to require that the form of proxy carry a bold-face, identifying legend, and a companion amendment was adopted with respect to the proxy statement in order that it, too, would be clearly identified.<sup>111</sup> The requirement of X-14A-4(a)(1) is, of course, literally satisfied by including in a management proxy a bold-face legend reading "Management Proxy"

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107. Since Item 18 refers specifically to "any report of the issuer or of its directors, officers, or committees or any minutes of meeting of its stockholders," questions arise as to when the item requires information where action is to be taken with respect to minutes. The item is only applicable when action approving the minutes amounts to ratification of action reported in the minutes. Exchange Act Release No. 461 (Jan. 21, 1936).

108. Item 19 requires that the "reasons for submitting" be explained, and it also requires statements detailing "the general effect of such submission" and "the effect of a negative vote on the matter." The "effect of a negative vote" entails a statement as to whether management intends to be bound by stockholders' disapproval. It will also be observed that Item 19 may "overlap" Items 8 through 18 and 20. However, if an item reached by any of the latter is voluntarily submitted to stockholders by management, Item 19 may be disregarded.

109. Where corporate by-laws or codes of regulations incorporate state corporation code provisions, an amendment of the code by the legislature will require a consideration of Item 20 by management. Even though various by-laws are submitted for approval or rejection as a whole, the form of the proxy should contain a separate ballot with respect to each by-law or group of related by-laws involving material changes, in addition to ballots for approval or rejection as a whole.

110. The final omnibus item, 21, simply provides that if action is to be taken with respect to any matter not specified by the preceding items, its "substance" shall be "described briefly . . . in substantially the same degree of detail as is required in the Items 5 to 20," which call for designated data covering the various individually specified proposals.

111. See Item 3(b) of Schedule 14A. See also Exchange Act Release No. 461 (Jan. 21, 1936).

beneath the name of the company, or by placing a bold-faced legend, above the company name stating "Solicited on behalf of the Management of . . ."

Paragraphs (a)(2) and (b) of X-14A-4 free the security holders from the necessity of "straight-ticket" voting with respect to all matters other than election to office.<sup>112</sup> The solicitor, however, under paragraph (b) may in connection with matters other than elections to office,<sup>113</sup> employ a proxy which either (1) affords a choice between approval and disapproval,<sup>114</sup> or (2) confers discretionary authority with respect to approval or disapproval. But if discretionary authority is sought, the proxy must state "in bold face type how it is intended to vote" the shares.<sup>115</sup> Notwithstanding the fact that the opportunity for an expression of approval or disapproval is required under the rule only in connection with matters other than election to office, management proxies have sometimes carried boxes to permit the security holder to indicate a choice for or against the various candidates for office. While this is, of course, not objectionable, since it permits individual consideration of the nominees, the accompanying proxy statement should explain the effect of a negative vote in the election of directors.<sup>116</sup> A similar matter that frequently arises is whether boxes for indicating approval or disapproval must be provided in connection with a proposal to fix the number of directors to be elected.<sup>117</sup>

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112. Insofar as election of officers is concerned, selectivity may be achieved by cumulative voting. Cumulative voting is, however, entirely a matter of the law of the state of incorporation, except for the informational requirements of X-14A-4(b) and Item 5(c) of Schedule 14A.

113. If the only matter to be acted upon is the election of directors, the form of proxy need not specifically mention the election as to the matter to be acted upon.

114. Clause (2) of X-14A-4(a) requiring that the form of proxy shall identify clearly and impartially each matter or group of related matters intended to be acted upon, should be read with the first sentence of X-14A-4(b). However, identification by subject matter is not necessarily required, and identifications such as "Proposal A" and "Proposal B" are permissible where matching identifications are employed in the proxy statement. See also note 109 *supra*.

115. For contrast of the phrase "intended to vote" in X-14A-4(b) with "will be voted" in X-14A-4(e), see note 125 *infra*.

116. While a negative vote is commonly counted for purposes of determining a quorum, the effect of a negative vote upon an election of directors ordinarily is to disenfranchise the security holder, for the result of the election will not be affected by his vote, unless there is only one nominee for a given directorship. Interesting questions of whether negative votes cancel affirmative votes may arise where there is more than one nominee and their affirmative votes are equal in number.

117. If the number of directors is required to be fixed each year incident to the election of directors, and amendments to neither the charter nor by-laws are involved, no boxes need be provided. However, boxes must be provided if the charter or by-laws are to be amended to increase or decrease the number of directors to be elected. The matter of election of directors should not, however, be confused with selection of auditors. Since the selection of auditors is under the first sentence of X-14A-4(b), a matter "other than elections to office," opportunity for an expression of approval or disapproval is required.

The 1948 proposals for amendment suggested that the requirement of X-14A-4(a)(2), that the form of proxy "identify impartially" the matters to be acted upon, be implemented by the addition of a third sentence to X-14A-4(b) expressly providing that "The form of proxy shall contain no recommendation. . . ." <sup>118</sup> The Commission believes that the proxy form is in essence a ballot by which the security holder exercises his franchise and should not be used as campaign literature. Consequently it is of the opinion that any recommendation management wants to make should be set forth in the proxy statement rather than in the form of proxy. However, management groups opposed the prohibition against recommendations in the proxy form on the ground that the security holders want to know management's position. After fully considering the question, the Commission agreed that in all likelihood it would be at least a convenience to stockholders, and perhaps advantageous to them, to have the management's position *identified* on the instrument by which they cast their vote. The Commission believed that, if the prohibition was construed as barring such identification, it would exceed its intended purpose, and consequently the suggested amendment was not adopted. <sup>119</sup> In some quarters the Commission's action was apparently regarded as authorizing the inclusion of recommendations in the proxy form. It should be remembered, however, that in adopting the 1948 amendments the Commission expressly stated that it would regard as contrary to the rule that matters to be acted upon must be set forth clearly and impartially, any statement or device which advocates any proposal, misleads or confuses the security holder, brings pressure to bear upon him in the exercise of his right of choice, or makes it mechanically more difficult for him to vote one way rather than another. <sup>120</sup>

The Commission did not adopt the 1948 proposal to modify the X-14A-4(b) provisions with reference to proxies conferring upon a solicitor discretionary authority regarding matters which he knows will be presented at the meeting. But it did amend the X-14A-4(c) requirements with respect to matters which the solicitor is not aware at the time of the solicitation are to be presented, provided that a specific statement is made to that effect in the proxy form or statement. This privilege of obtaining a discretionary proxy, like the privilege afforded

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118. Exchange Act Release No. 4114, p. 1 (July 6, 1948).

119. See address of former Commissioner Robert K. McConnaughey, *supra* note 72.

120. Exchange Act Release No. 4185, p. 2 (Nov. 5, 1948). In the same release the Commission added that among the devices which it would regard as contrary to the rule are arguments or recommendations as to the merits of proposals, emphasis upon the management's position beyond the mere statement of the fact that the management favors or opposes a proposal, the use of arrows or any other visual device designed to direct the stockholders' attention to the place on the proxy for voting one way and away from the place for voting the contrary, and the switching of boxes, in order to procure the result desired by the management.

by the last sentence of X-14A-4(b), is available to both management and opposition groups, if the requirements of the Rule are met.<sup>121</sup>

The two clauses of X-14A-4(d) express prohibitions respecting the proxy form. One clause prohibits the nomination for election to office of persons who do not intend to serve. The other bars premature solicitations by preventing the use of a proxy which relates to other than the next annual meeting. The first clause strikes at a practice once common, an illustration of which may be found in a New York case where it was held that a proxy solicitation was defective which did not disclose that the directors elected had agreed prior to the solicitation to resign in favor of another slate of candidates.<sup>122</sup> Whether a given candidate is a bona fide nominee within the meaning of X-14A-4(d)(1) presents, of course, a question of fact in each particular case.

Another problem arises under the requirement of X-14A-4(e) that the proxy or proxy statement must specify that, subject to reasonable, specified conditions, the shares represented by the proxy "will be voted," and "will be voted" in accordance with the security holders' specifications. The reason for the rule exists in the practice, at one time common, of neglecting to vote proxies which were marked adversely to the solicitor. This technique not only disenfranchised the security holder, but simplified the solicitor's task of gaining a majority, provided a quorum was secured. It was even possible to allow a few adverse votes in the interests of reaching a quorum as long as a safe majority could be achieved. The problem is illustrated in part by *Lizars v. Dahlberg*.<sup>123</sup> The case grew out of the refusal by the management of Certain-teed Products Corporation to have its proxy agents attend the annual meeting at which directors were to be elected. The litigation resulted in a decision upholding the Commission's view as *amicus curiae*, that management, having solicited proxies under the regulation for the election of directors, could not properly direct its proxy agents to refrain from attending the meeting to avoid having their proxies counted for the purpose of determining whether a quorum existed.<sup>124</sup> As a consequence of X-14A-4(e) a proxy or proxy statement may be cited as deficient if it states merely that "It is the *intention* that

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121. It is also to be noted that the last sentence of X-14A-4(c) permits use of a proxy conferring discretionary authority with respect to proposals omitted from the proxy form and statement pursuant to X-14A-8(c).

122. *Wyatt v. Armstrong*, 59 N.Y.S.2d 502 (Sup. Ct. 1945). See also *Levy v. Feinberg*, 29 N.Y.S.2d 550 (Sup. Ct. 1941), *rev'd sub. nom. Levy v. American Brewing Corp.*, 265 App. Div. 208, 38 N.Y.S.2d 517 (1st Dep't 1942).

123. Unreported opinion, Supreme Court of Baltimore City, Docket 1944, folio 264, May 22, 1944.

124. After the court's decision management's proxy agents attended the adjourned meeting, the voting at which resulted in the defeat of the management slate and election of directors proposed by an opposition group.

proxies not limited to the contrary will be voted in favor of said nominees." The rule requires modification of the quoted sentence to read "Proxies not limited to the contrary *will be voted* in favor of said nominee." <sup>125</sup>

While mechanically X-14A-5 is to the proxy statement what X-14A-4 is to the proxy ballot, the former does not rise to the substantive level of the latter. Except for X-14A-5(b) which in effect imposes limits within which discretionary authority with respect to matters to be acted upon may properly be sought, the entire rule is essentially concerned merely with the physical and formal aspects of preparing a proxy statement.

Some fairly sophisticated problems arise under X-14A-6 dealing with the material required to be filed with the Commission prior to undertaking solicitation.<sup>126</sup> Following in the wake of the "waiting period" provisions of X-14A-6(a) which call for the filing of the proxy, proxy statement and other soliciting material ten days before use,<sup>127</sup> is the requirement for the filing of "additional soliciting material."<sup>128</sup> It compels the submission of "additional soliciting material" at least two days, exclusive of Saturdays, Sundays, and holidays, prior to its use. The "additional soliciting material" provision, however, is limited to material emanating from the group or person filing a proxy statement. It does not cover subsequent material in regard to the proxy statement sent out by others. Recently a company president, who was adverse to the action proposed by the 4-3 majority of the company directors, had considered accompanying the majority's management proxy statement with a letter urging security holders to vote against the proposal.<sup>129</sup> The contemplated letter was not "additional soliciting material" of the management, since the president was in the position

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125. Compare 1948 Reliance Electric and Engineering Company proxy statement with its 1949 proxy statement covering its January, 1950 meeting. Comparison of the two will also show that the statement in the former that "[i]f, for any reason, any nominee is not available when the election occurs, the proxies will be voted for the election of such other person or persons as shall be acceptable to the management" was recast to comply more closely with X-14A-4 (which became finally effective on December 15, 1948) by substituting "not able to serve" for "not available." See address of former Commissioner McConnaughey, *supra* note 72, at 14-15.

126. Both preliminary and definitive material must be filed. See X-14A-6(a) and (c).

127. In computing the ten-day period, the filing date is counted as the first day, and the eleventh day is the date the material may be mailed, in the absence of acceleration pursuant to the last clause of X-14A-6(a). During the waiting period the material is processed for compliance with the regulation, and a deficiency or acknowledgment letter mailed to the filer. In the absence of deficiencies, acceleration is freely granted. See note 72 *supra*. For a case in which the Commission's charges included the mailing of material prior to the expiration of the "waiting period," see SEC v. McQuiston (S.D.N.Y. 1947) announced in SEC Litigation Releases Nos. 403 and 420 (May 21 and Aug. 13, 1947).

128. X-14A-6(b).

129. See 1950 Warner Aircraft Corporation proxy statement.

of opposing a majority of the directors. In order to have mailed the letter, the company president would have had to have first filed the letter and otherwise conformed it with the Regulation. Similarly, a security holder who used the security holder "proposal" provisions of X-14A-8 to urge adjournment of the annual meeting to afford him time to complete his report on his investigation into alleged misconduct of certain management nominees could not disseminate his report until he had filed a proxy statement, since the report was not "additional soliciting material" of the management.<sup>130</sup>

#### SECURITY HOLDER COMMUNICATIONS AND PROPOSALS

The value of information is proportioned directly to the extent it is utilized. Rules X-14A-7 and X-14A-8 proceed on this theory, and seek to stimulate participation in corporate affairs by affording security holders methods of contacting their fellows. The problem and near impossibility of securing a list of stockholders is approached through X-14A-7. The rule does not make it possible for a security holder to get possession of a list as such. Such a right depends upon state law. However, the rule does obligate management, apart from recourse to state courts and procedures, to mail a security holder's proxy statement to the other security holders, if management "has made or intends to make" any solicitation "with respect to the same subject matter or meeting." In order to avail himself of the privilege afforded by the rule, the security holder must (1) be entitled to vote on the matter or at the meeting, (2) request in writing the information enumerated in paragraphs (a)(1) through (a)(3) of the rule, and (3) defray the "reasonable" expenses to be incurred by the issuer in the performance of the acts requested. If he meets these requirements, the security holder can obtain the details he needs in order to prepare his proxy statement and place it in the hands of management for mailing.<sup>131</sup> If management does not want to mail the security holder's proxy statement, it has the option of turning over to the security holder a stock list.<sup>132</sup>

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130. See 1949 Argus, Inc., proxy statement. Cf. X-14A-6(f) which, however, merely relates to replies from security holders requesting further information as opposed to further information offered to security holders incident to an X-14A-8 proposal. Other material required to be pre-filed includes, as a consequence of the 1947 amendments, so-called "educational" material furnished to personal solicitors by either management or opposition groups. See Rule X-14A-6(d) and Exchange Act Release No. 4037 (Dec. 17, 1947).

131. See X-14A-7(a)(1)-(a)(3). See also X-14A-7(b) for further details concerning the mechanics of mailing. It will be noted that the first sentence of paragraph (b) makes it clear that the security holder, just as management, is not obligated to solicit all his holders. To minimize his costs, therefore, he could direct that only the holders of a specified number of shares are to be mailed his material.

132. See X-14A-7(c).



The principal shortcoming of X-14A-7 is that the solicited security holder may receive adversaries' proxy statements at different times. Consequently, one may not be available for comparison with the other even though the Commission, where possible, tries to coordinate the entry of its orders authorizing mailing so that both management's and opposition groups' material may be mailed simultaneously. Many stockholders either mail back the form of proxy at once and discard the proxy statement or simply consign both to the nearest waste basket.

X-14A-8, which permits a security holder to have his proposal included in the management proxy statement,<sup>133</sup> is directed to minimizing this problem. Except in the instance of directors' elections, X-14A-8 permits a security holder to have his proposal placed and considered in the context of management's proposals. Of special significance is paragraph (b) of X-14A-8, which in addition affords the security holder "100 words of reason" in support of his proposal, if it is to be opposed by management.<sup>134</sup> This in effect places the two sides on a more nearly even plane, so that each has an opportunity to assert the reasons for the action proposed. As a result, the security holders are better able mutually to appraise the matter at one sitting, before they mark their proxy. Moreover, the problem of coordinating receipt of the contestants' material is solved.<sup>135</sup>

The privilege accorded by X-14A-8 has sometimes been abused. In a few cases managements have been badgered by proposals which apparently were not submitted in good faith, or were submitted for the purpose of achieving some ulterior personal objective unrelated to the

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133. See X-14A-8(a). Note the "reasonable time" limitation in the first sentence of the paragraph, a phrase expanded upon in the paragraph's second sentence. Note also the last sentence of paragraph (a), which makes X-14A-8 inapplicable to elections to office. The security holders proposal provisions were upheld in *SEC. v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947) *cert. denied*, 332 U.S. 847 (1948).

134. See X-14A-8(b).

135. It should be noted however, that a security holder who has merely availed himself of the security holder proposal provisions of X-14A-8, and who has not filed a proxy statement as contemplated by X-14A-6, cannot solicit persons who communicate with him as a result of having read his "100 words of reason" and/or his proposal in the management proxy statement. Whether the security holders solicited vote for or against management, therefore, depends upon the extent to which the opposition gets his case before them through his 100 words and his proposal. A security holder may, however, answer unsolicited questions submitted by persons responding to the 100 words or the proposal if his answers do not constitute a "solicitation" within the meaning of the X-14A-1 definition. While he is likewise precluded from use of the proxy tombstone provisions of X-14A-2(g), until he has filed and received authorization to mail a proxy statement, he can, of course, solicit a "total" of ten persons under X-14A-2(a). See also Exchange Act Release No. 7020 (Dec. 2, 1946) for opinion holding that X-14A-8 does not require inclusion of proposals of an "obviously . . . political and economic nature."

interests of sound and fair management of corporate affairs.<sup>136</sup> In order to avoid further abuses, the Commission amended the rule in 1948 to provide that under certain specified circumstances, proposals submitted by security holders to the management may be omitted from the management's proxy material.<sup>137</sup> The Commission, however, did not make the amendment as stringent as was suggested by some management groups. To have done so would have resulted in virtually nullifying the security holders' right to submit proposals. In approving the amendments, the Commission was motivated first by a wish to eliminate clear abuses without, however, infringing upon the legitimate right of security holders to participate in the management of their companies by initiating proposals, and, second, by the hope that the possibilities of infringement upon the security-holders' proper franchise can be avoided without involving the Commission in a series of decisions turning upon slippery questions of motive. If the provision is fairly and objectively applied by corporate managements, it should achieve its objective of forestalling crackpot propositions without impeding consideration of opposition proposals that have at least debatable merit and are proper subjects for stockholder action.<sup>138</sup>

#### FRAUD

While it is difficult to appraise precisely the ultimate importance of the informational requirements, it seems accurate to say that the informational rules constitute the heart of the regulation. They are positive in character. On the other hand, the anti-fraud prohibitions are patently negative; their job is enforcement. By penalizing fraud, they provide a motivation for compliance with the informational rules.

Rule X-14A-9 prohibits on grounds of fraud the use of any proxy material or other communication, written or oral, containing false or misleading statements of any material fact or omitting to state a material fact necessary in order to make the statements made not misleading. The proxy fraud rule has been to court more often than any other proxy rule. It was also the first rule to receive judicial scrutiny.<sup>139</sup>

While the proxy fraud rule requires a full disclosure of all material

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136. Address of former Commissioner McConnaughey, *supra* note 72.

137. See X-14A-8(c) and (d).

138. Address of former Commissioner McConnaughey, *supra* note 72. The point was raised that if a proposal is omitted pursuant to the provision just discussed and security holders nevertheless introduced the proposal at the meeting, the management could not exercise discretionary authority in the matter because it was aware that the matter was to be presented for action. Since this would operate to defeat the purpose of the new provision regarding the omission of proposals, the Commission inserted express provisions that the proposals so omitted need not be mentioned in the form of proxy and that the management may exercise discretionary authority with respect to such proposals if they are presented for action at the meeting. Rule X-14A-4(a) and (c).

139. See note 142 *infra*. The Commission is not, however, confined to court action

facts, a proxy statement is neither false nor misleading because it fails to state all possible alternatives to the proposed course of action, or because it does not contain statements concerning the motive of the solicitor. The validity of this proposition was conceded in a Commission brief, and a federal district court has so held.<sup>140</sup>

The Commission has indicated that it does not consider that its proxy rules, which apply to "any person" under Section 14(a), are confined only to management and opposition groups. Their agents as well as any other persons who solicit are within the ambit of the regulation. Such an application of the regulation was considered by the Commission in an administrative hearing<sup>141</sup> brought under Section 15(b) of the Exchange Act to determine whether it should revoke a broker-dealer registration. The charges were confined exclusively to the possible violation of the proxy regulation by the broker-dealer. The facts showed that a proxy soliciting group had represented that its nominees for directors were bona fide, when it was known that at least one of the nominees was not bona fide, because his undated resignation had already been obtained. It also appeared that the group's proxy statement as filed with the Commission contained various omissions of material facts. While the Commission held that the evidence did not "establish that [the broker-dealer] participated in or caused the Investors Group to omit from its proxy statement the material facts set forth in the order for hearing," the case is none the less illuminating with respect to the scope of the application of the proxy fraud and other rules, and the availability to the Commission of remedies through administrative procedures and hearings.

*SEC v. O'Hara Re-Election Committee*<sup>142</sup> first announced the principal that the use of proxies may be enjoined when they are obtained as a result of misleading proxy soliciting material. The Commission sought to restrain the so-called O'Hara Re-Election (or Proxy) Committee

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to enforce the proxy rules. It has other sanctions as well. One available under the Exchange Act, as well as other acts it administers, is the authority in its discretion to make public under the second sentence of § 21(a), information concerning violations. About a year after adoption of the LA rules, the Commission, presumably because of the circumstance that the proxy regulation was still in an early stage of development and the fraud questions therefore somewhat novel, availed itself of the publicity sanction of 21(a). It released a four page statement in connection with a management solicitation of security holders of Consolidated Film Industries, Inc., which summarized the pertinent facts and pointed out that the president's letter might be misleading. See Exchange Act Release No. 903 (Oct. 22, 1936). As to the comparable publicity sanction of the Securities Act, see McCORMICK, UNDERSTANDING THE SECURITIES ACT AND THE SEC 298 (1948).

The word "material" used in the proxy fraud rule is defined in X-12B-2 to include "matters as to which an average prudent investor ought reasonably to be informed."

140. *Doyle v. Milton*, 73 F. Supp. 281 (S.D.N.Y. 1947).

141. In the matter of Charles A. Massie, Exchange Act Release No. 3944 (April 12, 1947).

142. 28 F. Supp. 523 (D. Mass. 1939). See discussion in Bernstein & Fischer, *supra* note 31.

from soliciting proxies from stockholders by means of misleading letters. It appeared that after complying with the requirements of the proxy rules, O'Hara sent out an additional letter of solicitation of stockholders, urging them to return him to the management of the corporation. His letter dealt generally with his version of mismanagement by the existing directors, contained allegations against the directors individually, and included "a great deal of innuendo." Some of these statements were false and misleading. After a hearing the district court issued a preliminary injunction. The court's order not only enjoined the use of the proxies, but, in order to avoid disenfranchisement of the stockholders, directed that the meeting of stockholders be postponed to permit proper resolicitation of the stockholders whose proxies were declared invalid. The court applied the same general use of its injunction powers in a similar but unreported case, *SEC v. National Rubber Machinery Co.*,<sup>143</sup> enjoining not only the use of the proxies at a stockholders' meeting scheduled to be held on the same day, but also temporarily restraining the company from holding its meeting on the date scheduled, except for the purpose of adjournment, in order that re-enfranchisement and compliance might be effected.

In cases that have followed, arguments that the Exchange Act should be narrowly construed to the point where the courts should only enjoin unlawful solicitation under Section 21(e) have been rejected. The courts have sustained the view that there may be granted to the Commission relief reasonably necessary to effectuate the purpose of the proxy provisions to insure fair and honest solicitation. Relief granted has included a requirement that a meeting be postponed or adjourned,<sup>144</sup> a prohibition on the use of proxies improperly obtained,<sup>145</sup> a requirement that a corrective statement be sent to stockholders,<sup>146</sup> and a requirement for solicitation in conformity with the proxy rules.<sup>147</sup>

Notwithstanding the presence of the administrative remedy as an

143. (N.D. Ohio 1944). *But cf.* *SEC v. Okin*, 58 F. Supp. 20 (S.D.N.Y. 1944), when the court enjoined Okin from using proxies obtained by false and misleading material, but was "troubled" by the fact that its decision would disenfranchise security holders who had given their proxies to him. The court felt that the result could not be amended since neither the corporation nor the security holders were parties to the action.

144. *SEC v. Transamerica Corp.*, 67 F. Supp. 326 (D. Del. 1946), *modified on other grounds*, 163 F.2d 511 (3d Cir. 1947); *Tate v. Sonotone Corp.*, unreported, (Civ. No. 41-139, S.D.N.Y. April 15, 1947); *Standard Gas and Electric Co. v. SEC*, CCH Fed. SEC. LAW REP. ¶90,400 (D.C. Cir. 1947).

145. *SEC v. Okin*, 58 F. Supp. 20 (S.D.N.Y. 1944); *SEC v. Metropolitan Mines Corp., Ltd.*, Civil Doc. No. 664 (E.D. Wash. 1947); *SEC v. McQuisten*, Civil Doc. No. 41-47 (S.D.N.Y. 1947)

146. *SEC v. Okin*, 48 F. Supp. 928 (S.D.N.Y. 1943), *modified*, 137 F.2d 862 (2d Cir. 1943).

147. *SEC v. Transamerica Corp.*, *supra* note 144. And see *SEC v. Topping* (S.D.N.Y. 1949), SEC Litigation Release No. 513 (April 29, 1949) and No. 543 (Oct. 6, 1949). For a recent case on the omission of a statement of probable adjournment as false

adjunct to the institution of civil and criminal <sup>148</sup> cases in courts of law, the most effective tool the Commission has in dealing with proxy fraud is the opportunity for the detection and elimination of fraud incident to the processing of proxy material during the ten-day waiting period, and incident to the rendition of interpretative services from its various regional offices. Examples of disclosures resulting from the Commission's examination of preliminary proxy soliciting material adequately demonstrate the effectiveness of this technique in giving stockholders full information of insiders' plans to promote unconscionable schemes.<sup>149</sup>

#### SUGGESTED REVISIONS

Whatever the minor difficulties presently existing within the proxy rules, their operation over 15 years of experience has become reasonably smooth and efficient. The Commission has recently stated that proxy rules "are probably the most useful of all the disclosure devices established by our various acts and represent an effective contribution to corporate democracy."<sup>150</sup>

The principal difficulty in the employment of the proxy rules, therefore, is not found in the rules themselves, but in the limited scope of their application. They do not apply, generally, to annual reports and their financial statements, and they do not apply to solicitations of proxies from holders of "unlisted" securities. This last limitation

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and misleading, see *Phillips v. The United Corp.*, CCH FED. SEC. LAW REP. ¶90,395 (S.D.N.Y. 1947).

148. No criminal cases based exclusively on the proxy rules have been brought by the Commission to date. In this connection refer to the notice-of-rules provisions of § 32(a) of the Exchange Act.

149. An example of disclosure, resulting from the Commission's examination of preliminary proxy soliciting material before it is mailed out, may be noted in one case in particular among the hundreds of filings recently processed. It involved an intended solicitation of proxies for the election of directors proposed by both the management and a minority group. The management slate was headed by the company's chairman of the board of directors, who had acquired a dominant position as a result of self-dealing, inter-company transactions which had converted his original \$150,000 investment into company stock worth \$246,950 and a promissory note from the company to him in the amount of \$650,000, or a total of \$896,950. In addition, a former board chairman purchased a subsidiary of the above company in consideration of his controlled company's note for \$250,000, and incident to a later stock transaction obtained a release and cancellation of the controlled company's note. As a result of the processing of the proxy statement, the Commission required that a full disclosure of these and other similar matters be given the security holders in the proxy statement. See 14 SEC ANN. REP. 39-40 (1948). For other disclosures obtained as a consequence of the processing of proxy statements, see 15 SEC ANN. REP. 49-51 (1949); 13 SEC ANN. REP. 42-3 (1941); 6 SEC ANN. REP. 113-116 (1940); 5 SEC ANN. REP. 60-2 (1939); 4 SEC ANN. REP. 69-70 (1938); and 3 SEC ANN. REP. 61 (1937).

150. REPORT OF THE SEC ON A PROPOSAL TO "SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES," H.R. DOC. NO. 672, 79th Cong., 2d Sess. 18 (1946). The report has been brought down to date by a supplemental report recently transmitted to Congress. Exchange Act Release No. 4399 (Jan. 9, 1950).

leaves a sizeable group of companies whose solicitations of proxies are not subject to the Commission's regulations. The resultant hiatus in the demands of full disclosure is also applicable to the registration and reporting provisions of Sections 12 and 13, and to the "insider-trading" provisions of Section 16 of the Exchange Act.<sup>151</sup> But the double standard of the disclosure requirements is not due to any well-defined policy of limiting them to listed and registered companies.

Although Congress intended that investors in securities traded on the over-the-counter market should have protection equal to investors in listed securities,<sup>152</sup> actual legislation has not been sufficiently extensive to achieve that objective. Brokers and dealers in the over-the-counter market have been subject to registration and regulation under Section 15 of the Exchange Act and a series of amendments thereto. In adopting the Holding Company Act in 1935, Congress made applicable to the securities of holding companies and their subsidiaries, whether or not such securities were registered on exchanges, protective provisions similar to Sections 12, 13, 14 and 16 of the Exchange Act. In 1936 Congress adopted Exchange Act Section 15(d),<sup>153</sup> requiring the filing of annual and periodic reports, including financial statements, by any issuer thereafter registering under the Securities Act any issue aggregating \$2,000,000, even though the issue was not registered on an exchange. The Trust Indenture Act of 1939 provided that issuers qualifying indentures under the Act were subject to the reporting requirements governing companies having securities registered on national exchanges.<sup>154</sup> Finally, the Investment Company Act, like the Holding Company Act, subjected securities of registered investment companies to requirements similar to those of Sections 12, 13, 14, and 16 of the Exchange Act, whether or not the securities were registered on exchanges.<sup>155</sup> Such fragmentary development has left important gaps in the protective scheme.

In 1946, the SEC estimated that there were in the United States 3,090 companies with \$3,000,000 in assets and 300 or more security holders, excluding banks.<sup>156</sup> Of these, some 1,600 were registered with

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151. The application and reporting provisions of §§ 12 and 13 apply only to companies with securities listed on an exchange; § 16 requires publicity to the holdings and trading of officers, directors, and principal (more than 10 per cent) stockholders, in the equity securities of their company if that company has equity securities listed on an exchange.

152. Section 15 of the Exchange Act, as originally enacted, made it unlawful for brokers and dealers to trade in the over-the-counter market in contravention of such rules and regulations as the Commission might prescribe "as necessary or appropriate in the public interest and to insure the investors protection comparable to that provided by and under the authority of this title in the case of national securities exchanges." 48 STAT. 895 (1933-1934). See also Exchange Act § 2.

153. See §§ 5, 12(e), 14 and 17, Holding Company Act.

154. § 314(a) (1), Trust Indenture Act.

155. See §§ 8, 20(a), 24 and 30, Investment Company Act.

156. REPORT OF THE SEC, *op. cit. supra* note 150, at 25-7.

the Commission under various acts; 500 more had to make reports comparable to those required by the SEC to another federal or state agency. This left an estimated 1,000 companies not then filing reports with any public agency.<sup>157</sup> In so far as proxy-soliciting practices are concerned, the report shows that many of the companies not effecting filings with the Commission are still following practices which Congress attempted to rectify as to listed companies by adopting Section 14 of the Exchange Act.<sup>158</sup>

In 1946 the Commission proposed an amendment to cure the deficiencies existing in connection with non-registered securities.<sup>159</sup> The Commission did not then press for immediate legislative action, but it has recently asked for separate consideration of the proposal, which is now embodied in the Frear Bill.<sup>160</sup> Currently the bill is before the Senate Banking and Currency Committee, after hearings before a subcommittee.<sup>161</sup> By way of general summarization, the bill would add a new subsection (g) to Section 12 of the Exchange Act, requiring companies engaged in interstate commerce, or in business affecting interstate commerce, or the securities of which are regularly traded in interstate commerce, to register with the Commission such of their securities as are not registered on an exchange. Such companies would file periodic reports similar to those filed in respect of securities registered on an exchange, and their securities would be subject to the provisions of Exchange Act Sections 14 and 16 whether or not a registration statement has been filed.

Issuers subject to the proposed amendment would be those having at least \$3,000,000 in assets and at least 300 security holders. The amendment is qualified by certain exemptions, among them being a provision making Section 14 inapplicable to any solicitation in respect of an unlisted security held by fewer than 300 persons. Another provision safeguards corporate action by exempted companies from any

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157. *Id.* The 1950 supplemental report by the SEC places the figure at 1,118 companies which are not presently filing with the Commission and 648 companies which file some but not all of the reports required by the Commission. See Exchange Act Release No. 4399, *supra* note 150.

158. *Id.* at 17-20 *et seq.* The report supplementing the 1946 survey "indicates that the need for legislation has not diminished since 1946. . . . [T]here appears to have been no significant change since 1946 in the reporting and proxy soliciting practices of the corporations which would be affected by the proposal."

159. *Id.* at 31, 32. The New York Exchanges have gone on record in the past in support of a program comparable to the present proposal. See REPORT OF THE SEC ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, House Committee Print, 77th Cong., 1st Sess. 35 (1941).

160. S. 2408, introduced August 8, 1949. A companion bill, H.R. 7005, was introduced in the house on January 26, 1950.

161. See *Hearings on S. 2408 before the Subcommittee of the Senate Committee on Banking and Currency*, 81st Cong., 2d Sess. (Feb. 7-10, 1950); *Wall Street Journal*, Feb. 8, 1950, p. 4, col. 3.

cloud of invalidity that might otherwise result from a violation of Section 14.

The Frear Bill presents a necessary adjunct to the present regulation of proxy solicitation, as well as a necessary enlargement of the application of Sections 12, 13 and 16 to all large, publicly-held companies. The proposed amendment, as drafted, should not create substantial additional burdens to the new companies encompassed by the amendment.<sup>162</sup> And such burdens as are added will be substantially outweighed by the significant advancement in corporate democracy embodied in the bill.

The Frear bill does not remove all the limitations in Section 14 and Regulation X-14 which, in many cases, still prevent security holders adequate information. Section 14 and Regulation X-14 require the submission of a proxy statement only when proxies are solicited. And Regulation X-14 does not, in most cases, prescribe the form and content of, or the information to be included in, the annual report and financial statements which must accompany the proxy statement. Some managements control sufficient voting stock to obtain a quorum at the annual meeting and therefore do not have to solicit proxies.<sup>163</sup> Other managements, although not controlling a quorum, may simply fail to solicit proxies with the result that a quorum is not obtained and they are continued in office by default,<sup>164</sup>

The larger percentage of managements who do solicit proxies may still not be affording their security holders a complete picture of the company's condition and results of its operations. An annual report containing a financial statement must be sent to the security holder in addition to the proxy statement if directors are to be elected at the annual meeting.<sup>165</sup> Since an election of directors is included in a very large percentage of annual meetings, the regulations require that security holders receive a financial statement in most cases.<sup>166</sup> But the regulation does not prescribe the information to be given in the annual report, nor the form and content of the financial statement. The annual report and financials are not even subject to the fraud provisions of the regulation or the Exchange Act.<sup>167</sup> Thus, even if listed com-

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162. REPORT OF THE SEC, *op. cit. supra* note 150, states that 85 per cent of the financial statements contained in the annual reports of 119 non-registered companies surveyed were certified by public accountants. Generally speaking, certification is a representation of adequate records to support the summary statement certified. The companies all had total assets of over \$3,000,000 and more than 300 stockholders.

163. Some corporation acts almost eliminate quorum difficulties. See, *e.g.*, OHIO GEN. CODE § 8623-48 (Page, 1949).

164. See REPORT OF THE SEC, *supra* note 159, at 35.

165. X-14A-3(b).

166. See note 81 *supra*.

167. See pages 652-4 *supra*. X-14A-3(b) provides in part, that security holders shall be sent an annual report, "containing such financial statements . . . as will, in the opinion



panies, and, with the passage of the Frear Bill, almost all other large, publicly held companies, have to file annual and interim reports with the Commission, there is no assurance that such information will get to their security holders.<sup>168</sup>

In 1941 the Commission recommended to Congress that Section 14 of the Exchange Act be amended to require, among other things, that issuers submit to their security holders, prior to annual meetings, the information required by the proxy rules.<sup>169</sup> This proposal would obviate the difficulty presented by managements who refuse to solicit proxies in order to avoid sending security holders a proxy statement. But it would not insure an adequate annual report or financial statement.

The mandate of full disclosure would seem to indicate, therefore, that the regulations be amended to provide that the annual report and financial statement disseminated in connection with annual meetings follow the general requirements of Form 10-K which in general prescribes the content of annual reports required of most listed companies.<sup>170</sup> The result would be, of course, that the form and content of the financial statement would be governed by the Commission's accounting regulation, Regulation S-X.

The non-financial information afforded by the proxy statement, while adequate in itself, is in many instances only required to be given if a certain item of business is to be considered at the annual meeting. Yet other matters may be relevant as a matter of good stewardship. Some managements might wish merely to send security holders copies of their Form 10-K, plus such other information as the proxy regulation requires. Others might wish to supplement their proxy statement with such basic Form 10-K non-financial information as the Commission may deem necessary to insure adequate disclosure in the annual report. In any event a synthesis of requirements should, of course, be established so that multiple reporting may be avoided.

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of management, adequately reflect the financial position and operations of the issuer. Such annual report, including financial statements, may be in any form deemed suitable by management."

168. See the criticism of the inadequate financial statements contained in the annual reports of 119 large, non-registered companies in *REPORT OF THE SEC*, *op. cit. supra* note 150, at 10-16, and Appendix C. For a similar criticism of the financials in the 1937 annual reports of 70 registered companies, see *KAPLAN & REAUGH, Accounting, Reports to the Stockholders, and the SEC*, 48 *YALE L.J.* 935 (1939).

169. See *REPORT OF THE SEC*, *op. cit. supra* note 159.

170. See §§ 12, 13, and 15(d) of the Exchange Act. Section 12 provides that any company desiring to list its securities on an exchange must file with the Commission and with the exchange an application on Form 10 containing financial and other information deemed sufficient for intelligent investor action. This information is kept up to date by the requirement of filing current and quarterly reports on Forms 8-K and 9-K, and an annual report on Form 10-K. See Exchange Act §§ 13 and 15(d). Financial statements accompanying these reports are governed as to form and content by the accounting regulation, S-X.

Aside from the financial statements, any adequate annual report should contain, at the least, such basic Form 10-K information as that dealing with parents and subsidiaries of the registrant (Item 2 of 10-K); material changes in business (Item 3); developments in pending proceedings (Item 4); names and addresses of directors and officers (Item 5); business experience (not previously reported) of executive officers (Item 6); indemnification of directors and officers (Item 7); intent of management in material transaction (Item 10); and information as to outstanding options, warrants, or rights (Item 13). The other items of Form 10-K are dealt with in Regulation X-14 itself, although usually the information required by the Regulation is less complete than that specified in Form 10-K.<sup>171</sup>

Accompanying this amendment relating to annual reports and financials, there should be a companion amendment repealing the provisions of X-14A-3(c) which operate to remove them from the fraud provisions of X-14A-9 and the civil liabilities of Section 18 of the Exchange Act. There should be not only full disclosure, but also full responsibility for the truthfulness or falsity of the disclosures made by management as fiduciaries to the owners of the business, the security holders.

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171. In the instance of unregistered gas and electric companies, the information should be generally comparable to that contained in the annual reports filed with the Commission by utility companies registered under the Holding Company Act.

### COMMUNICATION

"In my article 'Natural Law and Natural Rights,' in the January issue of the *Yale Law Journal*, I referred on page 236 to Heinrich Rommen, *Die Ewige Wiederkehr des Naturrechts*. This book was written during Nazi domination. It contained nothing that was contrary to Nazi theory, but also nothing that supported it. Rommen, however, was not a Nazi, but a Catholic Socialist. He was briefly arrested by the Nazis but soon released. A second and enlarged edition of his book, published in 1947, gives a fuller statement of his views. It is only fair to make this correction."

—MAX RADIN

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