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PROXY CONTESTS UNDER THE SECURITIES AND EXCHANGE COMMISSION'S PROXY RULES

Address of

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before the

CHICAGO CHAPTER

of the

AMERICAN SOCIETY OF CORPORATE SECRETARIES

Chicago, Illinois

February 9, 1955

When I addressed the Chicago Chapter of the American Society of Corporate Secretaries in January a year ago, I discussed in some detail the program for revision of rules, regulations and forms which had been inaugurated in 1953 and was then going forward full steam. I could give you a progress report on the rule revision program at this time, and I am sure you would be interested in the enormous progress which has been made in the revision and simplification of the regulations, and at the same time, in my opinion, the continued emphasis on investor protection under our regulations under the Securities Acts.

The Commission's Annual Report to the Congress for the fiscal year ended June 30, 1954, has been released within the last day or so. It covers the entire scope of the rule revision program as it has gone forward in the last 18 months. Accordingly, rather than deal with rule revisions today, I thought it would be pertinent and timely to discuss one of the important and most difficult types of problems that arises under the Securities Exchange Act of 1934. I shall discuss the administration of Regulation X-14, the proxy rules, as it pertains to the complicated problems occurring in proxy contests. What I am about to say represents my own observation of the manner in which the proxy rules have been administered in the context of hard fought proxy contests.

We have come to that season of the year when the corporate officials of listed companies are occupied with the preparation, and the Securities and Exchange Commission and its staff with the review, of proxy material for use in connection with the solicitation of proxies for shareholders' meetings. If past experience is a useful guide, the next few months will be a lively period for us and for some of you.

As you will recall the Commission's proxy rules were substantially overhauled in the fall of 1952. 1/ Further amendments, clarifying the requirements as to the disclosure of remuneration and placing reasonable limitations on the shareholder proposal rule, were adopted in the latter part of 1953, effective in January and February 1954. 2/

In the summer of 1954 the Commission, in reviewing with the staff its program for the fiscal year ending June 30, 1955, concluded that it would make no proposal for revisions of the proxy rules for this now current proxy season. In their application to the vast majority of solicitations, those relating to routine elections and other corporate business, the rules in general seem to be working very well. The amendments of a clarifying nature adopted in 1953 served to reduce substantially points of irritation and the number of comments resulting from the examination of proxy material by our staff.

1/ Securities Exchange Act Release No. 4775 (December 11, 1952).

2/ Securities Exchange Act Release No. 4979 (February 6, 1954).

The changes in the shareholder proposal rule appear to have removed much of the criticism of our rules arising out of "repeaters" and proposals which tend to project stockholder opinion into matters involving ordinary business operations.

The rules contain no formal requirements drawn specifically for the problems of fair disclosure arising out of proxy contests. However, in the handling of the cases the Commission has gradually reached certain results with certain types of problems. Commission thinking and Commission policy on the whole subject is still in a state of evolution.

We considered the possibility of formulating and circulating for comment rule revisions particularly relating to contests in an effort to make at least a beginning towards some solution. We concluded, however, to propose no changes in the rules and to observe the contest problem closely during the present proxy season.

Last year, that is in the 1954 proxy season, there were 28 proxy contests involving elections of directors conducted under our rules. A few of these, such as the New York Central and American Woolen cases, stimulated widespread interest and comment. Others, fought with equal vigor and frequently with bitterness, attracted no widespread public attention. It is impossible to predict the number of contests during the current period, but I think we can assume that there will be several.

I think it fair to say that the most difficult single question presented to the Commission in the administration of the proxy rules as applied to an election contest arises from the effort almost invariably made by one side or the other to subject one or more individuals to public attack on their personal character. I will have more to say on this subject in a few minutes. But before I develop that, I want to begin with a few words about the statutory basis for the rules and their general tenor.

Section 14(a) of the Securities Exchange Act of 1934 in general prohibits the solicitation of proxies with respect to securities registered on national securities exchanges by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. The Commission has promulgated rules under this section, known as Regulation X-14 under the Exchange Act, which seek to protect investors by requiring the disclosure to them of certain basic information at the time their proxies are solicited. The information prescribed for such disclosure is calculated to enable the average "prudent" investor to act intelligently upon each separate matter with respect to which his vote or consent is sought.

The Commission's proxy rules, although applicable in general terms to a solicitation with respect to a listed security by any person, naturally are most easily applied and understood from the viewpoint of a solicitation by management, and this is still, of course, the most common situation. But once public announcements are made by a participant in a proxy contest and as soon as preliminary steps are taken pointing to a proxy battle, the Commission's problems and your problems as corporate officers become much more difficult. Not only have these contests attracted increasing attention from the press, radio and television, but there is a growing tendency for contestants to hire public relations counsel to utilize these and other media to condition both public opinion and the opinions of present and prospective stockholders in their favor either before or after the filing of a formal proxy statement.

The Commission's difficulties in proxy contests thus may be due in part to the fact that contests involve a large number of people who take part in the preparation and distribution of soliciting material and who are more likely to be unfamiliar with the workings of the proxy rules than is usually the situation in routine elections. This discussion is intended to bring about a better public understanding of the proxy rules and how they are administered in the public interest.

Since most proxy contests relate to the election of directors, a brief sketch of the requirements of the proxy rules with respect to the election of directors may be helpful. To aid investors in making a judgment, the rules in general provide that security holders shall be furnished information in the form of a proxy statement which gives the names of the nominees for directors, and describes their positions with the company, their business experience, their compensation, their transactions with the company and their ownership of securities of the company, and certain details regarding the use of paid solicitors.

The rules also require that the proxy statement disclose the names of the persons who will directly or indirectly bear the cost of the solicitation. Normally the cost of proxy solicitation by the management of a corporation is borne by the corporation itself, and the proxy statements generally include information as to direct costs of soliciting. In the case of contestants opposed to the management, however, they or their cohorts must bear the expenses of solicitation, at least until and unless they are successful. Since the possibility of reimbursement by the corporation exists, the Commission has required contestants opposed to management to state whether or not, if successful, they will seek reimbursement from the company itself for the expenses of their solicitation.

Beyond this the proxy rules simply require that solicitations must not contain misleading statements nor omit material facts necessary to make the statements made not misleading in the circumstances. The

rules also provide that misleading statements or omissionspreviously made in soliciting material must be corrected in subsequent material. Although the Commission has power to seek an injunction in the courts for the correction of misleading statements, in practice it has rarely been necessary to invoke such a drastic remedy. The administrative processing by the staff and administrative rulings by the Commission usually result in appropriate and timely disclosures without the necessity of recourse to the courts.

Neither you nor the Commission can assume, however, that the thrust and parry in a contest for control are merely matters for the Securities Exchange Act of 1934 and the Commission's proxy rules under that statute. The problem involves some constitutional guarantees, such as freedom of speech and of the press, which are great bulwarks of American liberties and afford some measure of fair dealing if not abused. On the other hand, contestants should not expect to be free to take unfair advantage of traditional freedoms and of the public by using the press as a tool to accomplish indirectly that which the proxy rules prohibit if done directly.

A proxy contest for election to a corporate office is somewhat like a campaign for an election to a political office. A good deal of freedom for candidates in political contests has been traditional in American life. The Commission has always believed that in contests for control of corporate offices there should likewise be freedom to define the issues believed to be involved and that a wide range of debate and argument should be left to the contestants subject, however, to the rule which springs from our statute that investors must not be misled. The Commission's proxy rules thus are designed to assure that basic facts are disclosed, but to leave a wide area for fair comment by the contestants. As I see it, this is the basic philosophy.

In proxy contests of great intensity and publicity, as in the New York Central, American Woolen and New Haven cases, the Commission is confronted with questions as to when solicitation begins and what constitutes proxy soliciting material subject to the rules.

The term "solicitation" is defined in the proxy rules to include "(1) any request for a proxy whether or not accompanied by or included in a form of proxy, (2) any request to execute or not to execute, or to revoke a proxy, or (3) the furnishing of a form of proxy to security holders under circumstances reasonably calculated to result in the procurement of a proxy." In addition, through judicial decisions it appears that the Commission's authority extends to any writings, whether or not they strictly solicit a proxy, which "are part of a continuous plan ending in solicitation and which prepare the way for its success." 1/ The interpretations of the courts of the meaning of the

1/ SEC v. Okin, 132 F. 2nd 784 (C.A. 2nd 1943); SEC v. Topping, 85 F. Supp. 63 (S. D. N. Y. 1949).

term "solicitation" so as to include activity preceding the formal solicitation are extremely important.

In a proxy campaign, especially one involving one of our large corporations, as soon as there are announced intentions to engage in a proxy contest, public statements made by the contestants are generally made with the impending proxy solicitation in mind, and are calculated to induce eventual success. Consequently, in these situations the Commission takes the position that publication of preliminary letters, advertisements and prepared announcements, even though neither side has as yet requested the execution of a form of proxy, are properly to be considered as a step in a solicitation of proxies within the meaning of the Commission's proxy rules. This is true whether or not the material is to be distributed directly to security holders, so long as in fact the intent and effect of it is to align public opinion and the opinion of present and prospective security holders to the cause of the individual or group issuing the material.

Let me emphasize at this point that the proxy rules do not prohibit the release or distribution of soliciting material. The rules merely require that such material be filed with the Commission prior to its release to the public and that it conform to regulations designed solely to provide security holders with a fair presentation of the information necessary to an informed consideration and ultimate decision by them.

As you are well aware, the press, particularly at the inception of a campaign in respect of the control of one of the large corporations, becomes intensely interested in the views of contestants. Frequently such views are solicited by the press itself by means of requests for press conferences and radio and television news programs. Apart from the question of the freedom of the press, to which I alluded a moment ago, the Commission has never questioned the propriety of contestants to answer inquiries made by the press which have not been stimulated or induced or "planted" by the contestants. We have always recognized that any requirement that such answers be first communicated to or filed with the Commission would be hopelessly impractical. As a consequence, even though the answers given to unrequested press inquiries may be actually of a soliciting character, they have not been and are not required to be filed with the Commission. It must be obvious, however, how easy it could be to take advantage of the ostensibly spontaneous press inquiry which in fact is a carefully maneuvered part of a skillful campaign.

What is required, however, is that when a transcript of such questions and answers is sought to be distributed in connection with formal soliciting efforts, it must be filed with the Commission. Also, a prepared speech or a prepared release for inclusion in a newspaper or magazine or in a television or radio program is proxy soliciting

material if it is intended to condition public opinion and the opinion of stockholders favorably to the publishers of such releases and speeches. We have, therefore, consistently held that such material must be filed with the Commission for processing by the staff prior to its use. This has not caused timing problems, even when a prepared news release, to be newsworthy, must be disseminated promptly. In such cases, where necessary, we have permitted a telegraphic or telephoned version of the release to be "filed" with us and have processed it within a short period, often the same day, of such "filing".

Experience with many contests for control of corporate management indicates the importance of having literature, used by the competing parties in the period prior to the actual request for execution of a form of proxy, subjected to scrutiny pursuant to the proxy rules. Otherwise, the unrestricted use of such literature at the preliminary stages of a contest could effectively destroy the usefulness of the proxy rules to assure security holders fair disclosure regarding the matters on which they are asked to act. For this reason it has been settled administrative practice for the Commission to insist that preliminary literature be filed pursuant to the proxy rules before its use, and, as I indicated earlier, this administrative practice has received judicial support.

Much the same considerations apply to the use in proxy contests of reprints of newspaper and magazine stories and articles, published reports, and letters. In some cases the reprint sought to be used is a news story or a magazine article written by some person not involved in the proxy contest, which had been written and released in its original form under circumstances where the proxy rules had no application, but which one side or the other seeks to disseminate because it considers the material favorable to its cause. Obviously, such reprints could contain misleading statements or material omissions when viewed as proxy soliciting material.

The proxy rules could be easily circumvented and abused if statements which would be considered misleading and improper as proxy soliciting material could be freely circulated or given publicity by the parties in a proxy contest solely on the ground that such statements had already appeared in publications, the preparation and release of which had been accomplished apart from the proxy rules. Accordingly, the Commission has insisted that such material, whether or not prepared by or on behalf of the contestants, if used, must be filed as soliciting material prior to its use. Furthermore, in reviewing reprints of material which in its original form was not subject to the proxy rules but which is intended to be circulated or published by one side or the other in a proxy contest, the Commission has scrutinized such material in the same way it would scrutinize material originally prepared specifically as proxy soliciting material.

Where material emanates from one side or the other, stockholders are in a position to weigh for themselves possible bias. Where apparently independent magazine, newspaper or investment advisory articles are used, however, it is necessary to determine whether such material has in fact been originated, inspired, or paid for by one of the opposing parties, so that any lack of objectivity or independent comment in the presentation of the material may be spelled out to shareholders to assist them in appraising the material. Thus, the Commission has followed the practice of inquiring of a participant in a proxy contest whether or not he has instigated or paid for the preparation of apparently independent favorable material which he proposes to distribute, and, if so, to disclose this information in his soliciting material.

In some instances parties in a proxy contest have addressed letters or telegrams to the Commissioners or Division staff members -- I am referring to the staff members of the Commission's Division of Corporation Finance which, as you know, has charge of processing the proxy soliciting material -- for the purpose of using such communications as additional proxy soliciting material to be distributed to stockholders or otherwise publicly released. The use of such communications as proxy soliciting material containing, as they frequently do, self-serving declarations favorable to the user, has been considered misleading as implying, contrary to fact, that the Commission or individual Commissioners or staff members have agreed with or vouched for the partisan statements contained therein.

The use of such material would not only be a violation of the proxy rules, but it would inevitably embroil the Commission in partisan proxy fights. Consistent with the policy of the Commission to remain on the sidelines in proxy contests so far as its statutory responsibilities permit, the Commission has consistently taken the position that the use as soliciting material of communications to or from the Commission or Division would be objectionable.

The objection, of course, has applied only to the use of material in the form of a communication to or from the Commission, and there would be no objection to the use of the same data in another form if otherwise unobjectionable as soliciting material.

A problem closely allied to the question of the use as soliciting material of communications to the Commission is the question of the use in soliciting material of references to the Commission. At this point I want to emphasize that the Commission does not approve or disapprove material filed with it pursuant to the proxy rules. The Commission's position in this respect derives from Section 26 of the Exchange Act and is comparable to its position with respect to registration statements pertaining to new issues of securities under the Securities Act of 1933. The Commission does not approve registration statements or new securities and to represent that it does, under

Section 23 of the Securities Act, is a criminal offense. So, under the Exchange Act, the Commission does not approve proxy soliciting material. Accordingly, references in soliciting material to the Commission which state or imply that the Commission has "approved" or "cleared" or "sanctioned" the material are considered objectionable. In this connection, I should mention that the proxy rules contain no requirement that proxy material include a legend indicating that the Commission does not approve or vouch for the representations made. In any future revision of the rules such a requirement will be considered. The Commission's scrutiny of proxy material does tend to prevent the use of misleading facts or to correct them but it cannot guarantee such results. As a corollary to the fact that the Commission does not approve or disapprove statements made by opposing sides in proxy contests, I wish to emphasize also that the Commission is not responsible for the accuracy or adequacy of the material filed with it. The ultimate responsibility for the correctness of the information furnished to the security holders must rest upon those who prepare and distribute it.

Notwithstanding 20 years of administration of the Securities Acts, the Commission's role with reference to new security issues and proxy statements is still misunderstood and misconstrued, not only by the public generally, but also by many writers and others who should by now know better. The Commission administers the statutes, in accordance with the purpose the laws express, to secure fair and adequate disclosure for the protection of the public and the public investor. We are concerned with the enforcement of the statutes and maintaining the integrity of the statutes and our rules in terms of these standards. We do not express opinions concerning or approve or disapprove business transactions or matters submitted to stockholders for their action. We do not take sides in proxy contests. It is not our function to champion, or to oppose, any party concerned in election of directors or any other corporate project presented to security holders for their approval by the companies subject to our proxy rules. Our job is to require impartial fair disclosure of essential relevant facts to the investing public. The administrative procedures which have been successfully applied for so many years to the Securities Acts for this purpose have been brought to bear on the proxy rules.

We are bound to seek to enforce our proxy rules. There are two ways in which this could be accomplished. We could review material filed with us and institute court proceedings to compel compliance with our requirements. In other words, we might lie in wait, so to speak, and pounce on the person who violates or threatens to violate by bringing legal action in the Federal courts to prevent the use of inadequate or misleading information.

The other procedure -- the one which is followed -- is to advise persons involved of the respects in which it appears corrections or changes should be made. Our willingness to comment on material and

in fact assist people to comply with the statutory standards has led quite naturally to the custom, almost universally followed, of securing from our staff some expression of objection or non-objection prior to the use of proxy material. This non-objection has become foreshortened to "approval" and gradually the idea has become accepted that we "approve" or "refuse to approve" material and that, finally, "refusal to approve" is in fact a prohibition, all of which is a misconception of our function.

One popular misconception is that the Commission approves or prohibits the use of proxy material. A second misconception is that the Commission can by the exercise of some administrative power, prohibit the holding of a meeting or the voting of proxies. A third misconception is the idea which seems to be held that the Commission has a duty to participate in litigation or to initiate litigation for reasons and concerning issues which have nothing to do with our administrative responsibilities.

The following are a few basic truths, based on the statute we administer. The Securities and Exchange Commission has no power under the law to and does not approve the use of proxy material, nor can it prohibit the use of proxy material without obtaining an injunction in a Federal court. The Commission cannot prohibit the holding of a shareholders' meeting, the Commission cannot require the postponement of a shareholders' meeting, the Commission cannot compel or prohibit the voting of proxies. Jurisdiction to perform these functions rests in the courts alone, not in the Commission.

We will begin a court action or participate in a court action only when a problem of construction of the statutes or rules which might affect their administration is involved or when it appears to us that a violation has occurred. We do not defend proxy statements or registration statements before the courts, nor do we attempt to assert before a court that a person has complied with the rules. To attempt to do so would be administratively impossible. The burden is on the party in possession of the facts to assertthe facts which support his contention that he has not violated the law. In proxy matters, it must always be borne in mind that the parties involved are the only ones in possession of all the facts or in a position to secure them quickly and accurately. It must also be borne in mind that the institution of litigation is not solely the prerogative of the Commission. Stockholders and opposing sides may sue, asserting false and misleading representations under our statutes, and all manner of offenses under state law or other Federal laws. The Commission must maintain at all times complete freedom to appear in court in any case should that course appear necessary to compel compliance with the statutes and aid the courts in this purpose.

In the ordinary situation where business facts, accounting principles, or discussions of financial or business matters are at issue, our staff is competent and able to arrive at some working basis with the parties involved in securing what appears to be fair disclosure.

As I mentioned earlier, however, in a proxy contest sometimes there develops an effort to launch a public attack upon the character of an individual. Usually such an attack mentions people, places or events which by their very nature are such that we have neither the time, manpower nor competence to make even a cursory check as to fairness and accuracy. In addition, these may be couched in terms which necessarily raise serious questions whether they are in fact not misleading and inaccurate or omit other facts necessary in order to make the whole not misleading. Usually we warn against the use of such material absent an ability and willingness of the proponent to supply complete and adequate supporting and corroborating data. In most instances in the past these data have not been forthcoming. In a few cases in which we have been pressed notwithstanding warnings at staff level, the Commission has taken the position that the use of such material is contrary to the standards of fair disclosure unless it is in fact true and not misleading and that such material if used must be at the sole legal risk of the person proposing to publish it. The Commission reserves complete freedom to seek an injunction in the Federal court should it appear that the standards of our rules have not been met.

Out of this administrative practice and policy has come the notion that we "prohibit" the use of material of this character. The fact of the matter is, as I have already stated, only the courts can "prohibit". However, it has been our experience in these cases that without some assurance that the Commission will not at some later date appear in court alone or with the opposition charging a violation of law, the risks involved in publication of such material have not been assumed. It should be readily understood, therefore, in connection with potentially libelous and defamatory material that the Commission is concerned that no action by it or its staff in commenting or failing to comment upon such material is to be construed as having in any way indicated approval of material for its release or in any way having diminished the primary responsibility of the person who publishes it.

The Commission's experience in the administration of the proxy rules in connection with contests for control of management indicates that the problem with respect to potentially misleading statements of and omissions of material fact tend to fall into one of several general categories:

1. Distortion of business or financial facts for the purposes of creating inferences or impressions favorable to the contestants which are unwarranted by the underlying facts;

2. Expressions of opinions or conclusions concerning the operations of the company not supported by, or contrary to, the known facts or the facts asserted to substantiate or establish a basis for the statements made;

3. The use out of context of statements made by courts, Congressional committees and administrative agencies and similar bodies or reference to indictments or unproven charges or similar matters under circumstances which imply or infer conviction or guilt which has not in fact been established;

4. The expressions as fact of that which should be clearly identified as opinion;

5. Resort is had, without supporting facts, to personal attack by association with criminals, communists or references to illegal acts or events generally regarded as contrary to the public interest, or by the use of reprints or extracts from newspapers and periodicals of a generally derogatory nature;

6. The use of libelous, defamatory, scurrilous or similar material;

7. Claims, promises or projections as to future earnings, dividends, sales and increases in value of assets or stock based on mere conjecture or distortion or reconstruction of past operating results of the company without regard to generally accepted accounting, statistical or financial principles.

This summary of some of our experience in the administration of Regulation X-14 as applied to proxy contests is designed to help eliminate unnecessary delays and other impediments in the processing of soliciting material by the Commission's staff and the dissemination of relevant and truthful material to security holders.

Also, you will recognize that if these few but important ground rules which I have mentioned are followed, the risks of administrative delays and court proceedings will be materially diminished. Every one that I have mentioned resulted from actual experience with specific cases and in each instance the principle involved was hammered out administratively in an effort to hew to the line of fair disclosure for the benefit of the investing public.