Buffalo Law Review

Volume 33 | Number 1 | Article 8

1-1-1984

SEC Rule 14a-8: New Restrictions on Corporate Democracy?

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INTRODUCTION

RULE 14a-8,[1] the shareholder proposal rule promulgated by the Securities and Exchange Commission under Section 14(a) of the Securities Exchange Act of 1934,[2] has become one of the most interesting and controversial agency rules of the last decade.[3] Briefly, Rule 14a-8 requires the management of a corporation to include in its proxy materials any proposal submitted to it

1. 17 C.F.R. § 240.14a-8 (1984). The predecessor to Rule 14a-8 was Rule X-14A-7, which first required corporate management to include in its proxy materials any nonmanagement proposal that was a "proper subject for action by the security holders." Rule X-14A-7, 7 Fed. Reg. 10,656 (1942). Since 1947 it has been called Rule 14a-8, providing shareholders of public companies the right to have their proposals presented to the company's body of shareholders at little or no expense to the proponent. 17 C.F.R. § 240.14a-8 (1984).

2. 15 U.S.C. §§ 78a-78kk (1982). Section 14(a) authorizes the SEC to prescribe those rules or regulations "necessary or appropriate in the public interest or for the protection of investors . . . . " 15 U.S.C. § 78n(a) (1982).

3. Rule 14a-8 has been the subject of a continuous debate since its inception in 1942. Legal commentators have struggled to define an appropriate balance between the management and shareholder interests protected by the rule. One group of writers has taken an expansive, liberal view of the rule, arguing that the shareholder interest in maintaining an effective voice in the corporate governing process should be paramount to other interests. *See generally* Emerson & Latcham, *The SEC Proxy Proposal Rule: The Corporate Gadfly*, 19 U. CHI. L. REV. 807 (1952); Schwartz & Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 635 (1977); Propp, *The SEC's Shareholder Proposal Rule: Corporate Accountability at a Crossroads*, 11 SEC. REG. L.J. 99 (1983); Curzan & Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670 (1980); Comment, *Shareholder Democracy: A Description and Critical Analysis of the Proxy System*, 60 N.C.L. REV. 145 (1981) [hereinafter *Shareholder Democracy*]. Other commentators have held a more restrictive view, arguing that the shareholder proposal rule should have reasonable limitations on its use so as to reduce the cost and overall burden of the rule. *See generally* Manne, *Shareholder Social Proposals Viewed By An Opponent*, 24 STAN. L. REV. 481 (1972); Black & Sparks, *SEC Rule 14a-8: Some Changes in the Way the SEC Staff Interprets the Rule*, 11 U. TOL. L. REV. 957 (1980); Note, *Proxy Rule 14a-8: Omission of Shareholder Proposals*, 84 HARV. L. REV. 700 (1971). For a general discussion of other aspects of the shareholder proposal rule, see Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489 (1970); Note, *The SEC and "No-Action" Decisions Under Proxy Rule 14a-8: The Case for Direct Judicial Review*, 84 HARV. L. REV. 835 (1971); Comment, *SEC Shareholder Proposal Rule 14a-8: Impact of the 1972 Amendments*, 61 GEO. L.J. 781 (1973) [hereinafter *SEC Shareholder Proposal Rule 14a-8*].

by a record or beneficial owner of voting stock in the company, unless the proponent fails to satisfy the rule's eligibility and procedural criteria[4] or the content of the proposal falls within one of

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4. Paragraph (a) of Rule 14a-8 delineates certain eligibility and procedural requirements which must be satisfied by a proponent in order to present a resolution to corporate management for inclusion in the proxy materials. The provision states, in relevant part:

> (1) *Eligibility.* [i] At the time he submits the proposal, the proponent shall be a record or beneficial owner of at least 1% or $1,000 in market value of securities entitled to be voted at the meeting and have held such securities for at least one year, and he shall continue to own such securities through the date on which the meeting is held. If the issuer requests documentary support for a proponent's claim that he is a beneficial owner of at least $1,000 in market value of such voting securities of the issuer or that he has been a beneficial owner of the securities for one or more years, the proponent shall furnish appropriate documentation within 14 calendar days after receiving the request. In the event the issuer includes the proponent's proposal in its proxy soliciting materials for the meeting and the proponent fails to comply with the requirement that he continuously hold such securities through the meeting date, the issuer shall not be required to include any proposals submitted by the proponent in its proxy materials for any meeting held in the following two calendar years.
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> (2) *Notice and Attendance at the Meeting.* At the time he submits a proposal, a proponent shall provide the issuer in writing with his name, address, the number of the issuer's voting securities that he holds of record or beneficially, the dates upon which he acquired such securities, and documentary support for a claim of beneficial ownership. A proposal may be presented at the meeting either by the proponent or his representative who is qualified under state law to present the proposal on the proponent's behalf at the meeting. In the event that the proponent or his representative fails, without good cause, to present the proposal for action at the meeting, the issuer shall not be required to include any proposals submitted by the proponent in its proxy soliciting material for any meeting held in the following two calendar years.
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> (3) *Timeliness.* The proponent shall submit his proposal sufficiently far in advance of the meeting so that it is received by the issuer within the following time periods:
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> [i] *Annual Meetings.* A proposal to be presented at an annual meeting shall be received at the issuer's principal executive offices not less than 120 days in advance of the date of the issuer's proxy statement released to security holders in connection with the previous year's annual meeting of security holders, except that if no annual meeting was held in the previous year or the date of the annual meeting has been changed by more than 30 calendar days from the date contemplated at the time of the previous year's proxy statement, a proposal shall be received by the issuer a reasonable time before the solicitation is made.
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> (4) *Number of Proposals.* The proponent may submit no more than one proposal and an accompanying supporting statement for inclusion in the issuer's proxy materials for a meeting of security holders.

17 C.F.R. § 240.14a-8(a) (1984).

the substantive exclusions enumerated in the rule.[5] Since 1970,

5. Paragraph (c) of the Rule sets forth thirteen substantive grounds upon which management may rely in omitting shareholder proposals from its proxy materials. The provision states, in pertinent part:

> The issuer may omit a proposal and any statement in support thereof from its proxy statement and form of proxy under any of the following circumstances:
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> (1) If the proposal is, under the laws of the issuer's domicile, not a proper subject for action by security holders. . . .
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> (2) If the proposal, if implemented, would require the issuer to violate any state law or federal law of the United States, or any law of any foreign jurisdiction, to which the issuer is subject, except that this provision shall not apply with respect to any foreign law compliance with which would be violative of any state law or federal law of the United States.
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> (3) If the proposal or the supporting statement is contrary to any of the Commission's proxy rules and regulations, including Rule 14a-9 [17 C.F.R. 240.14a-9], which prohibits false or misleading statements in proxy soliciting materials;
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> (4) If the proposal relates to the redress of a personal claim or grievance against the issuer or any other person, or if it is designed to result in a benefit to the proponent or to further a personal interest, which benefit or interest is not shared with the other security holders at large;
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> (5) If the proposal relates to operations which account for less than 5% of the issuer's gross assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business;
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> (6) If the proposal deals with a matter that is beyond the issuer's power to effectuate;
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> (7) If the proposal deals with a matter relating to the conduct of the ordinary business operations of the issuer;
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> (8) If the proposal relates to an election to office;
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> (9) If the proposal is counter to a proposal to be submitted by the issuer at the meeting;
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> (10) If the proposal has been rendered moot;
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> (11) If the proposal is substantially duplicative of a proposal previously submitted to the issuer by another proponent, which proposal will be included in the issuer's proxy materials for the meeting;
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> (12) If the proposal deals with substantially the same subject matter as a prior proposal submitted to security holders in the issuer's proxy statement and form of proxy relating to any annual or special meeting of security holders held within the preceding 5 calendar years, it may be omitted from the issuer's proxy materials relating to any meeting of security holders held within 3 calendar years after the latest such previous submission: *Provided That*
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> (i) If the proposal was submitted at only one meeting during such period, it received less than five percent of the total number of votes cast in regard thereto; or
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> (ii) If the proposal was submitted at only two meetings during such preceding period, it received at the time of its second submission less than eight percent of the total number of votes cast in regard thereto; or
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> (iii) If the proposal was submitted at three or more meetings during such preceding period, it received at the time of its latest submission less than 10 per-

many shareholders have used Rule 14a-8 to raise social responsibility issues at annual meetings, often drawing the attention of the media and the scorn of the corporate community.[6] Churches, public interest groups, unions, and several institutional investors have exercised their rights as shareholders to place more than 100 social and political resolutions a year on corporate proxy statements.[7] Their proposals have raised popular social responsibility issues such as the use of nuclear power, the disposal of toxic waste, and the morality of commercial investment in South Africa, as well as a host of other issues such as trade with communist coun-

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cent of the total number of votes cast in regard thereto; or

(13) If the proposal relates to specific amounts of cash or stock dividends.

17 C.F.R. § 240.14a-8(c) (1984).

6. The genesis of the "social responsibility" proposal essentially began with the first Campaign to Make General Motors Responsible, in 1970. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 421-23 (1971). Since then, the variety of social issues proposed by stockholders has been diverse. In 1984, for example, the following issues were raised: corporate activities in South Africa, Rhodesia, Chile and the European communist countries; illegal corporate payments abroad; corporate political contributions and operations; equal employment opportunity; the world debt crisis; the disposal of toxic waste; corporate environmental policy; the use of nuclear power; computer contracts with the Soviet Union; the exposure of workers to toxic substances; media images of women and minorities; and the morality of genetic engineering—to name just a few. Corp. Examiner, Spr. 1984 (Interfaith Center on Corp. Responsibility newsletter).

According to the American Society of Corporate Secretaries, Inc. (hereinafter ASCS), a professional association which tracks shareholder proposals submitted to U.S. corporations for inclusion in corporate proxy statements, 870 shareholder proposals were submitted to 345 ASCS member and non-member corporations during the period of July 1, 1982 to June 30, 1983. Issuers contested 336 of these proposals by formally requesting the SEC to agree not to challenge the exclusion of these proposals, i.e., to issue an SEC no-action letter. The SEC granted such requests for 215, or 63% of the contested proposals. Am. Soc'y of Corp. Secretaries, *Report on Shareholder Proposals* 5 (1983).

Of the 870 proposals submitted for vote, ASCS compiled the following topical breakdown: 117 proposals on security issuance and stockholder's rights; 145 on directors and directors' meetings; 19 on auditors and accounting procedures; 8 on energy (non-nuclear) issues; 97 on compensation and benefit plans; 48 on nuclear power; 97 on foreign involvement; 79 on management and employees; 39 on corporate contributions; 94 on annual meetings and proxy material; 10 on environmental policy; 78 on public responsibility issues; 28 on political issues; and 11 miscellaneous proposals. *Id.* at 6.

7. According to the Investor Responsibility Research Center (hereinafter IRRC), an organization which tracks social responsibility proposals, the number of these proposals has remained relatively constant over the past several years. The IRRC reported: 133 proposals in 1976; 113 proposals in 1977; 95 proposals in 1978; 98 proposals in 1979; 108 proposals in 1980; 124 proposals in 1981; 109 proposals in 1982; and 111 proposals in 1983. C. Richardson, How Institutions Voted on Shareholder Resolutions in the 1983 Proxy Season 3 (Sept. 1983) (IRRC report) [hereinafter cited as IRRC Report].

tries, human rights, equality, and consumer protection.[8]

Until recently, the Securities and Exchange Commission viewed the proliferation of social and political shareholder resolutions without much concern or anxiety. The Commission had, prior to the recent rulemaking initiative, liberally interpreted the rule to explicitly confirm shareholders' rights to raise corporate issues through the medium of proxy materials.[9] The recent tendency to use the rule for the promotion of social and political issues meshed well with this liberal administrative posture and the Commission's desire to enhance corporate accountability and disclosure generally.[10] The SEC thus viewed the proposal mechanism as simply one instrument to adjust and tune a corporate structure which had become deficient in responding to social issues.[11]

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8. Although South Africa and anti-nuclear issues continue to outnumber all other types of proposal issues, there has been a significant increase in the number of conservative-sponsored resolutions in recent years. In 1981, for example, more than 25 companies received anti-communist resolutions. Most of them requested the company to adopt a "no trade" policy with European communist countries. One proposal, made to General Motors, called for a policy of ascertaining the number of avowed communists on the faculty of colleges before making donations to those schools. Other conservative proposals have included: I.B.M. Corp., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,009 (Feb. 2, 1979) (proposal seeking to amend the articles of incorporation to require the company to avoid business dealings with communist countries); Gager, Henry & Narkis, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,045 (Apr. 20, 1979) (recommendation that the company seriously consider a sale or merger of the company for at least $36/share) and Mobil Corp., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,832 (Feb. 26, 1981) (proposal requesting board to inform shareholders of all aspects of company's business in communist countries). *See also supra* note 6.

9. *See infra* notes 25-80 and accompanying text.

10. The proxy rules were originally based on the philosophy of "disclosure," the hallmark of the federal securities laws. *See infra* notes 25-39 and accompanying text. However, the Commission has acknowledged that Rule 14a-8 was also designed to enhance corporate accountability. The SEC once noted:

> Recent disclosures concerning a wide variety of questionable and illegal corporate practices, accomplished in certain instances with the knowledge and participation of top corporate management, have served to focus public attention on corporate accountability. A number of proposals designed to achieve a new "corporate governance," have been suggested. . . . The SEC, through its jurisdiction over proxy solicitations . . . recognizes that under existing regulations shareholders often may not be provided adequate opportunities to participate meaningfully in corporate governance or the corporate electoral process.

Securities Exchange Act Release No. 34-13482, 42 Fed. Reg. 23,901 (1977).

11. This position is illustrated by statements made by the SEC in a 1980 Staff Report. In this Report, the SEC recognized that the shareholder proposal rule may serve many functions: shareholder resolutions sensitize management to issues which it might otherwise ignore; the rule offers management an inexpensive device for listening to stockholder expression; and the resolution process provides a "means of questioning a management which

The SEC commitment to Rule 14a-8 rarely faltered, despite the fact that the shareholder proposal rule underwent a number of revisions and interpretations since its inception in 1942. Each regulatory response revealed the Commission's ability to maintain a fair balance between two competing interests: the management interest in an inexpensive, non-confrontational solicitation process, and the shareholder interest in maintaining an effective voice in the corporate governing process.[12] The administrative history of Rule 14a-8 is a testimonial to the SEC's effectiveness in preserving this delicate balance while simultaneously encouraging the liberal use of the rule.[13]

The placid tradition of the shareholder proposal rule was upset in 1970, when the public policy resolution became widely recognized as an effective instrument to facilitate shareholder participation in the control of the corporate enterprise.[14] As the number of social and political resolutions increased to new levels, many commentators became sharply critical of the Commission's effectiveness in maintaining the balance between management and shareholder interests.[15] The corporate community criticized the SEC for providing open access to the proxy rules for shareholders that were more interested in social issues than the business of the corporation.[16] The argument was that the mere submission of

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otherwise might tend to become self-seeking, ingrown and autocratic." DIV. OF CORP. FIN., SEC. & EXCH. COMM'N, STAFF REPORT ON CORPORATE ACCOUNTABILITY, 96TH CONG., 2D SESS. 136-37 (Comm. Print 1980)[hereinafter cited as STAFF REPORT]. *See also supra* note 10.

12. *See* Schwartz & Weiss, *supra* note 3, at 638; Comment, *Shareholder Democracy, supra* note 3, at 159; Black & Sparks, *The SEC as Referee—Shareholder Proposals and Rule 14a-8*, 2 J. CORP. L. 1 (1976).

13. *See infra* notes 25-80 and accompanying text.

14. *See supra* note 6.

15. *See* Schwartz & Weiss, *supra* note 3, at 638.

16. This argument has been made repeatedly by a number of corporations in their comments on SEC revisions of Rule 14a-8. In 1976, Union Carbide, commenting on the amendments to the Rule, made the following statement:

> [W]e would like to express at the outset our disappointment that the Commission has not dealt in the proposed amendments with a problem that is of growing concern to most stockholders. This is the increasingly common practice of individuals or groups having special interests—not related to the general welfare of either the corporation or the majority of its stockholders in their status as stockholders—obtaining an unfair share of the attention of management and shareholders. They even may do this by purchasing a few shares of stock several months before a corporation's annual meeting in order to qualify for submission of a proposal for consideration at the meeting. They may also do so by obtaining a proxy from an institutional holder. Their primary purpose is

these proposals, which were supported by only a small minority of shareholders, required considerable expenditures by the corporation to include them in proxy materials, an expense borne primarily by the majority.[17]

In response to mounting pressure from the business community and in order to ease the Commission's own burden of interpreting the new public policy shareholder proposals,[18] the SEC recently revised Rule 14a-8 to limit investor access to the proxy machinery.[19] In addition to placing stricter eligibility requirements on shareholders wishing to submit proxy proposals, the amendments deal with procedural changes, alter staff positions on exclusions, and extend some filing deadlines.[20] Nearly all of the revisions give issuers greater interpretative latitude to exclude shareholder proposals.

The new changes have drawn a split reaction from the public. The business community has generally applauded the revisions because they restrict shareholder access to the proposal process.[21]

> to obtain a forum for airing their views on a frequently narrow subject. Most such proposals are supported by the votes of only a tiny percentage of stockholders at the meeting, which not only dismays disinterested stockholders but more importantly, restricts the time available to deal with topics that are of major concern to the majority. The mere submission of the proposal also leads to considerable expenditures by the corporation to include it in its proxy material, an expense borne primarily by the majority.

Letter from John F. Shanklin, Vice-President and Secretary, Union Carbide Corp., to George F. Fitzsimmons, Secretary, SEC (Sept. 7, 1976) (SEC File No. S7-643), *quoted in* Schwartz & Weiss, *supra* note 3, at 638 n.16. For a discussion of past corporate efforts to pressure the SEC for a revision of the rule, see Propp, *supra* note 3, at 108.

17. Schwartz & Weiss, *supra* note 3, at 638 n.16.

18. Besides establishing the ground rules for the shareholder proposal process, the SEC also plays an active role in administering the rule. The SEC's Division of Corporate Finance must resolve numerous disputes between proponents and companies over whether a resolution has complied with the procedural requirements and has avoided one of the thirteen exclusions. The staff's decision is communicated to both parties in the form of a no-action letter. Court decisions in Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970) and in Kixmiller v. SEC, 492 F.2d 641 (D.C. Cir. 1974) have compelled the Commission not to review a staff no-action letter so as to avoid creating reviewable agency action.

19. In choosing to recast existing regulations, the Commission rejected two more sweeping proposals which would have in one case allowed companies and their shareholders to adopt their own procedures on the submission of proxy proposals and, in the other, required the inclusion of any proposal proper under state law except for election of directors. Securities Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 (1983).

20. *Id.*

21. *See, e.g.*, O'Connell, *Legitimate Voices Will Still Be Heard*, N.Y. Times, Sept. 4, 1983,

The new rule, it is argued, will reduce corporate expenditures associated with proxy materials and ease management frustration with being repeatedly second-guessed by their shareholders.[22] In direct contrast, socially-conscious investors and activist organizations have assailed the new changes as an effort by the SEC, under the direction of the business community, to employ arbitrary eligibility qualifications to limit shareholder participation in corporate governance.[23] These stockholders, lacking any other means to influence corporate decisions, have regarded Rule 14a-8 as a bastion of corporate democracy.[24]

To some outside observers, Rule 14a-8 may appear to be a relatively modest provision in the federal securities laws. But to management and shareholders, the rule goes to the heart of corporate law— affecting the fundamental relationship of shareholders and management to each other and to the corporation. Viewed from this perspective, the Commission's new amendments have raised serious questions about the extent to which shareholders should participate in corporate governance.

This Comment will examine the impact of the new rule on the ability of shareholders to use the proxy as a forum for social and political dialogue. Section I delineates the historic legitimacy of Rule 14a-8, demonstrating that the Congress, the courts, and the SEC have all viewed the rule as an indispensable utilitarian mechanism for shareholder influence on corporate decisionmaking. Section II examines the circumstances which initiated reform of the proposal rule, the objectives of the subsequent rulemaking proceeding, and the reasons for the final selection of the rule revisions. Section III then demonstrates that the Commission's final adoption of the new rule was based on: (1) the fallacy that there was an "abuse" of the proposal process in recent years; and (2) the mistaken belief that the rule revisions could materially reduce the costs associated with the proposal process. Some of the theoretical problems raised by the new Rule 14a-8 are also discussed. An im-

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§ 3, at 2, col. 3.

22. *Id.*

23. Lydenberg, *A Setback for Corporate Democracy*, N.Y. Times, Sept. 4, 1983, § 3, at 2, col. 3.

24. The stockholder proposal process has been recognized as providing a forum for dissent that many believe is essential to the successful functioning of corporations in a democratic society. Schwartz & Weiss, *supra* note 3, at 635.

portant theme runs through this entire discussion: the Commission's new attitude on the shareholder proposal process is a radical departure from past SEC policy and, as such, raises serious and alarming questions regarding the future vitality of corporate democracy.

I. THE HISTORIC LEGITIMACY OF THE SHAREHOLDER PROPOSAL RULE

A. *The Corporate Democracy Mandate*

The SEC promulgated the shareholder proposal rule in 1942 pursuant to Section 14(a) of the Securities Exchange Act of 1934.[25] This section gives the SEC broad authority to regulate the solicitation of proxies "as necessary or appropriate in the public interest or for the protection of investors."[26] Although Congress primarily designed the proxy legislation to require disclosure of relevant information and to prohibit the use of fraudulent market activities, the legislative history of section 14(a) reveals that members of Congress were also concerned with the preservation of corporate democracy as a concept.[27]

The widening divergence between the ownership of corporations and the management of these entities had raised concern in Congress about the potential abuse of corporate power.[28] Manage-

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25. 15 U.S.C. §§ 78a-78kk (1982).

26. Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1982).

27. Professor Loss noted that the SEC's "power under § 14(a) is not necessarily limited to ensuring full disclosure . . . [a]nd some of the rules do not fit into the disclosure mold . . . ." 2 L. LOSS, SECURITIES REGULATION 868 (2d ed. 1961). As one Congressman explained:

> Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies.

H.R. REP. No. 1383, 73d Cong., 2d Sess. 5, 13-14 (1934). *See* Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), where the court stated "it is obvious to the point of banality to restate the proposition that Congress intended by its enactment of section 14 of the Securities Exchange Act of 1934 to give true vitality to the concept of corporate democracy." *See also* Klaus v. Hi-Shear Corp., 528 F.2d 225 (9th Cir. 1975); SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948). For a discussion of the varied purposes of the proxy legislation, see Loomis & Rubman, *Corporate Governance in Historical Perspective*, 8 HOFSTRA L. REV. 141, 170-71 (1979).

28. The House of Representatives noted:

> Even those who in former days managed great corporations were by reason of

ment would, it was feared, seek to perpetuate itself by the misuse of corporate proxies when divorced from the responsibilities of ownership. Prior to 1934, many corporate officers solicited stockholder's proxies without telling the stockholders what matters would be considered at the annual meeting.[29] Management later used these proxies at the meeting for a variety of questionable purposes.[30] To eliminate the problems caused by the ownership-management divergence, Congress gave the SEC broad regulatory power to prevent "the recurrence of abuses which [had] frustrated the free exercise of the voting rights of stockholders."[31] The Commission was also directed to promote "fair corporate suffrage" as a fundamental principle of corporate governance.[32]

The Securities and Exchange Commission, acting pursuant to the congressional mandate for corporate democracy, promptly adopted rules which required management to provide shareholders with adequate notice of all matters it intended to bring before the shareholders' meeting.[33] These rules were later expanded to prevent management from stating that there would be no other matters before the meeting if, in fact, management had already been informed by a shareholder of his intention to introduce a resolution from the floor.[34] Although these provisions gave a shareholder a legal right to introduce a proposal at the annual meeting, the proponent often lacked support for a resolution since it was being introduced for the first time and because only a small percentage of stockholders ever attended these meetings.[35]

> their personal contacts with their shareholders constantly aware of their responsibilities. But as management became divorced from ownership and came under the control of banking groups, men forgot that they were dealing with the savings of men and the making of profits became an impersonal thing. When men do not know the victims of their aggression they are not always conscious of their wrongs . . . .

H.R. REP. No. 1383, 73d Cong., 2d Sess. 5 (1934).

29. *Id.* One congressman noted: "Too often proxies are solicited without explanation to the shareholder of the real nature of the matters for which authority to cast his vote is sought." S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934).

30. H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934).

31. *Id.* at 14.

32. *Id.* at 13.

33. Schwartz & Weiss, *supra* note 3, at 636 & n.7 (citing S.E.C. Rules LA-1 to LA-7, Securities Exchange Act Release No. 34-378 (Sept. 24, 1935)).

34. Schwartz & Weiss, *supra* note 3, at 636 & n.8 (citing S.E.C. Rule X-14A-2, Securities Exchange Act Release No. 34-1823 (Aug. 11, 1938)).

35. *See* Freeman, *An Estimate of the Practical Consequences of the Stockholders' Proposal*

It is evident that shareholder resolutions could have secured greater support if the proposals had been included in the company proxy materials. Unfortunately, the agency rules did not recognize this form of shareholder communication.

In 1938, the Commission addressed the issue of whether the full disclosure policy of the proxy rules could require the management of a corporation to include shareholder resolutions in the proxy materials. The staff concluded that the underlying premise of the securities laws required the inclusion of these proposals.[36] In so doing, the SEC implicitly stated that the proxy rules were based not only on the disclosure and fraud rationales, but also on theories of corporate governance and shareholder democracy.[37] In fact, the Commission itself once noted that its proxy rules were "probably the most useful of all the disclosure devices established by our various acts and represent an effective contribution to corporate democracy."[38] These revelations on the relationship between Rule 14a-8 and corporate governance are essential to an understanding of the current debate.[39]

B. *The Early Development of Rule 14a-8*

The SEC's interpretation of the proxy rule as including notions of corporate democracy was formally codified in 1942 when

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Rule, 34 U. DET. L.J. 549, 553 (1957).

36. According to one commentator:

> [T]he Securities and Exchange Commission interpreted Regulation X-14 as meaning (a) that if a stockholder has notified the management prior to the time the management has sent out its proxy material that the stockholder proposes to offer a resolution at the annual meeting on some subject which falls generally within the province in which a stockholder may properly propose resolutions . . . and (b) that if the management makes no mention of such proposal in its proxy statement . . . the proxy statement . . . is false or misleading. . . .

Dean, *Non-Compliance with Proxy Regulations—Effect on Ability of a Corporation to Hold Valid Meeting*, 24 CORNELL L.Q. 483, 499-500 (1939). The SEC also relied on the language of section 14, noting that it was empowered to regulate not just the solicitation of proxies but also the "conditions" under which proxies were solicited. H.R. REP. No. 1383, 73d Cong., 2d Sess. 14 (1934).

37. The dual philosophy which underlies the proxy rules has been recognized by several legal commentators. *See* Propp, *supra* note 3, at 102; Manne, *supra* note 3, at 484; Schwartz & Weiss, *supra* note 3, at 638; Loomis & Rubman, *supra* note 27, at 170-71.

38. REPORT OF THE SEC, PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES, H.R. DOC. No. 672, 79th Cong., 2d Sess. 18 (1946).

39. Manne, *supra* note 3, at 484.

the Commission adopted Rule X-14A-7,[40] the predecessor to the modern shareholder proposal rule. The regulation required management to include within its proxy statement, and to provide all shareholders with an opportunity to vote on, any proposed shareholder resolution that constituted "a proper subject for action by the security holders."[41] The "proper subject" standard was designed to invoke the substantive state criteria for delineating the authority of the board and shareholders.[42]

Initially, the interpretation of the "proper subject" test of Rule X-14A-7 was problematic. Most state corporation statutes had already conferred significant powers on the board of directors to manage the general affairs of the business at the expense of shareholder power.[43] Although these statutes required the initiative for major corporate activities to come from the board rather than the stockholders, the statutes did not necessarily preclude independent stockholder action in all areas of corporate activity.[44] The problem, however, was that very few cases had enumerated those areas that fell within the realm of stockholder control or initiative.[45] The paucity of state law, both statutory and decisional, compelled the SEC to develop its own administrative guidelines regarding when a proposal was a "proper subject for action by security holders." These guidelines often made staff interpretative decisions (i.e. whether or not to exclude a given proposal) dependent on the *form* of the proposal rather than its substantive content.

A clear illustration of this formalistic approach was the staff's development of a "by-laws" exception to the proper subject test. The SEC recognized that nearly all state corporation statutes grant shareholders the right to amend corporate by-laws.[46] A

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40. S.E.C. Rule X-14A-7, Securities Exchange Act Release No. 34-3347, 7 Fed. Reg. 10, 655-56 (1942).

41. *Id.*

42. *Id.*

43. The corporation law of Delaware, for example, states: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation . . . ." DEL. CODE ANN. tit. 8, § 141(a) (1983).

44. *See, e.g.*, SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

45. *See* Black & Sparks, *supra* note 3, at 965-66.

46. Traditionally, the power to make and amend by-laws has been vested in the shareholders. As the Supreme Court has stated: "[The p]ower to prescribe rules for the govern-

shareholder proposal which was cast in the "form" of a by-law amendment thus became eligible for inclusion in the proxy material even though the proposal was substantively not a "proper subject" under state law.[47] The same administrative approach was used to justify the inclusion of "precatory proposals" as well. The SEC recognized the principle that shareholders are entitled to give nonbinding advice to the board on matters that are within the authority of the board.[48] A proposal that was improper under applicable state law when framed as a mandate or directive, thus became eligible for inclusion when framed as a recommendation or request.[49] Both the "by-laws" and "precatory proposal" exceptions demonstrate that the Commission's interpretative posture was frequently contingent upon the *form* of the proposal and not its *content*. It was precisely this type of administrative creativity, however, which enabled the SEC to encourage the liberal vitality of the proxy rules while remaining deferential to the force of state

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ment of business corporations reasonably is deemed an incident of ownership and the voting power of the shares." Rogers v. Hill, 289 U.S. 582, 588 (1933).

Some modern statutes have recognized, however, that the shareholder power to make or amend by-laws can become inconvenient in large corporations with many shareholders. The legal necessity of waiting until the annual shareholders' meeting or calling a special meeting before making any change in the by-laws is impractical when time is of the essence. Accordingly, many state statutes now provide that the directors may make or amend by-laws—either exclusively or contingent upon shareholder rights. *See, e.g.*, N.Y. BUS. CORP. LAW § 601 (McKinney Supp. 1982-83).

47. *See* Black & Sparks, *supra* note 3, at 966. *See also* Kapp & Bancroft, *No-Action Letter Highlights*, 3 SEC. REG. L.J. 71, 73-80 (1975).

48. The SEC recognized the special nature of precatory proposals shortly after the decision in Auer v. Dressel, 306 N.Y. 427, 118 N.E.2d 590 (1954). *Auer* stands for the proposition that shareholders are entitled to give nonbinding advice to the board on matters that are within the authority of the board. *See id.* Subsequently, a note to subparagraph (c)(1) of Rule 14a-8 stated: "A proposal that may be improper under applicable state law when framed as a mandate or directive may be proper when framed as a recommendation or a request." S.E.C. Rule 14a-8(c)(1), 41 Fed. Reg. 52,994 (1976).

In a no-action letter to Marvin E. Schmalzried, Senior Vice-President and Secretary, American Home Products Corp., Peter J. Romeo, Special Counsel, S.E.C., stated:

> [T]he adoption by the Commission in 1954 of paragraph (c)(5) of Rule 14a-8, which allows the omission of recommendations or requests that "relate to the conduct of the ordinary business operations of the issuer", implicitly recognizes that proposals which would be considered improper under paragraph (c)(1) as directives are proper under that paragraph if phrased in precatory form, and may be excluded from management's proxy materials only if some other provision of Rule 14a-8 so requires.

Am. Home Prod., Inc. (March 4, 1976), *quoted in*, Schwartz & Weiss, *supra* note 3, at 661 n.134.

49. *See supra* note 48.

law.

The courts explicitly confirmed the validity of the SEC's liberal administrative approach. In an early case, *SEC v. Transamerica Corp.*,[50] a shareholder submitted a resolution asking for the repeal of a corporate by-law which gave the Transamerica directors virtually unchecked discretion to exclude proposed by-law amendments from shareholder meetings. The company refused to include the proposal in the proxy materials on the ground that management had a complete veto power over any shareholder attempt to amend the by-laws. The court recognized that the by-law upon which the directors sought to rely was in direct conflict with Rule X-14A-7. As such, it represented a significant challenge to the future of the proposal rule: could the operation of Rule X-14A-7 be obviated by a corporate by-law, arguably valid under state law, which gave the directors the exclusive right to decide which proposals warranted inclusion in the proxy?

Although the Third Circuit was able to invalidate the by-law under the provisions of applicable state law,[51] the court did indicate that even if the by-law had been valid under state law it would, nevertheless, be invalidated by the federal proxy rule X-14A-7.[52] Noting the potential limiting effects of state law on federal securities legislation, the court espoused the proposition that state corporate law cannot be interpreted to frustrate the purpose of the proxy rule. As Judge Biggs noted:

> If this minor provision may be employed as Transamerica seeks to employ it, it will serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934. It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of the great corporations by a very few persons was the abuse at which Congress struck in enacting section 14(a). We entertain no doubt that Proxy Rule X-14A-7 represents a proper exercise of the authority conferred by Congress on the Commission under section 14(a). This seems to us to end the matter. The power conferred upon the Commission by Congress cannot be frustrated by a corporate by-law.[53]

The *Transamerica* decision was fully consistent with the earlier administrative pronouncements by the SEC. The court agreed

50. 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948).

51. The Third Circuit held that the by-law granting discretionary power to the directors was, at least when applied "in all its strictness," invalid under state law. *Id.* at 518.

52. *Id.*

53. *Id.* (citation omitted).

with the Commission that the basis of the "proper subject" test was state law. However, no state law provision could grant directors a power so broad and sweeping as to effectively nullify the federal shareholder proposal rule. This supremacy doctrine, combined with the Commission's utilization of the "by-law" and "precatory proposal" exceptions, effectively established a new body of federal corporate law principles concerning shareholders' rights,[54] and thereby preserved the vitality of the proposal rule.

C. *The Emergence of the Public Policy Resolution*

Most of the shareholder proposals presented to management in the early years of the rule were limited to requests and/or suggestions about specific corporate business activities. The "social resolution," which has become controversial today, was not yet recognized by shareholders as a proper subject for independent shareholder action. Baldwin Bane, Director of the SEC's Division of Corporate Finance, had already stated that "matters which are of a general political, social or economic nature . . . were not proper subjects for [shareholder] action."[55] With social and political resolutions cast aside, the Commission and the courts were able to freely promote the liberal use of the proposal rule so as to maximize the voice of shareholders in the governance of large corporations.[56]

Beginning in the early 1950's the SEC observed, for the first time, an increase in the number of shareholder proposals based on the social and political views of the proponents rather than the activities of the issuer's business. Later, in 1952, the Commission

54. Professor Loss noted that the Commission was forced to develop its own conception of shareholder rights given the fact that "there is simply not very much state law to use as a guide in these matters." 2 L. Loss, SECURITIES REGULATION 905 (2d ed. 1961); *See also* Schwartz, *supra* note 6, at 440.

55. Securities Exchange Act Release No. 34-3638, 11 Fed. Reg. 10,995 (1945). The statement was made in response to a series of shareholder resolutions which had asked: that dividends paid to shareholders should be free of federal income tax; that the antitrust laws should be revised; and that all ensuing federal legislation providing for workers and farmers to be represented should be made to apply equally to investors. The SEC staff ruled that these proposals could be omitted from company proxy materials as not "proper subjects" within the meaning of Rule X-14A-7. *Transamerica Corp.*, 163 F.2d at 516-18.

56. This liberal attitude regarding the proposal rule was simply a logical extension of the theory of shareholder democracy, recognized by the SEC when it promulgated Rule X-14A-7. *See* Propp, *supra* note 3, at 102; Manne, *supra* note 3, at 484; Schwartz & Weiss, *supra* note 3, at 638; Loomis & Rubman, *supra* note 27, at 170; text accompanying note 37.

amended Rule 14a-8, the successor to X-14A-7, to prevent what it perceived as a potential abuse of the proxy process.[57] The new amendments allowed management to exclude a proposal if it "clearly appear[ed that it was submitted] primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes."[58] It appeared to be a simple codification of the staff's earlier opinion regarding proper subjects.[59] In effect, however, the rule allowed management to omit a proposal that was an appropriate subject for shareholder action if it was motivated by inappropriate purposes.[60]

Several years later, following more revisions of the rule, two significant developments forced the SEC to reexamine the entire scope and purpose of the shareholder proposal rule—the decision in *Medical Committee for Human Rights v. SEC*[61] and the Campaign to Make General Motors Responsible.[62]

In *Medical Committee*, the Court of Appeals for the District of Columbia Circuit held that an SEC decision regarding whether a particular proposal could be excluded under 14a-8 was reviewable.[63] The staff had approved a request by the Dow Chemical Company to exclude a stockholder proposal which sought to prohibit the company's sale of napalm to the military for use in Vietnam. Although the court did not decide the exclusion question, the court did indicate its willingness to permit shareholder challenges to corporate activities which it regarded as questionable or

57. Securities Exchange Act Release No. 34-4775, 17 Fed. Reg. 11,430 (1952).

58. *Id.* This provision is frequently referred to as the "general cause" test. The rule amendments were cast in the same form as an earlier SEC release which stated that "matters which are of a general political, social, or economic nature" were not proper subjects for shareholder action. Securities Exchange Act Release No. 34-3638, 11 Fed. Reg. 10,995 (1946). The SEC later relied on this release in 1951 to allow Greyhound Corp. to exclude a resolution recommending the abolition of segregated seating in the South—even though Greyhound itself used the practice. This "no-action" decision was upheld in federal district court. Peck v. Greyhound, 97 F. Supp. 679 (S.D.N.Y. 1951). The Release was later codified in 1952 into Rule 14a-8. *See supra* note 57.

59. *See supra* note 55.

60. *See* State *ex rel.* Pillsbury v. Honeywell, Inc., 291 Minn. 322, 330-31, 191 N.W.2d 406, 412 (1971) (shareholder's request to inspect corporate books and records denied because motivated by a social purpose unrelated to the business of the corporation).

61. 432 F.2d 659 (D.C. Cir.), *vacated and remanded as moot*, 404 U.S. 403 (1970).

62. *See* Schwartz, *supra* note 6. The Project on Corporate Responsibility chose GM to be the target of their initial effort to "test . . . the ability of the corporate and economic system to reform itself." *Id.* at 423.

63. 432 F.2d at 676.

unethical.[64] The court observed:

> We think that there is a clear and compelling distinction between management's legitimate need for freedom to apply its expertise in matters of day-to-day business judgment, and management's patently illegitimate claim of power to treat modern corporations with their vast resources as personal satrapies implementing personal political or moral predilictions. It could be scarcely argued that management is more qualified or more entitled to make these kinds of decisions than the shareholders who are the true beneficial owners of the corporation; and it seems equally implausible that an application of the proxy rules which permitted such a result could be harmonized with the philosophy of corporate democracy which Congress embodied in section 14(a) of the Securities Exchange Act of 1934. [65]

Shortly after the *Medical Committee* decision, the Project on Corporate Responsibility initiated Campaign GM. This campaign attempted to include nine resolutions in General Motor's proxy solicitation materials. Seven of the nine proposals were drafted in the form of social issues, asking for reform in the areas of safety, pollution and minority hiring. GM excluded these proposals from the proxy with SEC approval.[66] GM accepted two resolutions that consisted of: (1) an amendment to the by-laws to increase the number of directors by three;[67] and (2) the creation of a Shareholders' Committee for Corporate Responsibility consisting of 15 to 25 representatives of different interest groups unconnected with the automobile industry.[68] These resolutions apparently were easier to justify as "proper subjects" for shareholder action.

The GM proposals, as well as those advanced in the *Medical Committee* case, presented a strong challenge to the continued viability of the provision that permitted exclusion of proposals that were introduced "primarily for the purpose" of promoting general social, economic or political goals. The strength of this challenge should not be measured by the number of proxy votes received by these proposals but rather by the conceptual link they

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64. *Id.* at 681. *See* Deutsch, *Perlman v. Feldman: A Case Study in Contemporary Corporate Legal History*, 8 U. MICH. J.L. REF. 1, 58-59 (1974).

65. 432 F.2d at 681.

66. Schwartz, *supra* note 6, at 451-54.

67. *Id.* at 424.

68. The Project on Corporate Responsibility indicated that these new directorships should be filled with "public-interest directors." However, legal counsel to Campaign GM decided to omit this objective from the Campaign so as to avoid the rigors of an election proxy fight. The two admitted resolutions received, respectively, 2.44% and 7.19% of the votes cast. *Id.* at 422.

make between corporate policy decisions and public policy concerns. The courts and the SEC would no longer apply a blanket exclusion to shareholder proposals that were directed solely to noncorporate ends. Public policy resolutions became eligible for inclusion in the proxy materials so long as they were materially relevant to some aspect of the issuer's business.[69] This development represented a significant expansion of the previous administrative and judicial attitudes on the legitimacy of public policy resolutions.

In 1972, following a staff reexamination of the propriety of allowing investors to use the proposal mechanism as a forum for social and political dialogue at the corporate level, the Commission codified its new interpretative position.[70] The Commission revised Rule 14a-8(c)(2)(ii) to allow management to omit a proposal that

> [c]onsists of a recommendation, request or mandate that action be taken with respect to any matters, including a general economic, political, racial, religious, social or similar cause, that is not significantly related to the business of the issuer or is not within the control of the issuer . . . .[71]

On the surface, the revision appeared to be a setback to the legitimacy of shareholder activism. The language of the exclusion was more precise and appeared to impose new standards. In practice, however, the rule change was a reinforcement of the Commission's new position on public policy resolutions. The 1972 revision no longer allowed the staff to examine the subjective motivations of a proponent, the standard of the 1952 amendments. Instead, it encouraged the staff to develop a body of objective standards regarding what is a proper subject for action by security holders. This was an important administrative step. As two commentators pointed out: "[T]he SEC at least tacitly acknowledged that it was appropriate for shareholders to use the proxy process to raise social issues, so long as there was a *sufficient nexus* between those is-

69. The SEC frequently rejected management's argument for exclusion under the "general cause" test by arguing that management had failed to demonstrate that the shareholder's primary purpose "clearly appear[ed]" to promote a general cause. With this argument the SEC was able to deny exclusion for many proposals that were convincingly motivated by social, economic and political concerns. *See* Comment, *SEC Shareholder Proposal Rule 14a-8*, *supra* note 3, at 791.

70. Securities Exchange Act Release No. 34-9784, 37 Fed. Reg. 23,178 (1972).

71. *Id.* at 23,179.

sues and the business of the corporation."[72]

The 1972 amendments, fueled by the public attention on Campaign GM, signalled an increase of shareholder proposals on public policy issues.[73] The corporate community responded to this increase by requesting the SEC in 1976 to inject a "one-percent" test into the "significantly related" language of the general cause provision.[74] This economic standard would require the staff to exclude any resolution as not "significantly related to the business of the issuer" if the subject of the proposal related to less than one percent of the issuer's total business operations. Although the SEC had already adopted this approach in several no-action letters,[75] the Commission refused to codify an "economic significance" standard in Rule 14a-8. The SEC realized that there were many instances in which the matter involved in a proposal was significant to an issuer's business even though such significance was not apparent from an economic viewpoint.[76]

The Commission's decision not to inject economic criteria into the "significantly related" provision symbolized the SEC commitment to a proxy process that affords shareholders with the opportunity to question management on a broad range of corporate issues and public policies. As two commentators observed: "Once the ['significantly related'] standard is unmoored from a conventional economic materiality test, socially significant proposals seem to be as 'significantly related to the business of the issuer' as are traditional shareholder concerns."[77]

The SEC subsequently found that many social proposals made to various companies met the "significantly related" standard. A

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72. Schwartz & Weiss, *supra* note 3, at 657.

73. In 1973, 40 social responsibility resolutions were voted upon. IRRC Report, *supra* note 7, at 3. This figure climbed to 133 in 1976. *Id.* Since 1976 the number of public responsibility resolutions submitted to U.S. companies has remained relatively constant. *See supra* note 7.

74. *See* Propp, *supra* note 3, at 108.

75. The SEC first used the "one percent" test when it issued several no-action letters to corporations which had received resolutions questioning their compliance with the Arab boycott of Israel. To determine whether these resolutions were "significantly related" to the issuer's business, the Commission focused on the issue of whether the percentage of total sales, earnings and assets attributed to the boycott was less than one percent. *See, e.g.*, Division Letter to Libby-Owens-Ford Co., [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,437 (Feb. 3, 1976). *See also infra* notes 135-37 and accompanying text.

76. Securities Exchange Act Release No. 34-12999, 41 Fed. Reg. 52,994 (1976).

77. Schwartz & Weiss, *supra* note 3, at 662.

proposal to Newmont Mining Corp. to amend its charter to prevent operations in Namibia was deemed significantly related to Newmont's business because it called for the company to cease operations in a specific area.[78] A proposal to Marriott Corp., requesting a ban on charitable contributions that were not in furtherance of the corporation's business, was held to be "significantly related" despite their economic immateriality.[79] And a proposal to Citicorp to terminate all of the company's South African loan commitments was upheld even though the company's business in South Africa was less than 1% of its total business.[80]

These illustrations, as well as the prior SEC rulings and judicial decisions, demonstrate that a balancing process between two competing interests occurs each time the rule is used or modified. The SEC must, on the one hand, acknowledge the management interest in an inexpensive, non-confrontational soliciting process. On the other hand, the Commission must remain cognizant of the shareholders' interest in maintaining an effective voice in the governing process.

Prior to the recent rule changes, the SEC maintained an equitable balance between these two competing interests by affirming the Commission's commitment to two basic propositions. First, the shareholder proposal rule was an effective, perhaps indispensable, instrument of facilitating communication between management and its stockholders. And second, given the widespread public interest in social issues and the increasing concern for the vitality of

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78. Newmont Mining Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,325, at 82,985 (March 20, 1973).

79. The staff advised Marriott Corp.:

> Although the representations made by the Company's counsel as to the percentage of revenues and profits represented by charitable contributions tend to indicate that the subject matter of this proposal is not of economic significance to the Company's business, this is not the sole consideration under Rule 14a-8(c)(2)(ii). As indicated in Securities Exchange Act Release No. 12598, there are many instances in which the matter involved in the proposal is significant to an issuer's business, even though such significance may not be apparent from an economic viewpoint.

Marriott Corp., [1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,804, at 87,097 (Sept. 17, 1976).

80. Citicorp, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,520 (Feb. 23, 1978). *See also* Motorola Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,521 (Feb. 23, 1978) (same facts and decision as Citicorp ruling).

corporate democracy, Rule 14a-8 played a unique and important role in the governance of large, modern corporations with respect to social and political issues. Both principles represent the historic legitimacy of Rule 14a-8 as a means to effect the broad goal of corporate democracy.

II. The Impetus for Regulatory Reform

In recent years, the business community has grown increasingly impatient with the SEC efforts to maintain a fair balance between management and shareholder interests.[81] Many corporate executives believe that the Commission has wholeheartedly embraced theories of corporate democracy and accountability and ignored the abusive nature of the proposal process to issuers.[82] The result of this liberal regulatory posture, they contend, is that shareholders have been given the right to utilize corporate proxy materials to raise issues better left to the political process.[83]

To strike a new balance between management and shareholder interests, corporate leaders recently pressured the Reagan administration to provide regulatory relief to issuers and relieve the administrative burden on the SEC. They cited several policy considerations in support of the demand for more restrictive proxy rules. The first argument, and the most popular, was the claim that the proposal process had become too costly to issuers.[84] Under Rule 14a-8, a corporation that decides to include a proposal in the proxy statement must bear the cost of printing the proposal and management's response to it,[85] as well as the time and expense of tabulating the proxy returns. If the issuer elects to exclude the proposal, the company still incurs the expense of justifying this omission to the SEC.[86] The costs associated with either inclusion or exclusion, it is argued, had become excessive. The

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81. *See* Schwartz & Weiss, *supra* note 3, at 638 & n.16.

82. *See* Schwartz & Weiss, *supra* note 3; Black & Sparks, *supra* note 3; and Propp, *supra* note 3.

83. *See* Black & Sparks, *supra* note 3, at 972.

84. *See supra* note 16.

85. *Id.*

86. The pre-clearance procedure of Rule 14a-8 requires a company which has elected to omit a proposal to file copies of the proposal and the reasons for the omission with the SEC. If these reasons include questions of law, a supporting opinion of counsel must also be filed with the Commission and then fowarded to the proponent. Rule 14a-8(d), 17 C.F.R. § 240.14a-8(d) (1984).

contention here is that the majority shareholders have been forced to bear the costs of proposals which have traditionally received support from only a small minority.[87] Executives have also displayed concern regarding the potential for an "abuse" of the proposal process. Without meaningful restrictions on the use of Rule 14a-8, proponents could arguably flood the corporation with a multitude of proposals simply to harass management or advance their own frivolous, individualistic causes.[88] There is no economic incentive to impede this abuse because the proponents do not have to bear the costs of the proposal machinery.

Another policy argument that was made in support of the more restrictive rule provisions was the assertion that the new rule changes could streamline the appearance of the proxy to make it more understandable to shareholders. The thrust of the argument is that shareholder understanding of the proxy material has been significantly diminished as the increasing number of proposals make the proxy more complex. Without a regulatory response to this problem, many shareholders, it is suggested, would be unable to cast a meaningful vote on any of the issues raised by the proxy.[89]

The final criticism of the rule was that the SEC has allowed social activists to use the proxy mechanism for objectives which were never intended to be appropriate ends of Rule 14a-8. The corporate community contends that the "social proponent" is more interested in using the proposal rule as a forum for narrow social issues than as a popularly-based method of communicating valid shareholder concerns to top-level management.[90] Rule 14a-8, it is argued, was never intended "to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature. Other forums exist for the presentation of such views."[91]

These perceived misuses of the proxy system prompted the corporate community to pressure the SEC to exercise more re-

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87. *See supra* note 16.

88. *See id.*

89. *See id.*

90. *Id.*

91. This statement was made by an SEC staff member in 1945 and is frequently cited by critics of Rule 14a-8. Securities Exchange Act Release No. 34-3638, 11 Fed. Reg. 10,995 (1945).

straint in granting shareholder access to the proxy machinery. Several rule modifications were recommended. The most sought-after revision was an amendment to require each proponent to own a minimum amount of stock for a minimum period of time in order to be eligible to submit a proposal. Directors believed that this requirement would prevent a social activist from "buying a ticket" to the annual meetings of many different companies in order to present an individual cause.[92] The SEC was also asked to revise the rule to limit the number of proposals which could be resubmitted the following year. Suggested revisions required a proponent to receive a threshold percentage of the total shareholder vote in favor of the resolution in order to be eligible to resubmit the same proposal for the following year.

In 1976, the SEC responded to these suggestions and made an effort to prevent the perceived abuse of the shareholder proposal process.[93] New revisions of Rule 14a-8 subsequently required that a proponent be a beneficial owner of a security entitled to be voted on his proposal, and that he must continue to own the security through the date of the meeting.[94] The changes also allowed a corporation to exclude any proposal that was substantially the same as a proposal which received less than three percent of the vote when submitted the year before.[95]

Although this revision was, in theory, a significant step to reduce the overwhelming number of social proposals, it did not have an appreciable effect on the actual volume of these proposals. A majority of proponents seeking to advance social and political issues were still able to pass the threshold requirements of 14a-8.[96] This sobering fact led the Commission to initiate new revisions of the rule in 1983.

Under the guise of the Proxy Review Program, the Commission began rulemaking proceedings on the entire framework governing the security holder proposal process.[97] Initially, the staff

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92. *See supra* note 16.

93. Securities Exchange Act Release No. 34-12999, 41 Fed. Reg. 52,994 (1976).

94. *Id.*

95. *Id.* S.E.C. Rule 14a-8(c)(12).

96. *See supra* note 7.

97. Over the past several years, the Securities and Exchange Commission has initiated a number of major rulemaking proceedings designed to simplify, in a manner consistent with the protection of investors, many of the complex disclosure systems which have evolved under the federal securities laws. This process was responsible for producing the

asked for public comment on whether the shareholder proposal process should be maintained under the Securities Exchange Act of 1934 or left to regulation under state law.[98] After deciding that federal enforcement was more appropriate, the Commission invited public comment on three alternative proposals to revise Rule 14a-8.[99]

Proposal I retained the basic statutory framework of the current shareholder proposal rule but called for important procedural changes, a substantive alteration of the staff's former position on exclusions, the imposition of stricter eligibility requirements for proponents and the extension of filing deadlines.[100] Proposal II granted the issuer the right to vary the procedures specified in the shareholder proposal rule with the approval of its security holders.[101] This proposal permitted issuers to establish their own eligibility criteria for proponents, as well as the substantive bases for exclusion. It would essentially empower a company's management to establish its own "rules of the game" for filing resolutions, subject to certain minimum standards prescribed by the Commission. Proposal III required the inclusion of any proposal that was proper under state law and which did not involve an election of directors.[102] It also imposed a numerical limit on the total number of shareholder proposals required to be included in the proxy statement so as to reduce the costs associated with the proxy process.[103] This proposal would permit shareholders unfettered access to the issuer's proxy statement.

The substantive differences between these three proposals re-

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Integrated Disclosure System and Regulation D. The Integrated Disclosure System streamlined two of the three major disclosure systems—the system for the registration of securities under the Securities Act of 1933 and the continuous reporting system under the Securities Exchange Act of 1934. Regulation D, adopted by the Commission in 1982, was designed to achieve uniformity between state and federal exemptions and to facilitate capital formation. Securities Act Release No. 33-6389, 47 Fed. Reg. 11,251 (1982).

More recently, the Commission has begun to re-examine the third major disclosure system—the rules, forms, and schedules relating to the solicitation of proxies. The Proxy Review Program is designed to reduce the burden of compliance with the proxy rules, to increase shareholder understanding of the proxy materials and, overall, to make the proxy solicitation process more efficient and straightforward.

98. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (1982).

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

veal the difficult balancing process which the Commission has had to undertake when handling the shareholder proposal rule. Proposal II was drafted from an issuer's perspective, seeking to reduce the considerable time, effort, and cost associated with the proxy solicitation process. It is premised on the assumption that the board is responsible for the operation of the business and that the role of the shareholder should be limited thereby. In direct contrast, Proposal III is premised on the belief that the security holder process serves the public interest and preserves one of the few remaining elements of shareholder democracy. Advocates of this proposal, mainly socially-conscious investors and public interest groups, believe that the shareholder proposal rule guarantees accountability in corporate governance by forcing top level decisionmakers to respond to the interests of the security holders.

The middle ground between these two positions would appear to be, at least from its face, Proposal I. It neither vests management with complete control of the proposal process nor grants the shareholders unfettered access to an issuer's proxy materials. By also retaining the basic framework of the rule, Proposal I does not forego the SEC's role as a referee between the competing interests of the two contestants. It attempts to preserve the proposal process as an institution of corporate democracy while, at the same time, promising to reduce the tendency of a small group of proponents to abuse this process. According to a staff statement, Proposal I was an attempt to eliminate a fairly modern problem whereby

> a few proponents . . . use the rule as a publicity mechanism to further personal interests that are unrelated to the interests of security holders as security holders and that certain sophisticated proponents, who submit proposals annually to a variety of issuers, are able to require the inclusion of a proposal which has generated little security holder interest by simply changing its form or minimally varying its coverage. The rule was not designed to burden the proxy solicitation process by requiring the inclusion of such proposals.[104]

Of the three proposals advanced by the Commission, Proposal I received the most support from those commenting on the rulemaking proceeding.[105] Proposal I was ultimately selected as

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104. *Id.* at 47,422 n.8.

105. The Commission received 397 letters of comment. In these letters, 115 commentators expressed support for Proposal I. Proposal II was favored by 24 commentators, al-

the basis for the new rule revisions.[106] The changes became effective January 1, 1984.

The new rules require a shareholder to own at least 1% or $1,000 in the market value of a security for a minimum of one year prior to the date on which the proponent intends to submit a proposal.[107] Furthermore, the number of proposals that a shareholder may submit to an issuer in any one year has been reduced from two to one.[108] Rules regarding the resubmission of proposals have been similarly tightened. A shareholder is allowed to resubmit a defeated proposal to the same company only if that proposal received at least 5% of the vote the first year, 8% the second and 10% every year thereafter.[109]

All of these rule changes represent a significant departure from past SEC policy. The former rule did not require a minimum investment or holding period, it allowed each shareholder to submit two proposals per year, and it required a proponent to receive a 3% vote the first year, 6% the second, and 10% every year thereafter to be eligible to resubmit substantially the same proposal.[110]

In addition to the eligibility changes, the new rules will significantly alter the Commission's interpretation of several substantive exclusions. The "personal grievance" exclusion was amended to allow an issuer to exclude any proposal which is crafted to further a personal interest not shared by the body of shareholders at large.[111] The SEC injected an "economic test" into the exclusion provided by paragraph (c)(5) for proposals dealing with matters not "significantly related" to the company's business.[112] The "ordinary business" exclusion was changed to make it more difficult

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though there were an additional 18 letters which indicated some support for the concept behind Proposal II. Only 6 commentators supported the adoption of Proposal III, with an additional 16 commentators indicating support for the theory underlying the proposal. The remaining letters either expressed no preference for a specific proposal or suggested that there should be no change in the rule. Securities Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 nn.1-4 (1983).

106. *Id.*

107. S.E.C. Rule 14a-8(a)(1), 17 C.F.R. § 240.14a-8(a)(1) (1984). Holdings of co-proponents will be aggregated in determining the includability of a proposal.

108. S.E.C. Rule 14a-8(a)(4), 17 C.F.R. § 240.14a-8(a)(4) (1984).

109. S.E.C. Rule 14a-8(c)(12), 17 C.F.R. § 240.14a-8(c)(12) (1984).

110. *See* Securities Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 (1983).

111. S.E.C. Rule 14a-8(c)(4), 17 C.F.R. § 240.14a-8(c)(4) (1984).

112. S.E.C. Rule 14a-8(c)(5), 17 C.F.R. § 240.14a-8(c)(5) (1984).

for shareholders to solicit reports from the company.[113] And, the Commission revised the "mootness" exclusion to allow an issuer to exclude any proposal which the company had "substantially implemented" rather than "fully effected," the previous standard.[114]

The remainder of this Comment will examine the effectiveness of the SEC's professed balancing process by examining the impact of the new 14a-8 amendments on the ability of shareholders to influence corporate decisionmaking.

III. The Impact of the Revisions on Corporate Democracy

The adoption of the 1984 amendments to Rule 14a-8 was based on the Commission's belief that the proposal process had been abused in the past and that these particular revisions could reduce or eliminate this abuse.[115] The revisions, which were vigorously supported by the business community, were intended specifically to mitigate the cost of the proposal mechanism for issuers.[116] The rule was also designed to provide regulatory relief to the Commission by creating a simpler and more predictable regulatory process.[117]

These regulatory objectives were supposed to be obtained by tightening the eligibility criteria and the exclusionary interpretations contained in the rule. The new "1% or $1,000" threshold requirement, the higher resubmission percentages, and the narrower staff interpretations of the substantive exclusions were designed to give issuers and the Commission greater latitude to exclude questionable shareholder proposals. The subsequent reduction in the actual number of proposals submitted to issuers would then reduce the overall issuers' cost of the proposal mechanism. The infusion of objective standards into paragraph (c) would also enable the SEC staff to summarily dismiss more proposals—saving the time and expense associated with distributing no-action letters.[118] Unfortunately, these ambitious aims were vastly overstated.

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113. S.E.C. Rule 14a-8(c)(7), 17 C.F.R. § 240.14a-8(c)(7) (1984).

114. S.E.C. Rule 14a-8(c)(10), 17 C.F.R. § 240.14a-8(c)(10) (1984).

115. *See* Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (1982).

116. *Id.*

117. *Id.*

118. The Commission staff spent approximately one staff year (1208 hours) in processing materials submitted to it pursuant to Rule 14a-8 during the 1982 proxy season. *Id.*

This Comment will demonstrate, through an examination of the most significant rule revisions, that the Commission misinterpreted much of the data and the policy considerations raised by the rulemaking proceeding. Two specific defects in the rulemaking process will be alluded to: (1) the new rule is based upon the fallacy that the proposal process has been abused in the past; and (2) the rule revisions are premised on a spurious belief that the changes will materially reduce the overall cost and burden of the proposal process to both issuers and the Commission. This section will also argue that, in a larger context, the new rule has upset the fundamental balance, achieved by the SEC during the past forty years, between the management interest in an efficient proxy solicitation process and the shareholder interest in the preservation of an intracorporate dialogue. Several theoretical problems raised by the new rule will also be explored.

A. *The Fallacy of Abuse*

In the Proposing Release for the new rule revisions, the staff provided only three statistics in support of the rulemaking proceeding. They were: (1) the available information indicated that only a limited number of the approximately 9,000 companies whose securities are registered with the Commission actually receive proposals in any given year;[119] (2) statistics compiled by the American Society of Corporate Secretaries revealed that in the year ending June 30, 1981, 991 proposals were submitted to 376 companies and that this number was significantly lower in 1982;[120] and (3) in 1982 only 43 companies received 5 or more proposals.[121] These statistics, when viewed together, simply fail to support the Commission's theory that the process was being abused. Only four percent of the total companies registered with the Commission actually received a proposal last year, and this figure is on the *decline*.[122] For those companies which did receive one or more proposals, management elected to contest only 39% of

119. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420, 47,423 (1982).

120. Preliminary figures for the year ending June 30, 1982 indicate that approximately 850 proposals were submitted to 300 companies. *Id.*

121. *Id.*

122. In 1981, only 376 companies of the total 9,000 companies registered with the Commission received a proposal. *Id. See also supra* note 120.

them.[123] These figures hardly reveal that corporations have been inundated with a tide of resolutions.[124] To the contrary, they seem to suggest that shareholder proposals are a relatively rare occurrence. At the very least, this limited statistical proof raises doubts about the sufficiency of this evidence to serve as the basis for a major rulemaking initiative.[125]

Perhaps to ignore the import of this factual evidence, the business community has argued, in the alternative, that the abusive nature of the proposal process is more accurately reflected by the number of proposals submitted to a particular issuer rather than the total number of resolutions submitted to all corporations. This model allegedly demonstrates that malevolent shareholders have proposed hundreds of resolutions simply to harass a few, targeted corporations. The problem with this model, however, is that it lacks any factual foundation at the present time. Only 43 companies received five or more proposals in 1982.[126] This figure represents less than one percent of the total issuers registered with the Commission. More significantly, this figure was the only evidence produced by the SEC in the Proposing Release to support the theory of the "malevolent shareholder." This data suggests that the Commission imprudently responded to the fear of abuse rather than the existence of it. Administrative practice generally requires a specter of abuse to materialize before imposing new regulatory reforms on an entire class of corporations.[127]

The statistical data regarding the actual *cost* of the proposal process to issuers also fails to justify the adoption of the new rule. The SEC has previously requested information from issuers concerning the cost of complying with the former rule.[128] The Com-

123. The total number of contested proposals was 387. The total number of proposals submitted was 991. Securities Exchange Act Release No. 34-19135, *supra* note 119, at 47,423, 47,424.

124. *See also supra* note 7.

125. James Heard, of the Investor Responsibility Research Center, recognized this problem. He stated: "The Commission apparently assumes that the current system is widely abused and excessively costly to management. But it has provided little factual evidence to support many of the changes." Statement of James Heard, *quoted in* Lydenberg, *supra* note 23, at 2, col. 3.

126. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420, 47,423 (1982).

127. *Cf.* Comment, *Proxy Rule 14a-8: Omission of Shareholder Proposals*, 84 HARV. L. REV. 700, 720 (1971).

128. *See* Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420, 47,423

mission received only *one* response to its request.[129] American Telephone & Telegraph Company (AT&T) indicated that the cost of including 5 proposals in its proxy statement was $22,250 per proposal while the cost for the 11 proposals excluded from the proxy material was $3,740 per proposal.[130] This data does not constitute a sufficient sample of the corporate population with which to conclude that the proposal process is too costly for issuers. A sole response from one company does not necessarily represent the average cost incurred by all issuers. If the AT&T response reveals anything at all, it suggests that the actual cost of the proposal process to AT&T and its shareholders is miniscule when viewed in relation to other areas of corporate expenditure.[131]

The preceding analysis demonstrates the misguided approach of the latest 14a-8 rulemaking proceedings. The Commission has imposed significant restrictions on shareholder access to the proposal rule based upon the inaccurate theory that the proxy process was abused in the past. The reasons remain unclear as to why the Commission would adopt such a bold new set of revisions without more documentary support. One possible explanation is that the statistical data collected by the staff was obscured by the media and corporate dramatization of the process. To be sure, shareholder resolutions have produced widely publicized struggles between the "activists" (or "corporate guerilla fighters") and corporate management, thereby increasing the focus of the public on the annual meeting of shareholders. The Commission may have finally succumbed to the weight of the corporate pressure and media attention.

B. *The Practical Limitations of the New Rule 14a-8*

As mentioned above, the new Rule 14a-8 was designed to reduce the cost of the proposal process to both issuers and the SEC

(1982).

129. *Id.*

130. *Id.*

131. A comparison between the cost of the proposal process to AT&T ($22,250 per proposal) and other areas of corporate expenditure, e.g., corporate political contributions, reveals that compliance with the proxy rule is relatively inexpensive. These expenditures are further minimized when viewed in relation to the total per share cost of the rule to individual stockholders.

by reducing the number of proposals submited to issuers and by making the staff's regulatory role more objective and predictable. A close examination, however, of three specific rule revisions reveals that there are several practical limits on the ability of the Rule to accomplish these objectives.

1. *Rule 14a-8(a)(1)(i): Minimum investment and holding period.* The most significant amendment to Rule 14a-8 is the new requirement that a proponent own at least 1% or $1,000 in the market value of a security for a minimum of one year prior to the date upon which the proponent intends to submit a proposal.[132] This provision was specifically designed to eliminate the abuse of the proposal rule by requiring shareholders, who put the company to the expense of including a proposal in a proxy statement, to have some measured financial interest in the company.[133] The target of this regulatory scheme is the "gadfly" proponent; a transient stockholder who purchases small amounts of stock from several companies as a means of "buying a ticket" to the annual meetings.

The SEC implementation of a "financial interest" test does not represent an innovative development in corporate law. Some state statutes now require shareholders to demonstrate a financial interest in their corporations as a prerequisite to participation in the governance of these companies.[134] Security-for-expenses statutes, for example, often require a shareholder bringing a derivative suit to post bond for litigation expenses, including attorney's fees, unless the shareholder holds five percent of the outstanding shares or the shares have a specified market value of $50,000 or more.[135] By classifying the shareholders by the size of their stock holdings, these statutes attempt to discourage shareholders, who lack a significant financial interest in a company, from harassing that corporation with frivolous and expensive litigation.[136]

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132. S.E.C. Rule 14a-8(a)(1), 17 C.F.R. § 240.14a-8(a)(1) (1984).

133. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (1982).

134. *See, e.g.*, N.Y. Bus. Corp. Law § 627 (McKinney 1963 and Supp. 1983-1984); Cal. Corp. Code § 800(c)-(f) (West 1977 and Supp. 1983-1984); Ark. Stat. Ann. § 64-223(c) (1980).

135. N.Y. Bus. Corp. Law § 627 (McKinney 1963 and Supp. 1983-1984).

136. Commenting upon the New York security-for-expenses statute, the Appellate Division, Second Department, once noted:

> A stockholder motivated by personal gain instead of the welfare of the corporation, it was thought by the sponsors of the legislation, would be deterred from bringing a spurious action, when the onus of the expense incurred by the cor-

The practical benefits which are derived from "financial interest" tests, as in the security-for-expenses example, are readily apparent and widely accepted by students of corporate law. From a theoretical perspective, however, these classification schemes should raise some fundamental concerns. Financial interest standards, perhaps unintentionally, alter the basic legal relationship between the management of a corporation and its shareholders. These eligibility rules have made the rights of stock ownership contingent upon an arbitrary prerequisite of minimum stock holdings. As a result, company management can exclude a shareholder, with small stock holdings, from the corporate governance process without regard to the merit of the shareholder's concerns. The participation of such shareholders in the corporate governance process can be an effective tool for enforcing shareholder rights. As a result, the duties collectively owed to the shareholders by management can become more difficult to enforce.

States which have adopted security-for-expenses statutes, or other provisions utilizing financial interest criteria, apparently see a compelling need for these rules despite their theoretical weaknesses. The staggering cost of derivative suit litigation and the abusive nature of strike suits simply outweigh any concerns for the loss of shareholder rights. The exceptional circumstances of derivative suits, therefore, dictate the justification for abridging traditional shareholder rights. By incorporating a financial interest requirement in Rule 14a-8, the SEC apparently draws an analogy between the harassing potential of derivative suits and the abusive use of the proxy rules. This analogy is unfounded. The pressure exerted by shareholders through the proposal process is not of the same magnitude as the pressure exerted by those who bring derivative suits to question or challenge certain management decisions.

As previously discussed, data collected on the use of Rule 14a-8 suggests that the proposal process has not been abused in the past—particularly not by "gadfly" proponents.[137] To the contrary, the leading sponsors of public policy resolutions have been

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> poration in defending it would be ultimately cast on the plaintiff as a consequence of the exposure of the action as meritless.

Roach v. Franchises Int'l, Inc., 32 A.D.2d 247, 250, 300 N.Y.S.2d. 630, 633 (2d Dept. 1969).

137. Karpen, *Minding the Corporate Conscience 1981*, Council on Economic Priorities Newsletter (Apr. 1981) [hereinafter cited as *Minding the Corporate Conscience*].

well-organized and well-financed institutions. As one observer pointed out: "Since the mid-Seventies, the leading sponsors and co-sponsors of political and social proxy resolutions have been the 17 Protestant denominations and 170 Roman Catholic orders affiliated with the Interfaith Center on Corporate Responsibility. Together these church groups hold about $6 billion in corporate debt and equity."[138]

It is difficult to imagine how the new eligibilty criteria can preclude these large organizations from submitting social and political shareholder resolutions. The "1% or $1,000" requirement simply becomes a meaningless threshold when the large financial resources of these organizations are considered. This revelation suggests that the SEC justification for constructing a tighter exclusionary net was based on administrative discomfort with illusionary "gadflies."

For those individual stockholders who are legitimately interested in submitting public policy resolutions, the minimum investment and minimum holding period requirements should not present an insurmountable barrier. According to the revised Rule 14a-8(a)(1)(i), the holdings of co-proponents will be aggregated when determining the includability of a proposal. This provision will allow a proponent to join efforts with other stockholders in order to meet the eligibility requirements. The aggregation allowance is a major regulatory concession, perhaps providing small stockholders with the means of circumventing paragraph (a)(1)(i) entirely.

In sum, the extensive financial resources of the leading public policy sponsors, combined with the aggregation allowance for individual stockholders, significantly hampers the ability of Rule 14a-8(c)(1)(i) to reduce the number of proposals submitted to issuers annually. The extent of this regulatory failure, however, is not limited to the Rule's failure to accomplish its professed objectives. On a more serious level, the Rule appears to patently discriminate against individual stockholders who have used the proposal process responsibly in the past. The imposition of this burden on minority shareholders may not always be unjustified but, given the

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138. Vogel, *The Bull Market in Political Proxy Resolutions*, Wall St. J., May 18, 1981, at 26, col. 2. For a profile of the proponents who submitted public policy resolutions in 1981, see *Minding the Corporate Conscience 1981*, *supra* note 137.

lack of benefits derived from this particular rule change, it is arguably unwarranted under these circumstances.

2. *Rule 14a-8(c)(5): No significant relation to issuer's business.* Prior to the recent rule amendments, paragraph (c)(5) of the Rule permitted an issuer to exclude from the corporation's proxy statement and proxy form any proposal that dealt with "a matter that [was] not significantly related to the issuer's business."[139] Most of the difficulties associated with the staff's interpretation of this provision centered around attempts to establish an objective standard for determining the circumstances under which the subject matter of a proposal would be deemed "significantly related."[140]

In 1976, one such attempt raised considerable controversy. The Commission tried to implement a standard based on the economic significance of the subject matter of the proposal. Through a series of letters, the staff agreed to the omission of proposals presented by the American Jewish Congress if the issuers could establish that their business with Arab countries and Israel constituted less than *one percent* of the company's sales, assets and earnings.[141] When this no-action position was considered for codification in 1976, many commentators assailed the "one percent" test as being an overly-narrow interpretation of an otherwise flexible provision of paragraph (c)(5). A corporation with a large sales volume, it was argued, could preclude its shareholders from raising questions which, although less than one percent of its sales, had a significant impact on the corporation.[142] Other critics suggested that there were many instances in which the subject matter of the proposal was significant to an issuer's business, even though such significance was not apparent from an economic viewpoint.[143]

139. 17 C.F.R. § 240.14a-8(c)(5) (1984). The origin of this provision can be traced to Securities Exchange Act Release No. 34-4775 (Dec. 11, 1952) [17 C.F.R. 11,431] wherein Rule 14a-8 was amended to provide that a security holder proposal may be omitted from an issuer's proxy material if it was submitted "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes."

140. The Commission has acknowledged, however, that this provision was only considered in a limited number of cases from 1973 through 1976. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (1982).

141. *See, e.g.*, Division Letter to Libby-Owens-Ford Co., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,437 (Feb. 3, 1976).

142. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420, 47,428 (1982).

143. *Id.*

Seven years after this controversial interpretation, the Commission decided once again to resurrect the "economic significance" standard despite its utter failure in 1976. The new rules re-inject paragraph (c)(5) with a five percent test.[144] Thus, the exclusion can now be invoked if a proposal relates to operations accounting for less than 5% of the issuer's total assets and less than 5% of its net earnings and gross sales, (with both figures calculated to the most recent fiscal year) *and* the proposal is not otherwise "significantly related" to the issuer's business.[145] The retention of the "significantly related" language provides a loophole for any proposal that can demonstrate its significant relation to the issuer's business but cannot fulfill the five percent requirement. As the Commission explained:

> [T]he proponent [can] provide information that indicates that, while a particular corporate policy . . . involves an arguably insignficant portion of the issuer's business, the policy may have a significant impact on other segments of the issuer's business or subject the issuer to significant contingent liabilities.[146]

The futility of this provision is manifest. By retaining the "significantly related" test as a loophole to the objective five percent test, the SEC has enabled a proponent to rely on the former subjective interpretations of paragraph (c)(5). The loophole thus makes the entire revision of the paragraph meaningless—those proposal subjects which could establish a *sufficient nexus* to the issuer's business prior to 1984 should remain eligible for inclusion under the new rule. The Commission's vacillation on this issue merely confirms, moreover, the argument advanced by commentators in 1976—that it is inherently difficult to inject objective standards into a basically subjective administrative decision.

3. *Rule 14a-8(c)(12): Resubmission of proposals.* Prior to the recent rule amendments, paragraph (c)(12) provided that a proposal submitted by a security holder could be omitted from an issuer's proxy soliciting materials for three years following the inclusion in the issuer's proxy material of a proposal that was "substantially the same" and that failed to receive a specified minimum

144. Securities Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 (1983).
145. *Id.*
146. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (1982).

precentage of the votes cast in regard thereto.[147] Under this provision, a shareholder was allowed to resubmit a defeated proposal to the same company only if the proposal received at least 3% of the vote the first year, 6% the second, and 10% every year thereafter.[148] The purpose of paragraph (c)(12) was to relieve issuers from bearing the cost of including proposals that had generated little interest when previously presented to the security holders.[149] Most of the controversy surrounding the rule centered on the interpretation of the phrase "substantially the same proposal." The staff frequently interpreted this expression to mean "one which is virtually identical to" a previous proposal, drawing criticism from several issuers who claimed that the interpretation allowed proponents to evade the spirit of the provision by simply revising a previous proposal into a slightly different form.[150]

The controversy resurfaced in 1976, when the SEC proposed to change the test for excluding a proposal under the provision from "substantially the same" to "substantially the same subject matter."[151] The proposal was never adopted, however, due to the negative comments received by the staff during the note and comment period.[152] According to the 1976 Release, the commentators expressed the following reservations with the "substantially the same subject matter" language: (1) the abuses of the existing provision have been rare and do not justify the type of radical revision proposed; (2) the new standard would be almost impossible to administer because of the subjective determinations that would be required under it; and (3) that it would unduly constrain shareholder suffrage because of its possible "umbrella effect" (i.e. it could be used to omit proposals that had only a vague relation to the subject matter of a prior proposal that received little shareholder support).[153]

The 1984 revisions of paragraph (c)(12) have reincorporated the "substantially the same subject matter" language into the provision despite the unanimous opposition to this proposed change

147. 17 C.F.R. § 240.14a-8(c)(12) (1984).

148. *Id.*

149. *See* Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420 (1982).

150. *Id.* at 47,429.

151. *See* Securities Exchange Act Release No. 34-12999, 41 Fed. Reg. 52,994 (1976).

152. *Id.*

153. *Id.*

in 1976. In the Proposing Release, the Commission admitted that it would ignore the earlier criticisms expressed on this regulatory approach. The staff noted:

> The revision being considered is identical to the one proposed by the Commission in 1976 and would provide for the omission of a proposal if it "deals with substantially the same subject matter as a proposal previously submitted to security holders . . . ." While the Commission is well aware of the arguments advanced in opposition to the proposal in 1976, it is concerned about the increase in the abuse of the existing provision.[154]

For the reasons discussed earlier, the premise upon which the SEC has chosen to rely in advancing the new changes in paragraph (c)(12) is completely without factual foundation.[155] The staff has yet to produce any statistical data to support its fears regarding the abuse of Rule 14a-8. In fact, it is evident from what little data that does exist, that the rule is not being abused at this time. Nevertheless, the agency has chosen to ignore these statistical conclusions and proceed with new rule revisions which are manifestly unnecessary and unworkable.

In addition to adopting the new language of paragraph (c)(12), the Commission has also raised the percentage requirements for the resubmission of proposals. The 3% vote needed the first year a proposal is placed in a proxy statement has been raised to 5%, and the 6% vote that must be garnered the following year has been increased to 8%.[156] The 10% threshold requirement after two years will remain the same.[157] The higher resubmission percentages are premised on the Commission's belief that shareholder proposals have generated little interest from shareholders in the past. Although this statement may have been factually accurate in the early 1970's, recent data suggests that shareholder support for public policy resolutions has precipitously risen in the past decade. Whereas in 1973 only 17.5% of the social resolutions opposed by management received more than a 3% vote, 81 of 111 resolutions (72.9%) received more than the 3% needed for resubmission in 1983.[158] The Commission's justification for the higher

154. *See* Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420, 47,430 (1982).

155. *See supra* notes 116-32 and accompanying text.

156. *See* Securities Exchange Act Release No. 34-20091, 48 Fed. Reg. 38,218 (1983).

157. *Id.*

158. *See* IRRC Report, *supra* note 7, at 3.

resubmission percentages, therefore, is fundamentally inconsistent. The staff claim that the proposal process has been abused, by proponents who submit resolutions which lack shareholder support, is contrary to the statistical evidence on this issue. This suggests that the SEC is trying to discourage the use of the proposal process in a period when Rule 14a-8 is beginning to gain legitimacy as an instrument of corporate democracy.

The most significant defect in the SEC justification for the higher resubmission percentages, however, is not the inadequacy of the fact-finding proceedings. By adopting more stringent requirements for paragraph (c)(12), the SEC failed to recognize the realities which confront the current system of proxy voting. The cause of the lack of support for public policy resolutions, assuming that these proposals have been unpopular, is not the apathy of individual shareholders. To the contrary, the most cumbersome stumbling block to effective corporate democracy (i.e. the legitimacy of public policy resolutions and shareholder communication in general) can be traced to the role of institutional investors in the corporate electoral process.

4. *The role of institutional investors in corporate democracy.* Large institutional investors, including universities, banks, pension funds and foundations, vested with the discretionary power to vote the shares of beneficial owners, have become the major shareholders of many American corporations. The potential power of these institutional investors in the governance of major corporations cannot be underestimated, nor overlooked when considering regulatory programs for the securities industry. In 1933, when the first Federal securities law was adopted, institutions owned less than 8.5% of the outstanding stock listed on the New York Stock Exchange.[159] By 1979, however, the holdings of institutional investors climbed to approximately 35% of the value of all stock outstanding.[160] With the continued growth of private and public pension plans, it is predicted that at least fifty percent of the equity capital of American corporations may be held by pension funds by 1985.[161] These figures suggest that large institutional in-

159. Securities and Exchange Commission Staff Report on Corporate Accountability, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,674, at 83,712 & n.10, (Sept. 4, 1980) [hereinafter cited as S.E.C. Report on Corporate Accountability].

160. *Id.* at n.11.

161. *See* Curzan & Pelesh, *supra* note 3, at 683 (citing P. DRUCKER, THE UNSEEN

vestors possess the potential to exercise tremendous power in the corporate electoral system and that their involvement in the proxy system could have a profound impact on corporate behavior.

There is considerable disagreement over whether the power of institutional investors has been translated into support for public policy shareholder resolutions. Some commentators have argued that the investment managers of these large institutions rarely vote their beneficiaries' stock in support of social responsibility initiatives.[162] Others, notably the SEC, have contended that institutions are no longer voting in accordance with the "Wall Street Rule" (i.e. the practice of selling the securities of a company rather than expressing displeasure by voting against management) and have begun to seriously assess shareholder resolutions.[163] Presumably, the validity of the new resubmission requirements is contingent upon one's view of institutional investors as active shareholders. The former position leads to the conclusion that resubmission percentages are unreliable indicators of proposal popularity because a majority of the voting shares are either cast unwittingly by large institutions or never cast at all. The SEC position, on the other hand, suggests that the new minimum percentage requirements can legitimately weed out proposals which have been determined by a majority of the voting shares to be meritless or unworthy of reconsideration.

Although the Commission's assessment of the institutional investor's role as a shareholder participant may be accurate, the SEC regulatory response to this conclusion is unfounded. The problem with the participation of institutions in the corporate proxy system is not whether those institutions decide to vote in favor of social responsibility issues. The problem is more accurately defined as whether the institutional voting practices and procedures are legitimate in the sense that the views of the beneficial owners have been adequately represented by institutional

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REVOLUTION 15-16 (1976)).

162. *Id.* at 686-87.

163. S.E.C. Report on Corporate Accountability, *supra* note 159, at 83,712. According to a newsletter published by the Council on Economic Priorities, some institutional investors have even begun to sponsor their own social resolutions. For example, the California State Teachers Retirement System, with more than $7 billion in assets, has co-sponsored a resolution asking Standard Oil of Indiana to disclose certain employment-related data. The fund's action may signal an end to the reluctance of major investors to play an active role in the shareholder process. *Minding the Corporate Conscience*, *supra* note 137.

choice. The appropriate regulatory response to this problem is not the imposition of higher resubmission percentages but rather a coherent set of administrative rules aimed at reducing the discretionary voting power of investment managers, trustees, etc. These rules should encourage institutional investors to adopt one or more of the following options: (1) the establishment of formalized procedures for processing proxy statements and reaching voting decisions;[164] (2) the disclosure of their proxy voting practices to both their own shareholders and to the beneficial owners of the shares they manage;[165] (3) the offering to beneficial owners of the opportunity to influence institutional decisions on proxy issues (e.g., establish internal social responsibility committees);[166] and (4) the "pass through" of voting rights to the beneficial owners of the shares.[167]

Perhaps to its credit, the SEC in 1978 proposed similar although more limited disclosure rules to regulate the voting practices of institutional investors.[168] The proposed rule, Rule 14a-3(b)(11), would have required certain institutions and parent holding companies subject to the proxy rules to disclose their voting policies and procedures in their annual reports to shareholders. The major drawback with the amendment was that many large institutions, such as banks and insurance companies acting as trustees, were not covered by the proposed disclosure requirements since their securities were not registered pursuant to section 12 of the Exchange Act.[169] Although the proposed rule amendment was never adopted, the rulemaking proceedings nevertheless displayed the Commission's concern with the voting practices of institutional investors. Given the tremendous influence of institutional investors on the corporate proxy system and the SEC recognition of shareholder interest in institutional voting policies and procedures, the latest revision of paragraph (c)(12) should be regarded as an inadequate regulatory response to the exigencies of the securities industry. The SEC committment to corporate democracy and shareholder communication would have

164. S.E.C Report on Corporate Accountability, *supra* note 159, at 83,712.
165. *Id.*
166. *See* Curzan & Pelesh, *supra* note 3, at 691.
167. *Id.*
168. Securities Exchange Act Release No. 34-14970, 43 Fed. Reg. 31,945 (1978).
169. 15 U.S.C. § 78l(g)(2)(C), (G) (1982).

been better served if the staff had made a greater effort to bring the majority of institutional investors within the realm of a disclosure rule.[170]

In sum, the three rule revisions discussed above suggest that the Commission has created more regulatory burdens than it has alleviated. To a certain extent, this problem was created by the factual inadequacies of the Commission's rulemaking proceedings. Many of the staff's theories of the abuse of the proposal process were simply untrue. To a larger extent, however, the real regulatory nightmares of the 1984 amendments can be traced to the Commission's misplaced confidence in its ability to make objective administrative decisions. Perhaps the Commission would have done better if it had listened to the admonition of one of its own members. Commissioner Bevis Longstreth, who has frequently criticized the ability of the SEC to perfect the regulatory framework of Rule 14a-8 through continuous modifications, once observed:

> [Administering Rule 14a-8] has entangled the staff in a parade of issues turning on state law, corporate policy, social engineering and political questions to which we, as regulators, can contribute little . . . . [G]reater precision and more complex involvement by the Commission in the process does not necessarily result in more perfect regulation—just *more* regulation, together with greater cost and even more uncertainty for the private sector.[171]

The Commissioner's observations highlight the practical limitations of the new rules.

Conclusion

When the Commission first initiated the rulemaking proceeding for the Rule 14a-8 revisions, it noted that the process was "a reevaluation of the need for and desirability of providing a right of security holder access to the issuer's proxy statement . . . and if such right of access is to be continued, what the nature of such

170. After noting that the regulation of institutional investors pursuant to section 14 of the Exchange Act could transcend the existing authority of the Commission, the SEC pointed out that the staff would nevertheless be authorized to develop a legislative proposal to amend section 13(f) of the Exchange Act so as to require disclosure by institutions of the proxy voting practices and procedures. S.E.C. Report on Corporate Accountability, *supra* note 159, at 83,713.

171. B. Longstreth, "The SEC and Shareholder Proposals: Simplification in Regulation," Remarks to Nat'l Assn. of Manufacturers, Denver, Colorado (Dec. 11, 1981), *quoted in* Propp, *supra* note 3, at 101 n.6.

right should be."[172] The Commission's rhetorical query was an understatement. Since its inception, Rule 14a-8 has touched the heart of state corporation law—affecting the fundamental relationship of shareholders and management to each other and to the corporation.

It is not surprising, therefore, that the Commission's recent attempt to reform the regulatory framework of the Rule has been both applauded and denounced within the same breath. Those supporting the management interest maintain that the new rule is a well-conceived and balanced effort by the SEC to preserve an inexpensive, non-confrontational solicitation process. Critics of the new rule contend that the Commission has arbitrarily suspended the shareholders' interest in maintaining an effective voice in the governance of modern corporations. Both sides would be willing to agree that any modification of the rule is inextricably forced to benefit one side of this delicate balance at the expense of the other.

In 1980, SEC Chairman Harold M. Williams summed up the delicate nature of this balancing process and the importance of the SEC's sensitivity to the interests represented on either side. He stated:

> Americans have a deep rooted sense that power, no matter how beneficient its exercise, must be accountable to society at large, and we have witnessed in the past decade notable and well publicized instances in which corporate power has been abused to the detriment of the public. As a result, calls for legislative constraints on the corporate decision-making process have a deep appeal. It is this dilemma, the undeniable economic success of the corporation and the role which flexibility and governance mechanisms has played in that success on the one side, and, on the other, the growing sense that this flexibility ought to be restrained, which makes discussion of corporate accountability both challenging and difficult for those who are genuinely sensitive to both the importance of the national economic health and the significance of public confidence in the legitimacy of corporate power.[173]

Perhaps the most disturbing aspect of the Commission's latest revision of Rule 14a-8 was the staff's demonstrated ambivalence for preserving the historic legitimacy of the rule. The Commission chose to adopt several restrictive provisions, all designed to limit

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172. Securities Exchange Act Release No. 34-19135, 47 Fed. Reg. 47,420, 47,421 (1982).

173. Speech by Harold M. Williams to the Nat'l Conference on Corporate Governance in the 1980s, *reprinted in* A.L.I.-A.B.A. COMM. ON CONT. PROF. EDUC. 10 (1981).

shareholder access to the proposal process, despite the lack of documentary support for the changes. In so doing, the SEC repudiated a congressional mandate and a judicial recognition of corporate democracy, and, above all, a public sentiment which seeks greater accountability of the powerful economic institutions which affect our society.

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