

For Release Upon Delivery

"THE CORPORATE SECRETARY
AND THE PROXY RULES"

Address by

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to

The American Society of Corporate Secretaries

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I am glad to be here and to meet so many of you who, in spite of having been committed to my tender mercies as a staff member, have become and remain my good friends.

The interest of the corporate secretary in proxy solicitation is perennial. Your group has welcomed talks of S.E.C. people on proxy problems and we have been willing to comply. That's no more than fair; after all you fellows have to live with the statute and the rules we adopt.

I have had a unique advantage over my fellow-Commissioners in observing the proxy rules in action, for I have been on the staff firing line administering them since the adoption of the first simple and experimental rules under Section 14 of the Securities Exchange Act. I talk from experience when I say that corporate management has by and large accepted with more than good grace the additional obligations which have resulted in the enormous advances in management-stockholder relations effected by the rules.

In some cases management have simply bowed to the inevitable and taken the proxy provisions along with other new-fangled gadgets. But most have recognized that decent proxy practices are at the heart of decent and responsible corporate administration and have welcomed the improvement in their relations with stockholders that compliance with the rules has brought about.

Depending on the means afforded for its exercise the stockholder's franchise is either real or illusory. The proxy provisions of the statute and the rules have the obvious purpose of making a reality of the stockholder's right to vote.

It is a crucial right. I have always been struck by the resemblance between the modern, publicly owned corporation and a governed community. In both, the administration of community assets and affairs is given over by the citizen to a governing group. In both the governing group can hold its power either by the will of majorities or by manipulation of the means of control. In both, the day to day management decisions upon which the community welfare depends cannot be made subject to prompt routine check. Except in cases of critical actions requiring referendum or special stockholder approval the only effective check is for the voter to be informed of progress (or the lack of it) and to keep the management in or to vote it out.

As communities and corporations grow in size and diffuse their ownership, substitutes for the town-meeting and for stockholders' roundtables have to be found. It is not easy to find them, and even the strongest supporters of our proxy rules will have to admit that they are at best an inadequate substitute for a compact stockholders' roundtable.

But without some substitute corporate growth would carry with it increasing management irresponsibility. To the old die-hards who still insist that stockholders are a necessary evil and are entitled to know only what management chooses to tell them the American answer is that entrenched and irresponsible control is as odious in corporate life as it is in political life. Russian propoganda dotes on these die-hards. But the majority of our managements, living under our proxy rules, give the lie to propoganda that insists that big business is coextensive with big tyranny.

In a sense the benefits of our proxy rules to stockholders and to the corporate welfare have been immeasurable. Their usefulness does not stop at merely implementing the stockholder's voting rights. The proxy provisions pervade the atmosphere in which even day to day decisions are made. I have seen time and time again, proposals that have died a-borning because they could not stand up in the light of the disclosures called for by the proxy rules. Time and again managements have discovered that the stockholder electorate welcomes full discussion by management of its problems and may give an honest management more leeway for working out the company's destiny than an entrenched management might dare to take in fear of strike suits. The occasion of a proxy contest often opens management's eyes to the merits of the proxy rules - for the rules apply equally to all contestants. Neither the outside group nor the management is permitted to lie or distort and many managements have been spared a rabbit punch by the Commission's insistence on proxy compliance.

I believe in the principle of our proxy rules and I have tried to state some of the reasons why it is important for you and for us at the Commission to make them work. I would like to use this chance to give you a few ideas that have grown out of my working experience with the rules and with problems of compliance.

As you know the proxy load of the Commission tends to be seasonal and to concentrate in the early part of the year. It tends also to come at a time when the Corporation Finance Division of the S. E. C., which has primary staff responsibility for proxy clearance, is likely to be flooded with other work just as pressing. The load of clearing registration statements may be high. Many issuers, in order to avoid special audits which, though not required by the Securities Act of 1933, are often insisted upon by underwriters, try to plan their financing within three months of the end of their calendar-fiscal year. And annual report filings are likely to begin pouring in while the proxy rush is still on.

Our staff people are only human and notwithstanding rumors to the contrary are hard-working. In spite of the unfortunate concentration of proxy work in busy periods they manage in the vast majority of cases to process filed material well within the ten-day period of the rules.

Since clearance of material with the Commission is only one step in proxy solicitation and must be followed by printing, distributions and often by follow-ups, there is generally a pressure on the staff to rush through the clearance process. In the vast majority of cases the staff can meet this pressure well. By and large you fellows have gotten to know the ropes and your material presents few problems. But problems do arise. Failures of compliance are rarely intentional but, whether they result from oversight or failure to comprehend a requirement, they can be extremely troublesome.

Troublesome to you as well as to the staff. Many of these difficulties can be avoided by following a simple procedure. Think your problem through and if you have difficulty consult the staff. Get to know the Section Chief and the Assistant Director at the S.E.C. in charge of your corporation. After our years of administering the proxy rules the likelihood is that your difficulty has been met and solved before. The staff's experience and help is at your disposal. Both you and we will be helped thereby.

Of course I am by no means inviting you to ask our staff to write your solicitation material. You would be surprised at the number of cases in which that request is made openly and sincerely. But don't expect the staff to carry your burden and do your drafting.

Soliciting material for the annual meeting which does not raise any unusual issue for stockholder vote is likely to be routine. But major corporate changes, and proxy fights, are fertile ground for difficult problems. For many types of proposals, the schedule of items in the proxy rules contain specific requirements for relevant information. But there is no tailor-made formula for full disclosure in these cases; the corporate secretary must often coordinate the activities of many segments and levels of management in order to prepare the material. The job of presenting it fairly and clearly is sometimes tough, and the job of processing it by the Commission presents more than routine difficulty.

At these times there is a high premium on early preparation of preliminary material and consultation with the staff on difficult problems you anticipate.

Not all of you have lived through a tough proxy fight but differences of opinion can arise and proxy contests can develop even in the best of corporations. You are likely to discover that the Commission recognizes that once the ring is squared off elbow room has to be provided for the contestants. However, neither in a proxy fight nor at any other time will the Commission tolerate deviation from truthful disclosure.

But there is an area of characterization in which some latitude must be permitted. Don't condemn a staff member who clears an opposition solicitation even though the opposition expresses the opinion that the management is "incompetent". It is just as common for management to express the opinion that the opposition is "inexperienced" or "irresponsible". But neither side will be permitted to distort facts in any way..

Those of you who know how our staff works know also that it does its best to provide equal opportunity in cases of contest: Timing is often important and the staff makes special effort to accelerate clearance in order to avoid disadvantages to either side. It cannot do the job as quickly as it otherwise might in those instances where either side cuts corners in violation of the rules.

It may seem late in the day for the following tip - but it is surprising that many managements still need it: Get to know the practice and reconcile yourself to following it. As you know, several years ago the Commission was presented with attempts to use the proxy itself to carry statements or devices designed to influence the stockholders' vote. We did amend the rules to require identification of proposals as coming from management or from stockholders. But we did not accede to the view that the proxy, the ballot itself, should be a place for electioneering. Rule X-14A-4 requires matters up for vote to be "clearly and impartially" set forth in the proxy. And in a release the Commission expressly announced a policy against that practice.

Further, in 1948 Bob McConnaughey, then a Commissioner, made it clear in an address to your group that the Commission would not permit arrows, set-off forms of type, or other devices to be put on proxies to influence the vote. Yet we still get proxies - sometimes in the course of a contest and sometimes not - that do just that. They do not get by the staff and, short of creating unnecessary work and delay serve no purpose.

When our proxy rules were amended to permit stockholders to make and justify proposals within the sphere of proper stockholder action a bomb exploded. We were branded as wild-eyed radicals, a Congressional investigation was touched off, and it was confidently predicted that the proxy solicitation would be converted into a forum for crackpots, and hare-brained reformers.

That dire prediction never came true. You may be interested in knowing that according to our latest report figures the average number of proxy statements containing stockholder proposals has been about 25 per year out of the total of about 1600 statements filed. By and large managements have had little difficulty with these proposals. Many of them have been well within the sphere of stockholder action and have been, on their face, reasonable. I don't mean to imply that there have not been troublesome ones. A proposal to change the place of annual meetings, or to provide for rotating auditors is clearly a permissible one. Others are just as clearly too far off on the other side of the line. For example, proposals to require the corporation to make annual contributions to various organizations, to have the corporation petition for changes in the law, to have it favor various political schemes are, clearly, not permissible.

Others have hovered close to the line of doubt. Proposals affecting, directly or indirectly, dividend policies often pose great difficulty.

It would be fine if there were an automatic test of permissibility. But there is no such test. Resort to state law and often speculation about the law in untried fields is necessary as an aid in solution of these problems.

There is a constant temptation to color one's conclusions with subjective notions of the merits of the proposal to which objection has been taken. It is not an easy temptation to forego, but I have never permitted myself - either as a staff member or as Commissioner - to yield to it, nor have I been tolerant of any manifestations of that tendency in others. The President did not appoint me to sit in judgment on the merits of stockholder proposals. As I see it, my job is done when I have decided whether or not a proposal falls within the realm of stockholder action and otherwise complies with the rules.

Some of the most difficult problems we face in proxy clearance arise in connection with the disclosure of management profits in short-term trading. As you know, Section 16 (b) of the Securities Exchange Act provides for return to the corporation, in suit by or on behalf of the corporation, of all profits realized by an officer or director in buying and selling (or vice versa) the company's equity securities within a period of six months. Not many of you have had the experience of dealing with such profits as a proxy problem. But it does raise serious issues of proxy disclosure and occurs frequently enough to warrant some discussion of underlying principles.

First: Why is an officer's or director's short-term trading profit a subject for proxy disclosure? Section 16 (b) is not administered by the S.E.C. but by the courts in suits on behalf of the corporation. But the proxy rules provide that a proxy relating to the election of directors or remuneration of management must disclose information about the indebtedness of officers, directors and others. And the liability of an officer or director to return profits arising from short-term trading in his company's equity securities comes within this provision.

The simple case of profit realized from a matched purchase and sale or sale and purchase for cash presents few problems. But not all transactions are as simple as this. And out of the two words of Section 16 (b) "profits realized" we must extract the wisdom we need for most of the tough cases.

The earliest judicial decision in this field disposed of the question of pairing transactions in cases where there were purchases adding to and sales diminishing existing holdings. The court (in Smolowe v. Delendo) emphasized that the statute was intended to prevent possible conflict between duty and selfish interest. To accomplish the purpose of the statute the court held that it was necessary "to squeeze all possible profit out of stock transactions" within the prohibited period. It subtracted the lowest purchases within any six months' period from the highest sales in the period.

The court recognized that this method was different from that used for income tax purposes and that under this method "profits" might be returnable even though, if all purchases and sales within six months were considered, there would have been a loss. But only this method, in the court's opinion, would comport with the aims of the section.

It has been fashionable recently to compensate managements through options. Where the option is sold within six months it has been contended that the entire proceeds of the sale should be considered profit. But in a recent case the Commission expressed to the court the view that under the exact facts of that case if the options were issued under a bona fide employment contract and the recipients had no control over the timing, it would be proper to consider as the cost basis of the options their value at the time of issuance.

Complications arise if the options are exercised, stock acquired, and the stock sold. What is the "cost" of the stock in such a case? Some have argued that the market value of the stock at the time of exercise is the cost and that the profit must be computed on this basis. These people contend that to get the stock the option holder gave up the option plus cash for the exercise price and that the option is worth the difference between market value and exercise price. Others insist that the option is not "given up" as though in a sale, but is extinguished in the exercise. They say that if you exercise a contract to buy a \$100 ring for \$50 and then sell the ring for \$100 you have made a \$50 profit. But on the theory that you "gave up" your contract to buy the ring you would have no profit. For you would have spent \$50 plus a contract worth \$50 to buy a \$100 ring.

Neither the courts nor the S. E. C. have resolved this problem. We recognize that in some cases a refusal to accord value to the option may work a hardship. If a person holds an option for a long time during which value has accrued to it, exercises it and then sells the stock, he

may be returning long-term accretions in value if he is forced to return profits calculated as though the option had no value.

On the other hand, assuming a value for the option may open up areas of evasion. The history on which this law is based is full of illustrations of flagrant abuses by insiders by means of the option device.

Several years ago we asked for comment on a rule designed to assure that long-term option holders would not, by exercising the options and selling the stock acquired, have to account to the corporation for any increments in stock values beyond a six-month period. The rule would have measured the profit in such a case by the difference between sale price and the lowest market value within a short period before and after sale. There were mixed reactions to the rule and, at that time, there was some prospect that the courts would answer the problem in pending litigation. The litigation has been settled without decision. At the present time the Commission under these circumstances merely requires statement of the facts without conclusion as to liability under Section 16 (b).

In other cases the Commission has, of course, exercised its rule-making power to exempt transactions within the literal meaning of the section but not within its purposes. The most recent rule adopted involved a number of companies which had stock bonus plans under which the officers received a bonus in the form of stock in the company each year. It was pointed out to the Commission that the provisions of Section 16 (b) deprived the officers of some of the benefits of such plans; for any sale of stock made by an officer would be within six months of the receipt of such stock. Accordingly, he could not sell stock without run-
ning the risk that he would be required to return a portion of the proceeds of that sale to the corporation if the stock were issued to him at a cost basis less than that of the stock which he sold. The rule adopted by the Commission provides that any purchase made pursuant to a bonus or profit sharing plan is to be exempted from the section if certain safeguards for security holders are observed. However, any purchase, other than that expressly exempted, when accompanied by a sale within six months destroys the exemption for the bonus stock as well, and stocks acquired as bonus may be matched against the sales.

Section 16 (b) establishes standards of fiduciary relationship which, I am glad to say, almost all corporate management now observes. It is no longer possible to observe that profits from insider trading are one of the usual emoluments of corporate office.