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News Release

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"The Proxy Rules: Reflections on Some Proposals for Change"

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*/ The views expressed herein are those of Commissioner Lochner and do not necessarily represent the views of the other Commissioners or the Commission staff.

The Proxy Rules: Reflections on Some Proposals for Change

Thank you very much.

With the distinguished faculty at this program, there is little I can add to a discussion of the current environment for takeovers. Assuming environment is the right word --- it suggests something alive.

Instead, I thought I might take a few moments to look a little further into the future and discuss some suggested changes in the current proxy rules which at least certain groups have favored. If it is true that the '80's were the decade of the takeover, the 90's may be the decade of the proxy, then this may turn out to be a useful topic.

As you undoubtedly know, the SEC's staff is undertaking a review of the proxy rules, in part in response to some proposals that we have received for suggested changes in those rules. What I would like to do today is to discuss a few of these proposals for change in certain parts of the proxy rules: specifically, shareholder communications;

shareholder proposals under Rule 14a-8; confidential voting and independent tabulation of votes; and disclosure of beneficial ownership of shares and shareholder lists.

Before proceeding further, I should note that the views I express this afternoon are, of course, solely my own. Indeed, given the incomplete record so far before the SEC --- incomplete both in the sense of who we have heard from to this point and what has been said --- and given the continuing evolution in both practice and outcomes under the existing proxy rules, I would not even claim that the views I express today will necessarily be my views six months or a year from now. In fact, I have some reluctance to discuss the proposals for change at all since to discuss them suggests the Commission will necessarily take some action on them. As yet, no one should necessarily reach that conclusion.

The staff's review of the proxy process is, in one sense, broad in scope, covering not only the major proposals for change from interest groups, but also various legislative proposals, and academic research on governance matters as well. Further, the staff is looking at the effects of state law on the process and how federal laws, including federal laws not within the scope of the SEC's jurisdiction, affect the proxy milieu.

Given the wide sweep of the staff's review, my own best guess is that the Commission will not be in a position to take action, if any, to change any proxy rules until at least well into 1991. (But, remember, I predicted we'd see new Section 16 rules by last July.)

In another sense, the staff's review could be viewed as narrow in scope, since even should the proxy rules be changed, what is ultimately likely to result, for good or ill, will surely not be seismic in its impact on U.S. corporations. I say this not because the proxy rules are unimportant; they are, in fact, a basic building block in the structure of shareholder protection. But no change in the proxy rules will usher in either any new millennium, or any new dark age, of capitalism, as some of those who have participated in public discussion of the rules have claimed. Too many other variables — the economy, interest rates, the tax code, and international competition, to name but a few — are at work for that to be the case.

So much for the preliminaries.

Shareholder Communications

The first issue I would like to address is shareholder communications.

Shareholders who wish to communicate with each other must be aware of current SEC Rule 14a-1, which

provides — in yet another case of bad grammar under law — that a communication amounts to a proxy solicitation if it occurs "under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."

Proponents of change in this Rule believe that it impedes communications among shareholders, as well as communications with professional proxy advisors and a range of public interest and non-profit organizations. In this they are quite right. Indeed, many SEC rules impede communication — including the rule requiring the filing of a registration statement before offering securities to the public. The issue is not, of course, whether the Commission can or should impede communication but, rather, to what extent and with what results.

Determining the proper limits on shareholder communications presents, I believe, one of the thorniest issues in the current discussion on changes in the proxy rules. An ongoing dialogue among shareholders, and between shareholders and an incumbent board, is said to be desirable. Evolutionary change through constant dialogue may be preferable to the expense and distraction of a proxy fight — at least for those who are not securities lawyers, media advisors or proxy solicitors.

However, the Commission is statutorily charged, broadly stated, with ensuring full disclosure of matters material to shareholders and their decision-making as investors. Small investors need the protection of the proxy disclosure rules to prevent collusive activity which may be detrimental to their interests. For the SEC to withdraw from the proxy arena could open the way for back-room deals, as well as permitting secret solicitations involving coercion and/or misinformation. Indeed, some would say that the SEC needs to police more in this area, not less.

Others argue that sophisticated investors should be free to communicate among themselves, because they do not need the protection of the proxy rules. I would concur that it is possible that some institutions in some cases may not need to be protected by the proxy rules. But isn't it possible that without the protection of the proxy rules some large investors could cut private deals to their benefit and to the exclusion of other large investors? These issues need thorough discussion.

The ABA has proposed an exemption from Rule 14a-1 for preliminary, non-public communications among a limited number of shareholders, or between the registrant and a limited number of shareholders. The proposed safe harbor is designed to permit idea testing among shareholders, as well as between the incumbent board and shareholders, and would cover only communication that is not otherwise designed to solicit a proxy. Under the proposal, for a communication to be exempted, there could be no general public dissemination, thereby excluding communications through mass mailings, or television, radio, newspapers, magazines or other media.

Another proposal that has been suggested is that the SEC adopt a rule rendering all proxy rules, except the anti-fraud provisions, inapplicable to any communication made more than a certain number of days prior to the date of a shareholders' meeting, provided no proxy is expressly solicited in that communication. One hundred eighty days might be an appropriate period. This proposed safe harbor would include communications designed to measure the prospects and support for specific shareholder proposals or director nominees before a decision actually has been made to solicit proxies.

To the extent that the Commission decides to exempt certain communications, guidance will have to be provided concerning the extent to which a shareholder's participation in such communications and other collective activity requires the filing of a Schedule 13D.

The SEC staff has previously taken the position that simply voting in favor of a particular shareholder proposal does not make a shareholder a member of a 13D group. This is obviously correct.

However, there currently is little guidance as to what form of activity, short of an agreement to co-sponsor or solicit in support of a proposal, would constitute group activity.

One suggested solution is to require that any institution or group that owns 5% or more of a registrant's stock should report the substance of all communications with shareholders or the registrant on Schedules 13D or 13G, with management having a corresponding counter obligation.

Yet another approach might be to provide a safe harbor for all shareholders at any time so long as they did not form a group for 13D purposes. Once their communications went beyond that limit, full compliance with the current proxy rules could be required.

Reducing current restrictions on shareholder communications will have some implications for continuity in issuer management and the amount of resources the society devotes to such things as proxy contests. Whether these, among others, are costs worth bearing is a question that needs to be studied. At this point there is little consensus on how to frame these cost issues, much less on what the costs amount to.

Shareholder Proposals

Now I would like to turn from Rule 14a-1 to Rule 14a-8.

The number of shareholder proposals submitted to registrants, as well as the number of proposals actually included in proxy statements, has significantly increased in recent years. According to the Investor Responsibility Research Center, which follows the nation's 1,500 largest publicly held corporations, about 300 shareholder proposals relating to corporate governance matters were presented to shareholders in 1990, compared with about 240 in 1989. The increasing support for these proposals is evidenced by the fact that in 1990, 20 of such proposals won approval, compared with only 6 in 1989.

Despite the increasing number of shareholder proposals, and the increasing percentage of votes attained by such shareholder proposals, some groups are advocating a complete overhaul of Rule 14a-8.

There are at least two recurring criticisms of Rule 14a-8. First, it is said that the rule unnecessarily restricts the topics shareholders can address in the proxy statement, pointing specifically to the inability to nominate directors or submit statements in opposition to management proposals. Second, since 1984, proponents have been limited to submitting one proposal for any single proxy statement and this is said unnecessarily to restrict shareholder communication.

These limitations, of course, were originally put in place in large part because of perceived abuses by shareholders who held only a minimum amount of a registrant's stock, who put forward proposals which lacked broad appeal, and which garnered relatively few votes. It was believed then, and I think correctly, that a proxy statement need not serve the same purpose as a radio call-in program or the letters-to-the-editors column in a newspaper, providing a platform for any and all ideas, nostrums and views.

The subject matter limitations in Rule 14a-8 are, frankly, easily evaded. Many believe they should be tightened up, and that too much space in proxy statements is still taken up by the irrelevant and the immaterial.

There have been several proposals that would purport to address these issues by providing greater proxy statement access to a shareholder or group of shareholders who own a significant percentage of the registrant's stock, the theory being that large shareholders are unlikely to abuse the process by making proposals which have limited appeal to shareholders generally.

For instance, one commentor has urged that any shareholder or group of shareholders who owns the lesser of 5% or $50 million of an issuer's voting securities be allowed to nominate a full slate of director candidates, and automatically have those nominees included in the issuer's proxy statement. Senator Shelby of Alabama introduced legislation in 1989 that would have permitted a shareholder with 10% of a corporation's combined votes to incorporate in that corporation's proxy statement such shareholder's views on both election and non-election items being proposed for a vote. A bill introduced by Senators Armstrong and Metzenbaum would have allowed the same access at the 3% ownership level.

With respect to the limitation of one proposal per shareholder, another group has proposed that Rule 14a-8 be revised to allow a holder of at least 3% or $1,000,000 of securities of a registrant to submit more than one proposal.

Others, have objected to these proposals on the ground that all shareholders should be accorded equal right of access to a registrant's proxy statement. They argue that there is no reason to assume that only smaller shareholders would abuse the right of unlimited proposals. The same concerns obviously apply to proposals that would permit those with large shareholdings to comment on elections or propose their own slates of candidates. We also need to analyze whether it makes sense to grant preferential treatment to those who have the sophistication and resources to wage their own proxy fights and pay for their own proxy statements.

Of equal importance, in my view, is the need to study whether we should perhaps scrap the content-based restrictions in Rule 14a-8, and develop some other system for identifying shareholder proposals that would be permitted to appear in any proxy statement. I suggest this for purely practical reasons: it is no secret that under the current system the SEC staff, which must try to divine the application of vaguely drafted rules to artfully drawn proposals, spends many hours in review of 14a-

8 proposals and the objections to including them. The no-action letters that result are often viewed by the bar as contradictory, conclusory and unhelpful. Consequently, I believe we might be better off with a more mechanical system that limits the proposals that may included in a proxy statement, and doesn't try to distinguish between those that are "proper" and those that are "improper."

Permitting greater variety of shareholder proposals, or greater access to the issuer's proxy materials, once again raises basic resource issues. Will the result be more politicized issuers, constantly embroiled in contests over control waged through the proxy process? If that would be the result, is it desirable?

Confidential Voting and Independent Vote Tabulation

Next, let me address confidential voting and third party tabulation of votes. A number of companies have adopted a variety of confidential voting and independent tabulation measures, and the variety, in itself, suggests the difficulty of selecting a single proper approach to the issue.

Among the confidential voting procedures that can now be found are systems where all shareholder votes are kept confidential, and systems that keep confidential the votes of specific constituents --- such as employees.

Some confidential voting procedures prohibit all employees or affiliates of the registrant from reviewing proxies, while others only exclude senior management. In some cases the incumbent board, though excluded from learning who has voted in a particular manner, can direct that additional soliciting materials be sent to all shareholders who have voted against the incumbent board's position, while in other cases, such use of preliminary voting results is not permitted.

Proponents of confidential voting support it because they believe it protects vulnerable shareholders from coercive pressure; because they believe it removes whatever advantage an incumbent board may have to re-solicit adverse votes before the proxies are finally tallied; and because they believe it protects the voting privacy of shareholders.

Opponents of confidential voting argue that issuers have little coercive power over most shareholders and consequently shareholders do not need the purported protection of confidential voting; that true confidentiality is illusory anyway because proxy solicitors keep track of significant shareholders and often are able to determine how they vote; that eliminating the ability to review proxy results as they come in, and take appropriate action to insure that quorums and other voting requirements are met, will make it more difficult for corporations to hold required annual meetings; that a confidential voting system would interfere with and inhibit communication between the registrant and its shareholders; that confidentiality can be obtained without any rule changes if shareholders merely hold their shares in street or nominee name; that confidential voting is inconsistent with ERISA and other statutes which require fiduciaries to disclose their voting records; and, finally, that the stakes in contested proxy solicitations are too high to keep the votes cloaked in secrecy, out of sight of the parties and the adversarial process.

With respect to independent tabulation, proponents argue that such a system is necessary to insure the integrity of the tabulation process and to remove the ability of incumbent boards to tamper with the results.

Perhaps as a preliminary step it would be helpful merely for issuers to indicate in their proxy materials just how votes are tabulated and counted, and whether proxy confidentiality is observed.

Before moving forward with independent tabulation and confidential voting, however, it is important first to document the extent to which abuses of the voting process have actually occurred.

Presumably the abuses would have to be significant to justify mandated procedures and imposition of associated costs of changing the current rules. Given the variety of developing approaches, this may well be an issue best left, for the moment, to further ad hoc development, rather than rulemaking based on little practical experience. At least as importantly, we need to determine whether, and to what extent, the Commission has the authority to adopt rules relating to confidential voting and independent tabulation. It seems to me that there are at least non-frivolous arguments that call into question the Commission's ability to do so.

Disclosure of Beneficial Owners and Shareholder Lists

An issue related to confidential voting is the proposal that those owners who hold their shares in street name be required to register their shares with the issuer. Proponents argue that direct registration would enhance communication. It is further argued that this change would have the ancillary benefit of eliminating a system that purportedly has been used to facilitate illegal transactions such as insider trading, market manipulation and unregistered sales.

There are several concerns with this proposal. First, it is based on only an assumption that any significant percentage of stock held in street name is so held for illegal purposes. Second, ownership of stock in a public company should not necessarily mean that an owner must surrender his or her right to privacy. Third, most of those who argue for registration of street name stock would still allow it to be held by nominees. Accordingly, the true ownership of stock could still be concealed, though owners of street name stock would have to go to the trouble of setting up nominee accounts. Fourth, there are other means of enhancing communication with beneficial owners without requiring direct registration. For instance, if beneficial owners want to receive communications from a registrant they are free to designate themselves as a non-objecting beneficial owners. Finally, a question exists of the Commission's power to issue rules in this arena.

A related topic I want to mention is the shareholder list. Obtaining shareholder lists is a regularly litigated issue in proxy contests. Rule 14a-7 gives the registrant the option of either providing a current shareholder list to the contesting shareholder or mailing the contesting shareholder's proxy materials directly. A registrant typically prefers to mail a contestant's proxy materials rather than surrender a shareholder list; while contestants usually prefer to obtain shareholder lists so they can do their own mailing. It is argued that the current system favors the registrant in two respects. First, if the registrant chooses to mail the contestant's materials rather than provide a shareholder list, the registrant may control at least to some extent timing of the distribution. Second, in those instances where a registrant chooses to release a shareholder list, it need provide only the names of record holders — not the number of shares held and not information about non-objecting beneficial owners whom it intends to solicit directly.

A suggested change is to require the registrant to provide the shareholder list of record upon demand, rather than at the registrant's option, and further to require that the registrant provide information about beneficial owners, subject to restrictions as to the further use or further disclosure of such information.

This proposal would federalize the right to information about beneficial owners. Proponents argue that federalization of this right is appropriate because state statutory and case law in certain states already provides for dissemination of NOBO information to shareholder contestants. They further argue that mandatory disclosure of shareholder lists comports with the federal policy of granting shareholders access to information that will facilitate communication with each other about matters appropriate for determination by shareholders.

Opponents of changes in the law relating to shareholder lists use many of the proponent's arguments to reach a contrary result. For instance, they see the wealth of state law in the area as evidence that the issue has already been adequately addressed and view federalization as inappropriate. They also question whether a uniform federal law could adequately embody all the concerns about shareholder lists represented in current state laws, especially in the area of beneficial owners.

Both issues --- beneficial ownership and shareholder lists --- are of concern principally, it seems to me, because we have a slow and somewhat uncertain process of intermediation between shareholders and those who wish to communicate with them, whether they be registrants or other shareholders. Perhaps, however, with the advent of more media communication, the faults in the current process — if faults they be — can be circumvented. In any event the entire process of intermediation through banks, brokerage houses and others — and, indeed through institutions which hold shares directly — needs broad re-examination before sensible policies can be crafted.

Conclusion

By way of conclusion, I want to make two general observations.

First, it should be noted that all the proposals for proxy change --- revising Rule 14a-1 and Rule 14a-8; requiring confidential voting; and so forth --- are potentially interactive: the effect of adopting one change may interact with another change to produce an effect not contemplated when reviewing the individual changes separately. For example, both widening the scope of inter-shareholder communication under Rule 14a-1 and restructuring Rule 14a-8 to permit shareholders to include their own slates of candidates in an incumbent board's proxy materials may be a case of two plus two equalling five. The Commission has an obligation to study the individual proposals both individually and for their potential cumulative effects.

Second, I would like to caution against overblown rhetoric in this endeavor. Both the proponents and the opponents of change have, of course, specific agendas which they would prefer the SEC to adopt. Putting to one side the question of whether the Commission has the authority to do what some would like it to do, it is not even clear that the stated aims of many of these groups are rationally related to their rulemaking agendas.

Argument on these issues tends to be cloaked in language which only further confuses matters. For example, some proponents of proxy rule changes claim that all they want is a "level playing field." I doubt such a field exists outside of professional football. Even baseball has a pitcher's mound.

The reality of the situation is that no matter what the Commission does to alter the current rules, any change will invariably favor one group or another to one degree or another. Rather than assisting one or another group, or attempting to locate an entirely hypothetical level playing field, the Commission's proper goal, I believe, is to establish rational policies to affect the Commission's statutory mandate.

Thank you.